

## More Competition & Market Exposure Could Increase U.K. Social Housing Sector Credit Diversity

**Primary Credit Analyst:**

Robert Robinson  
London  
(44) 20-7176-3824  
robert\_robinson@  
standardandpoors.com

**Secondary Credit Analysts:**

Liesl Saldanha  
London  
(44) 20-7176-3571  
liesl\_saldanha@  
standardandpoors.com

Hugo Foxwood  
London  
(44) 20-7176-3781  
hugo\_foxwood@  
standardandpoors.com

Additional Contact: International  
Public Finance Ratings Europe  
PublicFinanceEurope@  
standardandpoors.com

**Publication Date**

Nov. 29, 2006

The U.K. government is keen to see a range of affordable housing solutions in the form of mixed-tenure schemes that spreads asset ownership more widely, and is therefore encouraging housing associations to develop more affordable social housing, in part supported by government grant. Although grant levels for affordable housing development have been increasing, the government is seeking to maximize the amount of affordable housing developed for a given level of grant.

The drive for new housing development and the increasingly competitive process to secure government grant, has increased the likelihood that certain housing associations will look to housing sales and market rental income streams to help support their social housing development ambitions. Despite the size and current balance sheet strengths of many housing association developers, reliance on forecast house sales income together with the pressures of managing larger and more complex development programs, could affect the credit standing of these associations in the future.

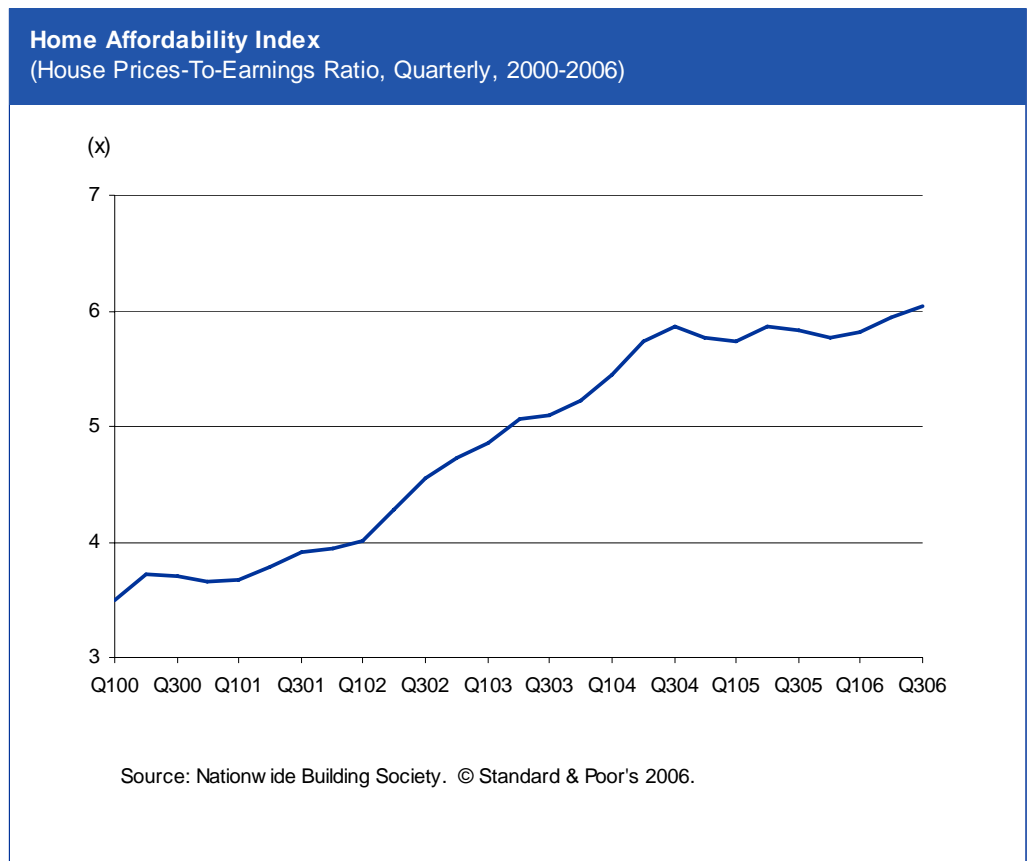
The introduction of private sector competition for social housing grant has opened up a number of challenges for the U.K. social housing sector that could significantly change the future social housing landscape. For example, a consequence of opening up of social housing grant to private housebuilders is the need to review regulatory arrangements so that there is a "level playing field" across all types of organization in receipt of this grant. The current strong investment-grade ratings in the sector are supported by the existing system of regulation and the stability and predictability associated with it. Given the changes that have occurred across the sector in recent years, however, it is fair to say that the upcoming review of social housing sector regulation is timely in terms of ensuring that the system of regulation remains effective for the future. The impact of any change in regulation will have to be taken into consideration when assessing potential credit implications.

Standard & Poor's Ratings Services has been examining the challenges facing the sector, in particular the sector's involvement in developing affordable housing to meet demand pressures

and its increasing exposure to market risk in order to cross-subsidize to meet government development targets.

### Growing Demand For Affordable Housing

The rise in house U.K. prices over the past decade has already made the prospect of home ownership increasingly unaffordable for many first-time buyers, therefore reinforcing the need for more affordable housing solutions. Since 2004, the average house price has remained higher than 5.5x times gross average earnings and reached an all-time high of just above 6.0x earnings this year (see chart 1). Despite recent increases in interest rates, house prices have continued to rise on average by about 5% so far this year, and Standard & Poor's expect there to be further house price growth in 2007. Despite 190,000 households being created per year, currently only 150,000 homes are being built per year. This is leading to a structural imbalance in the real estate market. Therefore, the affordability problem appears likely to remain in the near term, and could increase over the medium term. This problem is exacerbated by planning restrictions and infrastructure issues, which can delay proposals to increase housing supply. Furthermore, in the longer term in the absence of any correction in the housing market or supply side adjustments, this affordability problem is likely to be exacerbated by demographic factors such as later marriages, smaller family units, immigration, and an aging population.



The demand and affordability problems are particularly pronounced in certain areas such as London and the Southeast of England. Average house prices in London are about 50% higher than the average house price in the U.K. as a whole. The Department for Communities and Local Government (formerly the Office of the Deputy Prime Minister), which is responsible for the U.K. government's housing policy, is concentrating its plans for increasing housing supply particularly in areas in the south of England. One-half of the homes to be built under the government's 2006-2008 National Affordable Housing

Programme (NAHP) are due to be built in London and the Southeast, and population pressure is expected to continue in these demand hotspots for the foreseeable future. For example, about 12% of the U.K. population already live in London, but the capital's population is still rising and is forecast to reach almost 8 million by 2010, an increase of 8.3% between 2000 and 2010.

Despite the generally high demand for housing across the U.K. as a whole, there can be localized pockets of relatively low demand and low house prices. These areas are typically being addressed through local regeneration schemes. Regeneration in low demand areas requires a different set of management skills compared with developing housing to meet excess demand. This can often result in a reduction in housing units as part of the process of improving the attractiveness of the area as a whole for residents, through estate reconfiguration and providing more local services.

### **Government Plans To Build More Affordable Housing**

The government has recognized the problem of undersupply of housing, and the associated affordability problem and therefore is looking to increase the supply of both social rented housing as well as home ownership through schemes such as shared ownership. Mixed-tenure development offers the potential to move between tenancy types as individual circumstances change. The government is placing a growing emphasis on building homes for low-cost ownership, as well as continuing to develop social rented housing. Of the 84,000 new homes to be built under the 2006-2008 NAHP, 35,000 homes will be homes for shared ownership through the government's Social HomeBuy, New Build HomeBuy, and Open Market Homebuy schemes. The government has recently announced plans to extend the eligibility for shared ownership schemes, which will expand the potential customer base for these homes.

The Social HomeBuy scheme which is aimed at existing tenants of social housing (local authority or housing association accommodation), is likely to have only limited impact given that it is expected only relatively few social housing tenants will be able to fund up to the required 25% of the purchase price of the property, even with the promised discount.

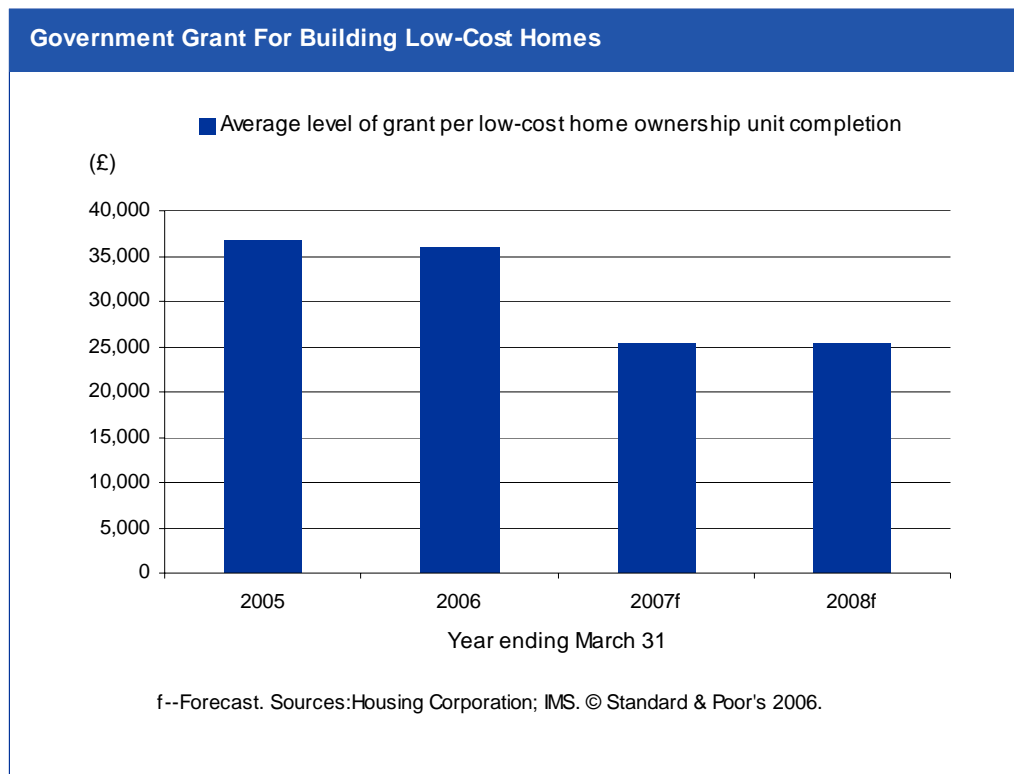
The New Build HomeBuy scheme allows people on low-to-middle incomes to purchase an initial minimum 25% share in a newly built home, with the housing association owning the remainder. There is the possibility of increasing the share of ownership of the property in the future. This scheme is likely to be more successful as it is available to a larger customer base, with a wider range of incomes.

Under the Open Market HomeBuy scheme, purchasers will be expected to raise finance to purchase about 75% of a home from one of the lenders participating in the scheme. The purchaser will receive equity loans from the government (through a housing association) and one of the participating lenders for the remaining 25% of the property. The providers of the equity loan—the government and the participating lender—will be exposed to falling housing prices, as the first 25% fall in value below the original price will have to be met by them.

Under the terms of the various shared ownership schemes, responsibility for the management and maintenance of the home would be transferred from housing associations to the private buyer. If properties are not sold and are not well looked after by the residents, this could lower the value of the home in the event that the property was returned to the housing association.

Shared ownership development is an important element of the government's affordable housing targets, but it does expose the housing association developer to more market risk compared with the traditional model of developing with grant for social rented use only. The overall amount of grant that the government is providing through the sector regulator, the Housing Corporation, to increase housing supply, will increase to £3.9 billion in 2006-2008 from £3.3 billion in 2004-2006. The amount of public funding per housing unit, however, is forecast to fall to £46,000 in 2006-2008 from an average of about £52,000 in 2004-2006 (Source: Housing Corporation). More specifically, the average level of Housing

Corporation grant for each new low-cost home ownership completion is expected to decline, falling by about 30% to about £25,300 for the year ending March 31, 2008 (financial 2008) compared with about £35,900 in financial 2005 (see chart 2). Consequently, the need for private finance is expected to increase. Lower levels of grant funding and higher debt funding will increasing gearing and may put pressure on housing association developers' interest coverage ratios.



The higher costs of private funding compared with grant funding should encourage developers to build more efficiently, but may also encourage a higher level of cross-subsidization from house sales and market rental income.

### Managing Increasing Market Exposure

In 2005, earnings without property sales for the social housing sector were 1.10x interest coverage, but with property sales they rose to 1.52x interest coverage. A significant number of housing associations, however, operate at below 1x coverage before property sales. For some period of time, housing sales have provided an important source of income for housing associations, but this revenue stream is likely to be more volatile than social rented income. Plans for more mixed-tenure developments are likely to increase housing association developers' exposure to potential market volatility. That said, for many social housing developers, given their typical size, current balance sheet strength, and hedging strategies, should be quite resilient to adverse interest rate movements and downturns in the housing market.

It will be important, however, for housing association developers to ensure that they generate a sufficient financial cushion commensurate with any additional market risk and extra debt, as well as assess and quantify this additional risk in a transparent fashion. An association engaged in delivering a significant program of mixed-tenure housing development will typically have a different credit profile to an association focused primarily on managing housing stock. Nevertheless, many housing associations have capacity to take on additional risk if the risk is managed prudently, in part because of the range of tenure options that they are increasingly providing. This means that if demand for one type of tenure declines, then typically there will be an increase in demand for another tenure option, which will go some

way to balancing the situation. That said, cash flow receipts from housing sales will be more concentrated than longer term rental streams, so associations will need to ensure that moving between different tenure types does not cause undue short-term cash flow pressures, if, for example, expected house sales targets are not met.

House prices and the volume of sales could be affected if there was a slowdown in the U.K. economy, which could be brought about by an external event, such as a supply-driven oil price shock. Standard & Poor's has commented in separate articles that a significant collapse in U.K. house prices is unlikely. Nevertheless, it is fair to say that the U.K. would be more exposed in the event of such a shock than other major European economies. Recent interest rises may soften demand for more market-based housing, including shared ownership. (See commentary titled "An Oil Price Shock Would Accentuate Divergence Between European Economies," published on Sept. 11, 2006, on RatingsDirect for further details about the possible effects of a supply shock).

The U.K. housing market is more exposed to variable interest rates than the U.S. housing market and a number of markets in Continental Europe—for example, in France and Germany only about 20% and 30% of all mortgages are variable rate as opposed to the U.K. where the figure is more than 70% (Sources: European Mortgage Federation, European Central Bank, and Eurostat).

Furthermore, certain associations are land banking in order to improve the likelihood of receiving development grant. Land prices can be subject to speculation, and, therefore, can be quite volatile. Although land banking is quite limited across the sector, pressure to have land available for development is likely to increase risk for certain housing associations in the future.

### **Increasing Involvement Of Private Sector Developers**

For the first time, under the provision of the Housing Act 2004, private developers were able to bid in competition with housing associations for government grant to build social housing in the 2006-2008 NAHP. The government hopes that introducing competition from private sector developers will lead to greater efficiencies that should reduce the cost of house building, thereby enabling more houses to be built for a given level of government investment.

Certain private developers took a relatively small part of available funding (about 2.5%), and some private developers were put off bidding by the regulatory burden associated with securing government grant.

Private sector developers may not want to manage social housing developments over the longer term. After construction, newly built social housing may be sold on to housing associations to manage the stock and to meet all the regulatory requirements. That said, social housing management contracts could be taken on by specialist private sector management companies. There is evidence of a market developing in the trading of social housing assets between housing associations, such a market would make it easier for private housebuilders to build and sell social housing assets in the future. In certain circumstances, housing associations purchasers may even pay a premium over the existing use valuation to reflect the strategic fit of the portfolio with existing stock and/or their view on future tenanted and untenanted house price values.

It remains to be seen whether private house builders will maintain a long-term interest in the sector. Their involvement to date has created a new dimension to the social housing landscape, but their impact so far has been limited. It may be that over the longer term private house builders will work more in partnership with housing associations rather than in direct competition. Nevertheless, their involvement in social housing should encourage greater efficiencies and should help innovate more successful mixed-tenure solutions.

## **Private Sector Investment Also Likely To Increase**

Private sector investment in the social housing sector continues to be dominated by bank lending, and there is no sign that the banks appetite for lending to the sector will slow down in the near future. There is, however, some suggestion that over the next few years other forms of financing will make in-roads into the sector.

Many housing associations also have capacity to take on additional debt, particularly those with relatively high asset value areas on their balance sheet and relatively low levels of existing debt. Relative to other property developers, housing association leverage levels tend to be quite low and balance sheets are managed in a conservative way. Furthermore, a number of large-scale voluntary transfers (LSVTs) will emerge through their initial business plan phase over the next few years with capacity to take on more debt. The increasing concentration of development in the hands of a few housing associations, partially a result of government policy of focusing the distribution of grant among a group of housing association development partners, could increase banks' exposure to individual borrowers and therefore could lead to an increase in borrowing costs. It remains to be seen whether the UK banking market can continue to satisfy the demand for increasing levels of debt at very low lending margins, or whether the sector will look more toward the bond markets to meet their funding requirements.

Although government grant has been increasing in recent years, the government's 2007 Comprehensive Spending Review is likely to be quite prudent and it is expected that a greater use of private finance will be sought to meet policy objectives. The Housing Corporation expects that more than £4 billion of private finance a year will be needed over the next five years by the social housing sector. Both bank and bond finance will be sought to fund the development of affordable housing, and there could be growth in equity investment to help fund the unregulated and riskier areas of housing association activities.

The ability to grow the unregulated businesses is in part limited by planning opportunities, the ambitions of housing associations, the need to keep an appropriate balance between regulated and nonregulated business, and increasingly the need to share risk. Given the government's objectives to build more mixed-tenure developments, however, there may be increased scope to involve external equity investors to share the risks and rewards of market-exposed activities alongside housing associations.

Returns for investors in mixed-tenure developments may be lower compared with traditional residential or commercial portfolios, however, well-managed mixed-tenure developments are likely to provide greater stability. This may be attractive to particular types of third-party investors. For example, investors in real-estate investment trusts (REITs) and institutional investors may have a longer-term outlook on property and could follow "buy and hold" strategies.

REITs require a minimum return on investment, which could theoretically be met by returns from market rental and housing for sale. Certain housing associations, and groups of housing associations, have already expressed interest in REITs as this could be a more efficient way of funding their new developments for potential sale or the private rental market.

The U.K. government plans to introduce REITs by Jan. 1, 2007, to promote tax transparent investment in property. REITs are equity-oriented, tax-efficient vehicles that allow investors to pool funds for indirect participation in real estate ownership or financing. Their introduction is expected to increase real estate investment opportunities for private equity investors. If housing associations do set up and run REITs, this would suggest increasing housing association interest in more market-exposed activities in the future.

Another vehicle for new investment could come via an increase in social housing Private Finance Initiative (PFI) activity. PFIs have been taking longer than expected take off in the sector, partly because of the risks associated with refurbishment of existing tenanted housing and the time taken to negotiate

contracts. New build PFI development schemes go some way toward addressing some of the concerns associated with refurbishment risk and tenant management. PFI investors, as well as sharing social housing development risk, would be able to share the risks and rewards of development for sale and market rent.

### **Upcoming Regulatory Review Could Affect Credit Ratings**

The system of regulation that underpins social housing is of crucial importance to credit analysis. An appropriate form of regulation can help support cash flow predictability and this can help entities with marginal financial profiles achieve strong investment-grade ratings. When considering regulation as part of credit analysis, Standard & Poor's assesses a number of key risk mitigants, including the stability and track record of the regulatory regime, transparency, sustainability, credibility, timeliness of the regulatory response, and regulatory flexibility.

The social housing sector in England is subject to wide ranging and quite complex regulation. Currently, regulatory functions are delivered via several organizations, and there is a degree of overlap. The Housing Corporation is the main regulator for the sector. Its role includes the regulation of rent, the allocation of grant, and it has powers of intervention in the event of poor performance by a particular housing association. The Housing Corporation does not guarantee housing association debts, but its regulatory role alongside other providers of regulation and government support has presided over a period of stability and predictability during which there have been no recorded defaults. The strong credit ratings in the sector and the attractive lending terms reflect this situation.

It is fair to say that the current system of regulation has developed over a number of years in a somewhat ad-hoc fashion. The Housing Corporation has adopted its regulatory role in recent years to meet some of the changing needs of the sector. For example, the move toward a risk-based system of regulation has lightened the regulatory burden on well-performing associations, while focusing regulatory attention on the weaker performers.

Nevertheless, a number of practical factors have created the need to examine the role of regulation to ensure it is fit for purpose for the future needs of affordable housing. These include:

- The need to provide a level playing field between housing associations and private sector developers bidding for government grant.
- The recent legislative clarification of the Housing Corporation's powers of delegation has served to highlight the question of what are the exact legal powers of the Housing Corporation.
- The current low level of regulated rent increase relative to earnings growth is contributing to the gap between social and market housing in terms of funds available for investment.
- The increasing size of associations and their capacity for self-regulation.
- The increasing diversification and financial sophistication of larger associations.
- Recent well-publicized discussions regarding possible merger between English Partnerships and the Housing Corporation.

In April 2006, a review of regulation was announced by the government. Following ministerial changes and departmental reorganization, the scope of the review was expanded. A comprehensive review of regulation will address the relationship between affordable housing strategy set by government, and the delivery of strategic objectives through the different regulatory bodies and local government. It is expected to be completed by the summer of 2007.

The outcome of the review will be of key importance to credit ratings in the sector. Any regulatory change will need to take into consideration a number of factors. Relaxing regulation, for example, could help increase competition and efficiency, but may also negatively affect the favorable borrowing terms currently enjoyed by housing associations. Conversely, increasing regulation and support could increase

the risk that housing associations are seen more as public bodies and a part of government, and this could risk private sector lending to the social housing sector at some stage being consolidated on the government's balance sheet.

In terms of ensuring more of a level playing field of regulation between housing associations and private developers for development grant, it is possible that a contract-based system of regulation may be adopted. The level of contractual regulation will similarly need to strike a balance between its impact on associations' borrowing costs and the efficiencies associated with increased competition.

Standard & Poor's will closely follow the regulatory review over the next year, and expects that there will be some changes to the system of regulation to make it more suited to future affordable housing needs. Whether these changes will have a material credit impact on the sector remains to be seen.

### **Risk Strategies Are Key For The Future**

Competition, increasing market risk exposure, and regulatory change are important considerations for investors in the UK social housing sector. The risk from market exposure remains relatively low at the moment, but over the medium to long term this risk is likely to grow for certain associations. Housing associations will need to ensure that they continue to maintain prudent levels of liquidity commensurate with risks that they are taking on. Risk management skills and associated debt management strategies will need to address larger and more complex development programs. In addition, strategies designed to manage and share the risks associated with increasing market exposure with other parties are likely to become more important.

Additional writing: Paramita Mondal

Published by Standard & Poor's, a Division of The McGraw-Hill Companies, Inc. Executive offices: 1221 Avenue of the Americas, New York, NY 10020. Editorial offices: 55 Water Street, New York, NY 10041. Subscriber services: (1) 212-438-7280. Copyright 2005 by The McGraw-Hill Companies, Inc. Reproduction in whole or in part prohibited except by permission. All rights reserved. Information has been obtained by Standard & Poor's from sources believed to be reliable. However, because of the possibility of human or mechanical error by our sources, Standard & Poor's or others, Standard & Poor's does not guarantee the accuracy, adequacy, or completeness of any information and is not responsible for any errors or omissions or the result obtained from the use of such information. Ratings are statements of opinion, not statements of fact or recommendations to buy, hold, or sell any securities.

Standard & Poor's uses billing and contact data collected from subscribers for billing and order fulfillment purposes, and occasionally to inform subscribers about products or services from Standard & Poor's, our parent, The McGraw-Hill Companies, and reputable third parties that may be of interest to them. All subscriber billing and contact data collected is stored in a secure database in the U.S. and access is limited to authorized persons. If you would prefer not to have your information used as outlined in this notice, if you wish to review your information for accuracy, or for more information on our privacy practices, please call us at (1) 212-438-7280 or write us at: [privacy@standardandpoors.com](mailto:privacy@standardandpoors.com). For more information about The McGraw-Hill Companies Privacy Policy please visit [www.mcgraw-hill.com/privacy.html](http://www.mcgraw-hill.com/privacy.html).

Analytic services provided by Standard & Poor's Ratings Services ("Ratings Services") are the result of separate activities designed to preserve the independence and objectivity of ratings opinions. Ratings are statements of opinion, not statements of fact or recommendations to buy, hold, or sell any securities. Ratings are based on information received by Ratings Services. Other divisions of Standard & Poor's may have information that is not available to Ratings Services. Standard & Poor's has established policies and procedures to maintain the confidentiality of non-public information received during the ratings process.

Ratings Services receives compensation for its ratings. Such compensation is normally paid either by the issuers of such securities or by the underwriters participating in the distribution thereof. The fees generally vary from US\$2,000 to over US\$1,500,000. While Standard & Poor's reserves the right to disseminate the rating, it receives no payment for doing so, except for subscriptions to its publications.

Permissions: To reprint, translate, or quote Standard & Poor's publications, contact: Client Services, 55 Water Street, New York, NY 10041; (1) 212-438-9823; or by e-mail to: [research\\_request@standardandpoors.com](mailto:research_request@standardandpoors.com).