

Special Report

The UK Social Housing Sector: FAQs Answered

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■ Introduction

Fitch's Special Report answers bond investors' most frequently-asked questions on recent issues in the UK social housing sector. The report includes comments on the effects of possible changes in the payment of housing benefit, as well as the implications for the sector following the recent publication of the Barker report on housing in the UK. Fitch also sets out its views on the challenges the sector is likely to face in future.

■ What are Housing Associations ("HAs") and Registered Social Landlords ("RSLs")?

From small beginnings at the time of the 1975 Housing Act, HAs have expanded steadily, and 1,857 HAs currently manage nearly 1.7 million homes, housing nearly 3 million people. More than 75% of the total number of homes is accounted for by only 7% of HAs, yet the largest association owns only 45,000 units.

The UK government's objective was to provide an alternative source of low-cost rented property to Local Authorities. The Housing Corporation ("HC") was established to channel public money to the social housing projects started by registered HAs in England to supervise their performance, and regulate their conduct. Their funding was supplemented by mortgage loans from banks and the then building society sector. By an Act of Parliament in 1988 the sector's ability to raise finance from the private sector was greatly extended.

A Housing Association can be a trust overseen by a body of trustees, a society or a company established for the purposes of the construction and management of housing accommodation. HAs do not trade for profit and do not issue preference capital / capital which pays interest or dividends. HAs are often Industrial and Provident Societies (a legal status), which are not-for-profit organisations, usually delivering a "public service". They are not owned or controlled by external private shareholders and all surpluses are reinvested into the entity. They are also legally independent of the UK government.

HAs can be either registered or unregistered. A Registered Social Landlord ("RSL") is a HA which has registered with the HC and abides by its regulations, on the basis that it wishes to receive public investment for social housing.

■ What are Large Scale Voluntary Transfers (“LSVTs”)?

LSVTs are transfers of social housing stock in excess of 500 units from Local Authorities to newly-constituted RSLs. In general, these are block transfers of a large number of properties, usually in their thousands, at a price well below even the existing use value of the unit as social housing stock.

The consideration paid, often to the Local Authority, will be based on the value of the properties as social housing, after taking into account various other factors. These factors include the HC’s regulatory requirements, as well as any agreement reached with existing tenants that rents will not increase above a certain level for a fixed period (usually 5 years from transfer). Such rent agreements are a feature of LSVTs because existing tenants must vote to approve any transfer and need to be persuaded to vote in favour by the transferee. Another important factor is the amount of future remedial capex required. The stock, although externally in good order, may require significant internal investment (such as new wiring, bathroom and kitchen, or refurbishment of common/community areas) to bring it up to, firstly, a good and tenable condition (a legal requirement under the 1985 Housing Act) and, secondly, to the more demanding Decent Homes Standard (which has been made a target for all RSL stock, but is not yet a legal requirement, by the Office of the Deputy Prime Minister, “ODPM”).

The LSVT RSLs are invariably financed with higher leverage than longer-established RSLs that over the years have received subordinated social housing grant. The business plan for a LSVT funding may often include prospective rental uplifts, subject to regulatory constraints and any agreements with existing tenants that voted for the transfer to take place, to help remunerate the purchase price and capex requirements. Tenants’ rights to acquire their property are protected in such transfers, the profits from which are usually split between the RSL and Local Authority for a certain period of time following the initial transfer.

■ How Popular are Right to Buys (“RTBs”)?

The Right to Buy scheme allows qualifying Local Authority tenants the right to purchase their home, provided that they have been living there for at least two years and satisfy other criteria. This right is preserved following transfer to an RSL (known as a “preserved right to buy”). There are discounts of up to 60% available to purchasing tenants to the open market value of the property, which vary according to the area (up to a maximum of GBP38,000 for

London and the South East). For preserved RTBs, discounts may be reduced to reflect amounts spent by the RSL on buying, maintaining or repairing the property.

If a tenant is not eligible for RTB, but has been an RSL tenant for at least two years, then they are potentially eligible for the Right to Acquire (“RTA”) scheme. This gives tenants in eligible HA or RSL accommodation the legal right to buy the home they currently rent. Unlike the RTB, the RTA is attached to the property and not the tenant. In order to qualify, amongst other factors, a property must have been built or purchased by a RSL after 1 April 1997 using social housing grant. It will also qualify if it has been transferred from a Local Authority. The number of RSL tenants able to take advantage of this scheme is small. There are discounts available to purchasing tenants to the open market value of the property, which vary according to the region and are currently between GBP9,000 and GBP16,000.

The current rise in house prices ought to lead to fewer tenants exercising their rights to buy or acquire. This is because the differential between the social housing rent and an equivalent mortgage payment is increasing all the time, even in the North of England. It is also unlikely that a tenant entirely reliant on housing benefit would be able to obtain a mortgage from a commercial lender. Furthermore, the ODPM is considering limiting the maximum discount under RTB to GBP16,000.

There is some evidence to suggest that, despite these difficulties, tenants are continuing to exercise their RTBs, perhaps because of the current low interest rate environment. Given that the RTB applies only to ex-Local Authority tenants and only if they pass other tests, the number exercising their RTB will reduce as time goes on following a LSVT. However, the opposition Conservative Party has been considering an overhaul of the RTB/RTA regime, including increasing purchase discounts, particularly with regard to LSVT property, if they were elected. This would also have the political benefit of reducing the perceived imbalance in the differing rights of social housing tenants.

Any policy of increasing discounts on RTB/RTA, or extending the schemes to more tenants, may have severe implications for RSLs. LSVTs, who have purchased ex-Local Authority stock using secured bond and bank debt to upgrade these homes and therefore have above average leverage, may be particularly affected. The Council for Mortgage Lenders has indicated that extending the right to buy and increasing discounts would cause difficulties for RSLs and their lenders. Bondholders in RSL

securitisation transactions could be affected if net proceeds received from RTB/ RTA sales are less than the net present value (“NPV”) of the future rents receivable from the properties sold.

Historically RTB/RTAs completed have been around 2% of RSL social housing portfolios on a per annum basis. Although RSL forecasts show this rate of sales continuing in the future, there is a general view within the sector that the combination of lower discounts and higher property prices (i.e. effectively meaning that acquiring tenants have to take out larger mortgages) is likely to restrict RTB/RTA to perhaps no more than 1% of the portfolio per annum.

In many cases, clawback agreements have been negotiated with transferring Local Authorities for a certain period of time following transfer, although these often allow RSLs to keep at least the NPV of future lost rentals. In addition, in some cases clawbacks are transferred to a “community fund”, which enables LSVTs to have access to funds for construction in the future while ensuring that Local Authorities are not required to transfer these proceeds back to central government. In rating RSL rental cashflow securitisations, Fitch always considers whether the clawback provisions are likely to pose a risk to bondholders’ interests.

■ What are Target Rents?

In 2000 the UK government decided that it would be beneficial for social housing in the UK to see a gradual convergence of rents within the public sector and most notably between Local Authorities and RSLs. The main aim was to smooth out anomalies in rents between and within RSLs, as well as between RSLs and Local Authorities. A secondary but no less important aim was to restrain rising social housing rents (and hence UK government subsidy) by way of housing benefit. To achieve this, a period of ten years from 2002 was given to social housing providers to allow them to move towards prescribed “Target Rents”.

Target Rents are set by the HC for each property within an RSL using a national formula, based on, amongst other things, local property existing use values (assuming rental on the open market), average county manual earnings and a bedroom factor (*see Appendix 1 at end of report*). The latter ensures that smaller properties with fewer bedrooms attract a lower rent than bigger properties with more bedrooms. The property value component is given only a 30% weighting, which means that future improvement capex spend is not proportionately rewarded.

RSLs must be in line with Target Rents by 2012, although within a RSL a tolerance of +/-5% is permitted per unit. Where actual rents are currently below the Target Rent, RSLs can increase them by RPI+0.5% plus a maximum of GBP2 per week on a 52 week year, until these are in line with the designated target level. In the event that the actual rent is currently above Target Rent, per year, rentals can be reduced by up to a maximum of GBP2 of the weekly rent.

The property value component of the Target Rent calculation does not automatically change each year and is fixed as at 1999. However, if an improvement is made to a property, it may be re-valued as at 1999. Similarly, the manual wage component is fixed as at 1999, based on data from 1997-1999. Target Rents will thus only change each year with RPI or if improvements are made to the property. The HC is currently undertaking an update review of the regime. Fitch will monitor whether this will have any impact on how Target Rents are calculated in future.

In Fitch’s recent new issue report on the Harbour Funding PLC transaction (25 March 2004), the differential between actual and Target Rents within the participating RSLs was between 0% and 20%. RSLs can therefore increase rents at RPI+0.5% plus GBP2 (on a 52 week basis) until Target Rent levels are reached. Anecdotal evidence would suggest that a large number of RSLs, especially in the South East, have decided to move to Target Rents as quickly as possible. For example, new tenants are generally put at the Target Rent immediately. This is in the context that actual rents are, on average, 50% in the South East, but more like 30% in North East, below open market rents in the private rented sector, where properties often are not of the same quality nor have the same maintenance back-up as most larger RSLs. Such rent increases are unlikely to reduce demand, given the long waiting lists for social housing, even in some parts of the North of England.

In the event that actual rents are above Target Rents, RSLs have not necessarily reduced rents by the stipulated GBP2 of the weekly rent and are instead waiting for inflation to catch up under the RPI + 0.5% formula. This is permitted by the HC. The incidence of units with actual rents above Target Rents is small in the South-East, but more widespread in the Midlands and North of England. In the South East, it is often restricted to types of stock that do not have universal appeal (such as bedsits, mobile homes and pre-fabs) or require heavy remedial works. These properties tend to have actual rents above Target Rents, partly as a result of long-term stay tenants who may be indifferent to rental levels because they are entitled to full housing

benefit. These tenants are effectively paying more rent than a RSL could obtain should it try to re-let to a new social housing tenant.

There are a limited number of exceptions where the HC allows rent increases of more than RPI+0.5%. This is generally limited to LSVTs where the HC has pre-agreed to permit higher rent increases, given their heavier capex requirements to bring the ex-Local Authority stock up to the Decent Homes Standard (see section below).

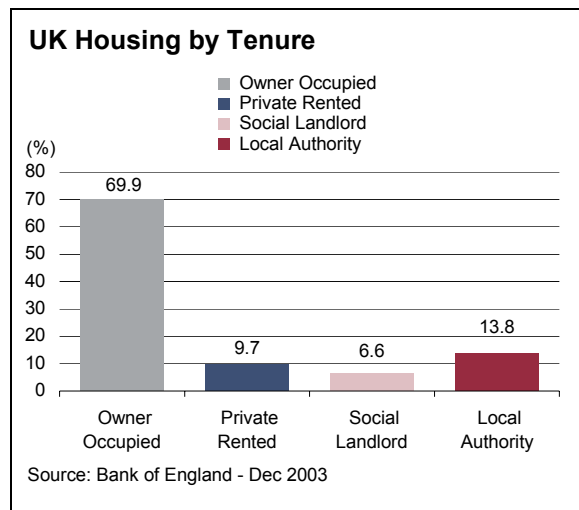
Such rent restructuring is set to continue and is aimed at relating social rents more closely to the types of property on offer and bringing Local Authority and RSL rents more closely into line over time.

For the securitisation bond transactions, the provisions of the HC's rent regime are taken into consideration when assessing projected rental cashflows, which are then monitored over time. Any changes in the scheme could affect bond performance. However, even in the recent Harbour Funding plc transaction, Fitch gave no credit for the ability to increase rents to Target Rents when running its cashflow stresses.

■ Are There Possible Changes to Housing Benefit?

For a number of years the UK government strongly supported the social housing sector on substantial funding terms (forecast spend GBP5.5bn in 2004 for housing benefit and social housing grant). This policy had its roots in the serious underinvestment in affordable housing in the UK over many years, evidenced by substantially lower unit construction rates than in other European countries (UK 2003 private, HA and Local Authority: construction of 183,000 units, France 300,000 units,¹ even though the number of households in each country is similar). As a result of this undersupply, a long-term trend of house price rises above inflation has become endemic, with householders taking on high levels of mainly variable rate debt to participate in the UK housing market. This has resulted in a much more volatile housing market with changes in values implicitly linked to changing interest rates. Faced with this unstable policy environment, the UK government is beginning to work on reforming both the construction supply side and the funding of mortgage debt (with the possible idea of creating a UK version of the USA, Fannie Mae).

¹ Source: INSEE June 2003



Although the UK social housing sector is a key component today of housing provision, at some 20% of UK stock², it is possible that the government will change both the way it hands out housing benefit and its basis for supporting RSLs. The UK government is also keen to involve the private rented sector in social housing in the belief that it will bring greater efficiency to the sector.

Around 60%-70% of gross rental income for HAs comes from tenants dependent on state housing benefit, who have typically waived their right to direct housing benefit payment in favour of the HA, as part of their tenancy agreement. In such circumstances, housing benefit is currently paid directly to HAs by Local Authority Social Services. Payment can sometimes be subject to 6-8 weeks' delay, although under certain contracts Local Authorities guarantee to pay 90% of housing benefit on time. In addition, some Local Authorities pay rental four weeks in arrears.

In 2002, the UK government announced that it was preparing a consultation document on the whole question of housing benefit and allowances. Under this document, it is expected to propose to move towards a system of housing allowance rather than housing benefit. Rather than a benefit related to a tenant's actual rent, the new housing allowance would be based on family size, income and the broad level of rents in the area for the type of property the tenant requires. The payments would no longer be directly related to the rent due on the property in which the tenant is living.

Under such a system, housing allowance beneficiaries would be in a better position to shop around for affordable and suitable accommodation. This would create a form of 'market forces

² Source: Bank of England, December 2003

constraint' on unjustifiable increases in rents – perhaps for RSL rents which have not been effectively equalised by HC regulation, but particularly in the private rental sector, where rentals are not subject to regulatory caps - which a tenant on housing benefit can currently nurture, particularly in the tight supply South East region of the UK. Recipients of housing allowance could be encouraged to take non-RSL accommodation under such a scenario, particularly in areas outside the South East, where the gap between market and RSL rentals is smaller. Tenants could choose either to make up any shortfall between private rentals and their housing allowance, or choose a cheaper property and keep the change. It would also make tenants on housing subsidies less indifferent to the rents being charged.

The Audit Commission and the Council of Mortgage Lenders has, however, raised concerns at the prospect of housing benefit being paid directly to tenants, in view of its possible effects not only on RSL cash flow and hence arrears and profitability, but also on the minority of tenants who may use the subsidy for other means.

A recent housing benefit pilot scheme at the London & Quadrant Housing Trust, in which tenants were paid their housing benefit directly, saw arrears quickly rise to 9% (the UK RSL average is currently 5.5%). Although this increase could ultimately be controlled, either by offering incentives for early payment and/or appointing more housing officers to chase late payers, it would involve additional costs for RSLs. Fitch estimates that operating profits could fall by up to 10% under such a scenario, assuming that half of the additional arrears would have to be chased up by additional housing officers.

Under current proposals, tenants would also be able to opt to continue having their housing allowance paid directly to the RSL, and incentives could be offered to tenants who choose to do this.

It is clearly a concern for the securitisation bond transactions that arrears may rise significantly. The transactions generally incorporate an arrears test, under which gross rental income after payment of debt service is trapped if arrears rise above pre-determined levels. Continued failure of this test constitutes an Event of Default under the bond documentation and could lead to enforcement of security. However, if the arrears problem was of sufficient magnitude, this could adversely affect the rating of the bonds.

Securitisation bondholders should also note that it has not been publicly opined whether the mooted change of method of payment would constitute a

Rescheduling Event. Triggering a Rescheduling Event usually results in the trapping of gross income after payment service but does not constitute an Event of Default under the Bonds, so the bond security could not be enforced. A Rescheduling Event can usually be declared if the amount of housing benefit falls by more than 85% compared to the previous year. It has yet to be publicly opined whether paying housing benefit directly to tenants would action this clause, although Fitch has received indications that it was not intended to do so.

■ Is There a North/South Divide in the Housing Association Market?

Fitch has been asked by investors whether there is a north / south divide in the English social housing sector, with northern RSLs expected to perform less well in future than their southern counterparts. In fact, this is better described as a divide between areas of low and high housing demand. Although many areas of low demand are in the North of England, there are also pockets of higher demand in certain parts of Yorkshire, Nottingham and the Manchester area. Similarly, there are areas of southern England where demand is low, notably parts of Luton, Newham, Tower Hamlets and Thamesmead. Recent changes in the social housing sector may indeed mean that RSLs in areas of low demand will find it harder to succeed than their counterparts in higher demand areas.

Many RSLs in low demand areas are likely to suffer further in future, as inner city social housing tenants continue to move out to suburbia or to other areas to find employment. This may change as the benefits of inner city regeneration begin to come through, but any benefits are yet to manifest themselves. In more popular areas, by contrast, demand for social housing continues to increase as potential tenants cannot enter the home ownership market owing to spiraling house prices, private rents are around 50% above social housing rents, and there is a shortage of supply in the RSL sector because they cannot compete with the prices paid by private developers.

RSLs in areas of lower demand point to the fact that despite a falling population, the *number of households is still rising* throughout the country (owing to people leaving home earlier or living alone). With property prices also rising throughout the country and discounts on RTB/RTAs under pressure, it is likely that more people everywhere will turn to the social housing market because they cannot afford to purchase. If, however, discounts under RTB/RTA were to rise - for example under mooted Conservative party ideas - RSLs in areas of low demand for housing – and hence lower property prices - would be likely to be the first to be affected

by increased sales under RTB/RTA. This is because the differential between equivalent mortgage payments and rentals is lower in such areas, thus making it more likely that RSL tenants in areas of low demand will exercise their RTB/RTA than their counterparts in higher demand areas.

RSLs in higher demand areas are also likely to be in a better position if housing benefit is paid directly to tenants, because of the shortage of good quality, affordable housing in the private rented sector in such areas. By contrast, in areas of low demand, a more competitive market already exists for RSL tenancies, and RSL rentals are only around 30% below private rentals. In such areas, housing benefit tenants already shop around for the best deals and only the best RSLs having long waiting lists. This is likely to be compounded if the proposed payment changes take place.

With the Target Rent system weighted in favour of county manual earnings and property values, RSLs in more prosperous local economies are likely to benefit most from the new scheme. In addition, targeted housing benefits may begin to be paid to "key workers" in the South East (who are currently being assisted by a GBP690m fund to provide interest free mortgage loans), meaning that RSLs in the less popular areas of the Midlands and the North may find their revenue generation ever more constrained by the public purse.

There are therefore significant concerns for RSLs operating in areas of low demand. This is not to suggest that effectively managed RSLs in such areas cannot be successful. However, Fitch will be monitoring these RSLs particularly closely over the coming years of housing policy change.

■ What are the Sector's Cost Pressures?

For all RSLs, the cost of building and maintaining new properties is rising faster than rents or available public finance and this will test RSLs' managements' ability to control costs. As we have already cited, rent increases are limited to RPI+0.5% per annum once Target Rent levels are reached and capital grants from central government only accounted for 21% of the GBP3.7bn of housing assets added to the sector in 2002. To this should be added the cost inflation in the construction sector with wage price inflation higher than RPI, due to a shortage of skilled trades in the sector, particularly, but not exclusively, in the South East of England. The shortfall has been made up entirely by increased borrowing rather than an increase in government grants.

Operating costs, including maintenance and management have been increasing faster than rents for the past two years, due in particular to higher national insurance and pension contributions. The more go-ahead RSLs have responded by introducing call centres to coordinate responses to tenants' requests for repairs, sometimes using sophisticated critical path IT software to maximise the number of callouts in any particular day. In some cases, RSLs have sought to control labour costs by bringing maintenance staff in-house, although many RSLs still opt for the dual system of an in-house team and external contractors on a prescribed panel. This appears to assist benchmarking for categories of maintenance and repair work undertaken and keeps external contractors on their mettle. Some RSLs have sought mergers or group structures that enable operating costs to be reduced via economies of scale. As discussed below, Fitch expects this trend to continue.

Although their cost base is not under the same pressure from wage inflation as in more prosperous areas, particularly in the South East of England, there is now some anecdotal evidence of shortages of skilled trades throughout the country, particularly in areas where large construction/regeneration programmes have been underway (see also below). Combined with other RSLs needing skilled tradesmen to bring their stock up to the Decent Homes Standard, this has resulted, in some cases, in delays in carrying out refurbishment programmes.

Given the relatively tight interest cover ratios that the not-for-profit RSLs report in their accounts, an increasingly high percentage of their attributable profits is used to cover net interest costs. Attributable interest costs have probably fallen in 2003 due to lower interest rates, although the larger RSLs finance themselves primarily by way of fixed rate long-term debt and hence their interest costs will probably not change significantly immediately. This masked, however, large differences within the sector, with the larger, more financially sophisticated and disciplined RSLs displaying better management of interest rate risk than their smaller counterparts. The amount of total debt outstanding is also likely to continue rising with GBP3bn of new housing developments currently in the pipeline.

■ What is Decent Homes Standard and How does this Affect Capex Spend?

All RSLs and Local Authority Landlords must try to meet the Decent Homes Standard by 2010. This standard effectively specifies a certain set of internal and external building and internal fitting-out requirements for social housing units. For example,

kitchens should not be more than 20 years old and bathrooms 30 years old. Currently c.23% of HA properties do not yet measure up to the Decent Homes Standard, although this is reducing every year.

It is not a statutory requirement that RSLs and Local Authorities meet these standards. At the current time, these are only minimum “best practice” targets to be achieved by 2010. The minimum statutory “good and tenable condition” measure will continue to be set by s.604 of the Housing Act 1985 for the time being. The proposed Housing Health and Safety Rating System, under a further revision of the Housing Act, would enshrine at law higher standards on certain aspects of housing specification (such as electrics) already addressed by the Decent Homes Standard. This revision to the Act is currently at the consultation stage with the Government and other parties.

Under existing secured financial RSL transactions, properties only need to be in “good and tenable condition”, which meets even the minimum standard required to rent or sell the property on the open (private sector) market. However, the Decent Homes Standard may be a more relevant standard if there were to be a transfer to another RSL. This is because the price another RSL would be prepared to pay for a unit would be net of the future maintenance spend needed to bring the unit up to the Decent Homes Standard. HC guidelines suggest, however, that Decent Homes Standard regulatory requirements may be waived in certain transfer situations. This could mean that a substitute RSL may be prepared to pay a higher price.

In recent meetings with RSLs, Fitch has learnt that many aspire to exceed the Decent Homes Standard over the long-term. However, the Standard has introduced a timing discipline into the process, which may cause some of the smaller, less well-managed RSLs to struggle to meet HC targets.

■ Will There be Consolidation in the Sector?

With annual rent increases now constrained by the RPI + 0.5% factor and the UK government determined to improve value for money in the social housing sector (as it believes that the cost base is too high and that there are too many RSLs overall: Liverpool currently has 51 RSLs), it is inevitable that the sector will see consolidation over the next 5-10 years, much like the building society sector saw in the 1980s.

Already we are seeing RSLs change group structures to facilitate such mergers, partly driven by the cost

pressures discussed above. This is because the smaller RSLs will be increasingly challenged by the combination of regulated rent increases on the one hand and rising labour costs on the other, combined with a requirement for increased capex spend to bring properties up to the Decent Homes Standard, yet they have no real ability to benefit from economies of scale over larger portfolios of property. The possible future payment of housing allowance directly to tenants would provide more choice to tenants, but would probably give an advantage to the larger RSLs, who will be able to set up marketing campaigns to attract tenants to their sites. Larger RSLs will also be better equipped to manage the inevitable rise in arrears.

A further consolidation catalyst is provided by the minimum HC development project grant application now being GBP10m, which has already led to RSLs forming loose partnerships in order to bid jointly for government subsidy.

The main exception to the “big is beautiful” argument may be the emergence of specialist RSLs, who continue to operate thanks to a particular skill in the RSL market (for example sheltered quasi-care homes on the South Coast).

Consolidation is unlikely to affect secured funding arrangements as this funding is asset-specific with less analysis of the credit of the RSL than of the quality of the property units. However, for the acquired and the acquirer, all lenders will want management not to be distracted by mergers.

■ How Could the Barker Report Change the Sector?

The Barker report published in March 2004 emphasised that the provision of social housing has not kept pace with demand. The Decent Homes Standard has meant that RSLs have concentrated their budgets on maintenance and repair of existing units rather than building new homes. As a result it estimates that a minimum of an additional 23,000 social units need to be built every year to keep up with demand, including previously unmet demand. The cost of this programme would be between GBP1.2-1.6bn, but would not be entirely met by UK government.

Part of the funding could come from efficiency gains within RSLs. According to the Barker report, a 3% efficiency gain would release GBP200m for new build. This amount of saving is considered possible, given that there is currently a variation of 300% in the management costs of the best-managed and the worst-managed RSLs. Nevertheless, it places even

more pressure on RSLs struggling to cope with increasing labour costs.

The funding could also come from traditional RSLs (as opposed to LSVTs) increasing leverage from the relatively comfortable levels of today (average LTV ratio of 31% at 2003, *Source: The Housing Corporation 2003*). Lenders continue to regard social housing grant as quasi-equity within the balance sheet structure and will allow traditional RSLs to leverage accordingly, albeit within the confines of covering interest costs with net rental profits.

One of the main tenets of the Barker report is the UK government's wish that the private sector become more actively involved in the provision of social housing. This may involve more development schemes where a private sector house-builder sells units on a bulk basis for social housing to a RSL. Alternatively, RSLs may seek to expand their private sector development subsidiaries to cross-subsidise their social house-building programmes. There is also a suggestion in the Barker report that private sector house-builders should now be allowed to bid for new development grants to provide social housing.

If a change of payment method of housing benefit such that it is paid directly to tenants becomes a reality, the lines between social and the private open market housing could become more blurred, and the private sector may become more involved in social housing. Already the distinctions are falling away, with RSLs providing student or key worker accommodation, often via separate subsidiaries within the same group. By moving housing benefit subsidy from the supplier to the "tenant/customer", in some areas more competition between providers of housing, both RSL and private, may be created. The more enlightened RSLs may also increase further their involvement in the private rented sector. They will also have the advantage of having larger and more cost effective management and maintenance services than small scale private landlords.

■ What are the Ramifications of the Salvage Case?

The May 2003 High Court decision *RE the Salvage Association* has led to market concern that Industrial and Provident Societies may be subject to the corporate administration regime. This is contrary to the previously held consensus view that Industrial and Provident Societies could not be put into administration. The balance of legal opinion is that the risk remains remote. Fitch continues to monitor the situation.

■ Which Valuation Basis Used is the Best Estimate of Worth of a Social Housing Portfolio?

Valuers have traditionally used three types of valuation instruction to establish the worth of HA property portfolios:

1. **Existing Use Value (Social Housing) – Voids Relet:** This calculates the value of the portfolio by reference to the discounted cash flow earned on the units, which are let on a social housing basis. It assumes that a void unit is re-let as a social housing unit after a certain turnaround time. The valuation also assumes that, on enforcement, the properties can be sold to another RSL (i.e. a price obtained under a transfer of engagement) or else creditors can wait to be repaid from regulated rental proceeds over time. This is despite the fact that mortgagees in possession need not be bound by HC regulatory requirements with respect to rent increases.
2. **Market Value (subject to tenancies)** (also known as Existing Use Value (vacant properties sold)): This values the stock as above but assumes that units that become vacant can be sold at open market value. This valuation works on the basis of a normal churn of vacancies during any one year and not on the basis that the whole portfolio benefits from vacant possession. The Secretary of State's permission for sale of void properties on enforcement is generally obtained prior to RSLs entering into any form of secured financing.
3. **Open Market Value:** This method of valuation estimates the worth of the stock on an open market basis, usually on a comparables basis with other housing in the surrounding area. In some cases a discount of 5% may be applied to this value to reflect the local environment in which the stock is located.

Overall values under (2) are between 40% and 75% above values under (1), and values under (3) are between 150% and 350% higher than under (1).

In Fitch's opinion valuation (2) is the most realistic approach. This is because this valuation basis allows the sale of marginal vacant stock that RSLs wish to sell at open market rates, which is consistent with actual practice at RSLs today (where the numbers of stock are small, it is usual practice for ODPM officials to give permission for sale on behalf of the Secretary of State). To value an entire RSL portfolio on an open market value basis seems unrealistic, as this would involve selling a concentration of stock

into specific markets on the assumption that this would have no effect on underlying values of comparable housing units within the area.

How Will RSL Managements Cope in a Changing Environment?

During Fitch's recent visits to a number of RSLs, a broad array of management competence has been evidenced. However it is clear that the larger RSLs are now beginning to employ much more dynamic and sophisticated management teams, particularly in the financial management function, who are eager to learn the lessons, and reap the rewards, of the private sector approach. As the consolidation of the sector accelerates and the challenges grow, management's ability to run ever larger and more complex portfolios of properties professionally and more varied business models will become a key determinant of success.

Comfort may be drawn from the fact that it tends to be the larger and more financially sophisticated RSLs who enter bond financings in the first place. However, when Fitch assesses RSL borrowers within securitisation transactions, it also looks for evidence of a strong corporate governance regime.

■ Summary of Challenges for the Sector

Fitch views the key challenges for the RSL sector in the future as follows:

- Restraint on RSL rent increases once target levels are reached (see page 3).
- Payment of housing benefit directly to tenants and possible effect on arrears and Rescheduling Events (see page 4).
- Wage inflation / costs rising faster than rents (see page 6)
- Additional capital expenditure requirements in order to meet Decent Homes Standard (see page 6)
- With higher capital expenditure spending per unit and UK government pressure to increase social housing provision, there is pressure upon RSLs to increase their leverage (see page 7 and 8)
- Possible lower levels of grant support from central government in the future (see page 7)
- Sector consolidation and effect on smaller RSLs (see page 6 and 7)
- Increased competition from the private sector (see pages 4 and 8).
- Possible changes to RTB provisions (see page 2)
- Pressure on RSLs outside the more popular areas of the country to maintain demand (see page 6)
- The need for RSL management to become increasingly financially sophisticated to meet the growing challenges within the sector (see page 9)

■ APPENDIX 1: Basic Target Rent Formula

Weekly Rent is Equal to

70% of the average rent for the sector (either RSL or Local Authority)

x relative county manual earnings

x bedroom weight

plus

30% of the average rent for the sector (either RSL or Local Authority)

x relative property value

Where

- **Average rent** for the sector was estimated by the then Department of the Environment, Transport and the Regions (DETR) for the year ended April 2000 and increases at RPI+1% for RSLs in 2001/2 and RPI+0.5% thereafter. For Local Authorities, DETR average rental estimates for year ended April 2000 may increase at RPI+2% in 2001/2 and RPI+1% thereafter.
- **County manual earnings** were derived by DETR from 1997-1999 data and are not updated each year. They are compared to the England average for the same period to reach a relative measure.
- **Bedroom weights** are as follows:

Number of Bedrooms	Weight
Bedsit	0.80
1	0.90
2	1.00
3	1.05
4 or more	1.10

- Property values are based on January 1999 vacant possession values, assuming rental at private sector levels – i.e. the existing use value (but not assuming regulated rents, to avoid circularity). These are compared to a DETR January 1999 average property value of GBP41,350 in the Local Authority sector and GBP49,750 in the RSL sector.

NB. Note that the basic formula set out above is subject to variation in certain circumstances, including the application of a rental cap based on property type in high value areas.

Source: Guide to Social Rent Reforms, DETR March 2001.

■ UK Housing Association Sector

Fitch Ratings

(As at 04 May 2004)

Finance for Residential Social Housing PLC ("Fresh")

Loans from the Housing Corporation and Housing for Wales, Tai Cymru, to approximately 1,000 housing associations

Series 1 Class A1, Series 1 Class A2 and Series 2 Class A notes due 2058 'AAA'.
Series 1 Class A3 notes at 'AA' and Series 1 Class B and Series 2 Class B notes due 2058 'BBB'.

Harbour Funding PLC

Borrowers Include: Notes due 2044 'AA'

- Hermitage Housing Association Limited
- Maidenhead & District Housing Association Ltd
- North Hertfordshire Homes Limited
- Pavilion Housing Association

Haven Funding PLC

Borrowers Include: Notes due 2037 'AA'

- Bromford Carinthia Housing Association Limited
- Cheviot Housing Association Limited
- Devon and Cornwall Housing Association Limited
- Hanover Housing Association Limited
- Hyde Housing Association Limited
- Kelsey Housing Association Limited
- Metropolitan Housing Association Limited
- Portsmouth Housing Association Limited
- Portal Housing Association Limited
- Shaftesbury Housing Association Limited
- Sovereign Housing Association Limited
- Swaythling Housing Association Limited

Sunderland (SHG) Finance PLC

Borrower: Sunderland Housing Group Limited Notes due 2042 'AA'

UK Rents No.1 PLC

Borrowers Include: Class A1 Notes due 2025 'AAA'

- Beaver Housing Association Limited
- Cheviot Housing Association Limited
- Kelsey Housing Association Limited
- Mercian Housing Association Limited
- Portico Housing Association
- Portsmouth Housing Association Limited

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