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## INTRODUCTION

The Housing Finance Corporation (T.H.F.C.) is the foremost organisation dedicated to raising private sector finance for the development of social housing. Since its inception in 1987 T.H.F.C. has raised almost £1.5 billion for lending to registered housing associations.

This review describes the political and social context in which housing associations operate, their characteristics as housing businesses and the legal, regulatory and financial framework for their activities. Finally it outlines the way in which T.H.F.C. is structured to provide secured investment opportunities in this sector.

It has been estimated that registered housing associations will expect to raise up to £11 billion from the bank and capital markets over the next three years for transfers of local authority homes and for programmes of further housing development. This investment for housing development will be complemented by government grants of over £4 billion.

T.H.F.C.'s aim is to provide financial instruments with a range of interest structures and maturity profiles to assist housing associations in meeting their requirements for balanced loan portfolios. T.H.F.C. raises finance in a variety of markets through public debenture stocks, private placements and bank loans.



## SECTION 1

### HOUSING IN THE UK

#### THE POLITICAL AND SOCIAL ENVIRONMENT

There are two broad categories of residential housing in the UK: owner occupied and rented housing. 69% of homes in England are now owner occupied, compared with 57% in 1979, as government policies as well as personal aspirations have generally favoured home-ownership. The percentage of rented housing has declined over the same period and is low compared with most of the other major European countries. Private rented housing accounts for about 11% of all homes, and not for profit 'social' rented housing the remaining 20%.

Despite a slight revival of the private rented market in the 1990s this has probably now peaked. The social housing sector provides housing for those on low incomes, the elderly and those with other special needs. The term 'social housing' covers the provision of housing for people for whom open market private housing, either for sale or rent, is unaffordable or unsuitable.

Local authorities have provided the vast majority of social housing in the past, but in the last ten years the national share of housing association homes has risen from 3% to 7%, in part through new development but very significantly through the transfer of local authority homes to housing associations. Over 600,000 homes have so transferred since 1988.

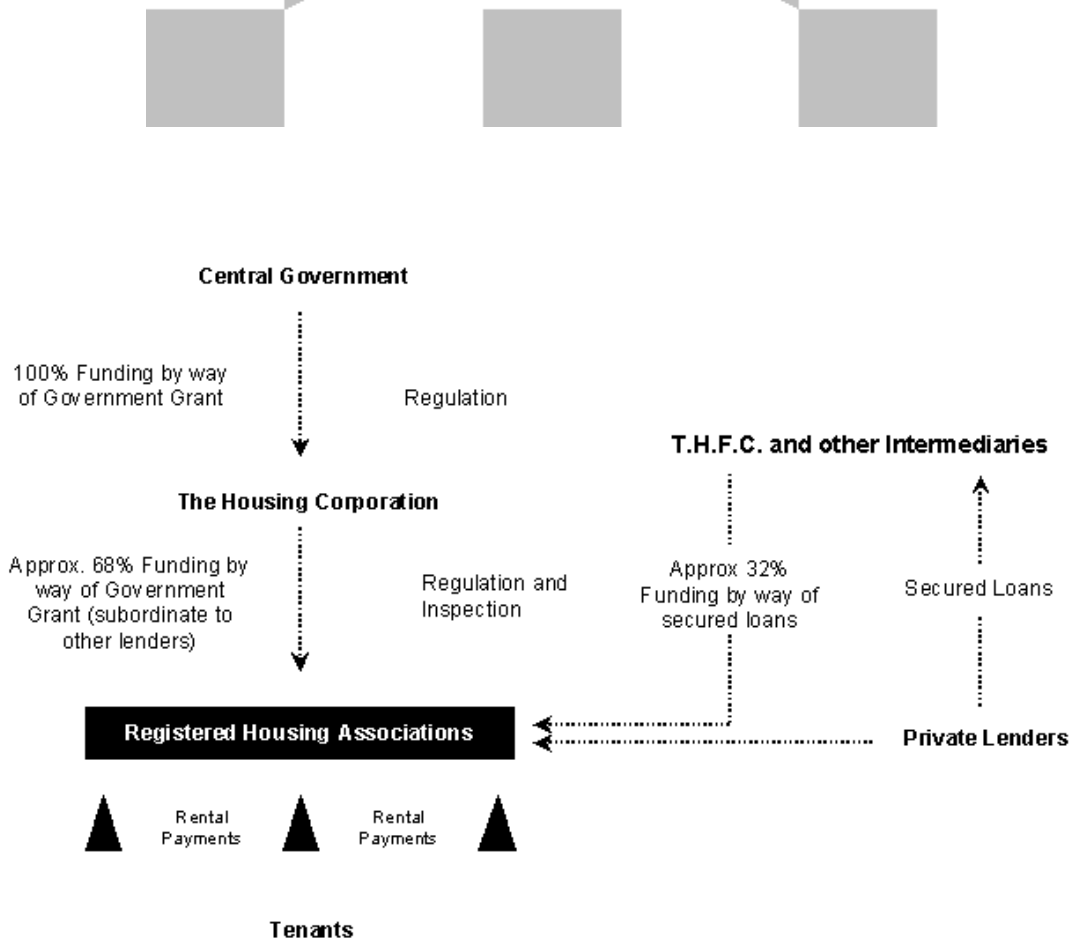
Housing associations are the government's preferred provider of new social housing, and the local authorities' role has been shifting to that of strategic enabler rather than provider of new housing. Nevertheless they still remain the largest owners and managers of social housing and retain key responsibilities for meeting local housing need. A high proportion of housing association tenancies is allocated to nominees of local authorities under 'nomination agreements' in return for the public support which associations receive by way of grant.

More recent developments increase the need for investment and reinvestment in housing stock through the housing association sector. First, in a major Government policy statement on housing in December 2000, targets were set for all social housing to reach at least the 'decent homes standard' by 2010. Whilst this target impacts particularly on local authority housing, transfers of this stock to housing associations are a good and tried way of bringing in the necessary private finance for the reinvestment needed. Associations also need to bring their own homes up to good standard as well.

Second the pressures of housing demand in the south east and London and in some other parts of England have focused attention on the housing needs of 'key workers' who cannot afford either market rents or the first step to home ownership. The Spending Review announcements in July 2002 for the period to 2006 commit increased resources to providing additional homes for nurses, teachers and other public service workers and new social housing for the homeless and families in bed and breakfast accommodation.

### HOW PRIVATE AND PUBLIC SECTORS RELATE

The funding of new social housing development in England has, since the late 1980s, involved the private and public sectors in an early form of public-private partnership. The relationships are shown below, and the roles are described in more detail in the following Sections.



## SECTION 2

### THE HOUSING ASSOCIATION SECTOR

#### HOUSING ASSOCIATION HISTORY

A key characteristic of the housing association sector is its diversity of historic origin and purpose. The earliest examples are charitable almshouses, some of which were founded in the 12<sup>th</sup> century. The 19<sup>th</sup> century saw the establishment of housing trusts by philanthropic industrialists and, in the 1960s, inner-city associations were promoted by the housing charity Shelter, and national associations developed to meet the needs of the elderly and other specific groups.

Most associations, whenever they were founded, grew out of and are still motivated by individual or community concern about local housing conditions.

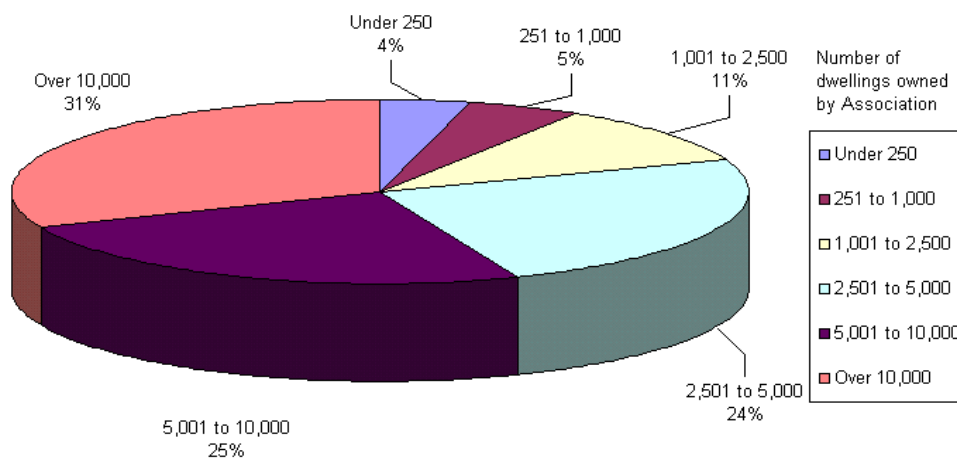
#### SIZE AND DISTRIBUTION

There are around 2,200 housing associations in England, Wales and Scotland registered with their respective regulatory authorities, the Housing Corporation, National Assembly for Wales and Communities Scotland. Since under 3% of T.H.F.C.'s lending is to Welsh and Scottish associations, statistics and references below are to associations registered in England in 2001.

The largest 205 associations all have over 2,500 homes in ownership – 11% of associations owning collectively 80% of all homes. The majority of associations are small with 39% owning 25 homes or less. In any one year some 200 associations are each receiving public grant of over £1 million to develop new schemes and these are widely dispersed across inner-city, urban and rural areas. Several receive grant of over £20 million each.



Percentage of stock owned by housing association size



Homes owned and managed*	Number of associations	% of associations	% of all homes
1 to 25	724	39	1
26 to 100	471	25	1
101 to 250	185	10	2
251 to 1,000	166	9	5
1,001 to 2,500	107	6	11
2,501 to 5,000	115	6	25
5,001 to 10,000	57	3	23
Over 10,000	33	2	32

\*Includes only homes managed for organisations other than housing associations

Source: The Housing Corporation

Included within the above table are associations, founded since 1988, which have taken transfer of the whole of a local authority's housing stock, or in some cases single estates, after a tenant ballot. This part of the housing association sector and its requirements for private funding are described more fully in Section 4.

## LEGAL STATUS OF HOUSING ASSOCIATIONS

The majority (58%) of housing associations are Industrial and Provident Societies registered with the Financial Services Authority. Many of those which have taken transfers of local authority housing in recent years have become companies limited by guarantee. Both Financial Services Authority and company registered associations may operate under either charitable or non-charitable rules or memorandum and articles. An association may also be a charitable trust, registered with the Charity Commission.

All registered associations are non profit-distributing and operate under the general statutory framework provided by the Housing Associations Act 1985, as amended and added to by the Housing Acts 1988 and 1996. Association files held at the Financial Services Authority are publicly accessible and contain details of the association's rules, rule changes, annual returns and accounts, and all floating charges registered on their assets. Company associations follow the filing requirements of Companies House. The Housing Corporation also maintains a public register of all registered association accounts, and basic details on each association are on the Corporation's website [www.housingcorp.gov.uk](http://www.housingcorp.gov.uk).

## HOUSING CORPORATION REGISTRATION

Since 1974, all housing associations using public grant in England have been registered with, and thus brought within the regulatory framework of, The Housing Corporation ('the Corporation'), a statutory body funded by government. The Corporation's constitution and powers are substantially laid down in the Housing Associations Act 1985 and the Housing Acts 1988 and 1996. They are described more fully in Section 6. In Wales the National Assembly now regulates associations, and in Scotland Communities Scotland fulfils this function.

## THE GOVERNANCE OF HOUSING ASSOCIATIONS

Housing associations are governed by non-executive boards consisting of unpaid individuals without any financial interest in the affairs of the association but with skills and experience relevant to its work. There are some exceptions. It is possible for up to two of the senior executive staff of the association to be co-opted onto the board, if the association so wishes. A few have done so.

Second, most of the associations set up to receive transfers of local authority housing have tenants on their boards, and more recently the typical transfer board composition has been one third tenants, one third local authority representatives with the remainder being individuals selected for skills and experience to complement those of other board members. Increasingly, longer established associations are bringing tenants onto their boards.

The composition and expertise of the board are scrutinised when the Corporation registers a new association, and as part of the ongoing process of regulation. The National Housing Federation, the trade association for the sector, has developed a Code of Governance to which the vast majority of associations subscribe.

The principal role of the board is the overall control and monitoring of an association's operations, the formulation of strategy and policies and the appointment of senior executive staff. By law no member of the board can be a principal proprietor of, or directly concerned with the management of, any business which trades for profit and which undertakes paid work for the association. The daily management of housing associations, except in the very smallest, is the responsibility of paid, professional staff reporting through a chief executive to the board.

In recent years, most of the larger associations have developed group structures. The reasons have varied. In some cases it has been to separate charitable and non-charitable activities. In others changes in the tax and grant regime affecting associations have made it desirable to enable the use of gift aid to a charitable member of the group. A more recent trend has been to establish locally based subsidiaries to foster local governance and accountability, particularly for example where local authority housing is transferring to an existing association.

## SECTION 3

### HOUSING ASSOCIATION ACTIVITIES

#### PROPERTY MANAGEMENT AND RESIDENT SERVICES

Housing associations' core business is the letting and management of rented properties for low income households. Some associations (or their groups) have more diversified activities. Examples are shared ownership and other forms of low cost ownership provision, residential and nursing homes for the elderly, student and key worker housing, market renting, employment and training schemes related to community regeneration initiatives.

For their social housing, associations must comply with the Corporation's Regulatory Code and have regard to regulatory guidance. The Code is also concerned with their governance (see above) and their viability (see Section 6). The sections on management are concerned with:

- target rents which are on average below those in the private sector and which reflect size, property value and local earnings; associations are normally expected to move towards these over the period to 2012;
- management arrangements which are appropriate to ensure their activities are adequately monitored, undertaken efficiently and effectively, and backed by proper assurance systems for internal control;
- continuous improvement and value for money in their service delivery, using Best Value techniques;
- providing good quality homes which meet people's needs and preferences, including giving priority to necessary investment in the future of the stock;
- providing good quality housing services for residents and prospective residents, using fair lettings policies and giving choice of home where possible, offering the most secure form of tenure compatible with the purpose of the housing, and providing high standards of customer care;
- working with local authorities to enable authorities to fulfill their duties to the homeless, the vulnerable and people in priority housing need;
- ensuring strategies and policies are responsive to the economic and social environment, linking into regional and local housing strategies.

The condition of housing association properties is better than that of local authorities or the private rented sector. The English House Condition Survey 1996 shows that this is primarily because of the high proportion (34%) of post 1980 dwellings in the sector, 62% of whose dwellings are post 1965. Average costs of remedying disrepair were about £800 per dwelling, compared with £1,830 for all housing stock.

The total cost of dealing with a backlog of work where key building elements have exceeded their lifetime was estimated at £1.7 billion at 1996 prices. But this works out at an average of around £1,800 per housing association dwelling, where the comparable local authority dwelling figure averaged £2,880.

## **DEVELOPMENT**

In contrast with much local authority housing, association properties have been predominantly low rise and of traditional construction. The majority of the current programme is new building although associations traditionally have been very active in the refurbishment of older properties.

An association may use architects, adopt a 'design and build' formula or purchase completed dwellings from a building contractor. Whichever procurement method is used, the standard of the dwellings must comply with Corporation scheme development standards. New housing normally carries National Housebuilders Council or equivalent insurance protection against structural defects.

Associations work closely with local authorities to determine priorities for housing developments and, if public grant is required through the Corporation, allocations will depend on needs identified in local, sub-regional and regional strategies. Associations also enter into partnerships with building developers, who may often under planning approvals need to include elements of social housing for rent within new residential developments for home ownership. Developers may also be required to offer 'planning gain' which may include a financial or physical contribution to such social housing.

Partnership arrangements which are 'Egan compliant' under the report 'Rethinking Construction' are often entered into with construction firms. The Government has backed the aims of 'Rethinking Construction' to improve the quality of social housing construction and reduce costs. For 2002/03 the Corporation has been set a target of 60% of the construction costs of new developments being procured through methods in line with the recommendations. The hope is that longer term partnering arrangements will bring benefits in respect of costs, reduced defects, improved construction methods including off-site prefabrication and reduced construction periods.

Over 86% of Corporation approvals for grants for 2002/03 were targeted at schemes which contributed to regeneration objectives through works to existing homes, rehabilitation of new acquisitions for both rent and sale, and new build schemes on brownfield (previously used) sites.

## **FORMS OF TENURE**

The housing which associations develop is let under forms of rental and leasehold tenure described in statute. These are:

### **Assured tenancies**

Assured tenancies were introduced in the Housing Act 1988 and apply to all housing association tenancies created since its implementation. The Act sets out, inter alia, the grounds under which the landlord may obtain a court order granting possession of the property. These include:

- the tenant has not paid the rent due;
- the tenant has broken, or failed to perform, any of the conditions to the tenancy;
- the tenant has caused damage to the property;
- the tenant has caused nuisance to neighbours;
- the landlord can show that vacant possession is necessary to carry out works, or that the property is required for someone who needs the special amenities provided and suitable alternative accommodation is available to the tenant.

Associations usually retain the right under their forms of tenancy agreement to increase the rent no more than once a year by giving one calendar month's notice in writing of the increase. The tenant can exercise the right to apply to a statutorily established Rent Assessment Committee to have a market rent determined, though in practice this right is very rarely used as rents charged are on average well below market level.

### **Assured shorthold tenancies**

These are a modified form of assured tenancy that can be ended without showing grounds after they have run for at least six months. The tenancies are used in circumstances such as hostels and student accommodation where longer term tenancies are inappropriate.

### **Secure tenancies**

Tenancies continuing from before 15 January 1989 are secure tenancies with 'fair rents' which are subject to rent officer assessment of the levels every two years.

### **Private sector leasing**

A number of associations have entered into agreements with local authorities whereby the association leases property from private owners, and then lets the accommodation on assured shorthold tenancies to people nominated by the local authority, which in turn guarantees the rental income for the period of the lease.

### **Shared ownership**

Shared ownership is a form of leasehold which enables occupiers effectively to own a share of the property and pay a rent on the remainder. As the occupier's personal circumstances change, further shares can be purchased until outright ownership is achieved. The scheme is principally intended for first time buyers who would otherwise find difficulty in embarking on home ownership.

A variant introduced in the late 1990s is the Homebuy scheme whereby tenants of associations or local authorities or those on housing waiting lists in housing need may purchase a home with the assistance of an interest free loan of 25% of the purchase price. When the home is sold the owner repays 25% of the value at the time of sale. Housing associations administer the scheme and carry the loans on their balance sheet with grant support from the Corporation.

## **RIGHTS TO BUY OR ACQUIRE HOMES**

Secure tenants (see above) of non-charitable associations retained the right to buy their home at a discount to vacant possession value, in a similar way to local authority tenants. Other housing association tenants do not have the right to buy under the scheme introduced in the 1980 Housing Act. Tenants with the right to buy must have had two years in a relevant tenancy, and there are exceptions preventing purchase where tenants live in sheltered housing or if the home is particularly suitable for older people. Discounts vary between houses and flats but are based on length of residence and are also now capped. Where a tenant buys a flat, the housing association continues to own the freehold and remains responsible for major works, to which the leaseholder contributes.

When local authority tenants transfer from a local authority to a housing association (see Section 4) they bring with them a 'preserved right to buy' similar to the statutory right above, though their discount may be reduced if in certain circumstances the reduced sale price would cause financial difficulties for their landlord.

Finally the 1996 Housing Act introduced a statutory 'right to acquire' which applies to all transfer tenants as an alternative to preserved right to buy, and to new tenants of schemes developed with public grant since that Act. Tenants receive a grant administered by the Corporation but passed on through their association landlord to help the acquisition. The Corporation also administers a scheme which allows associations to allow or encourage sales to its existing tenants, with a similar grant assistance, where the tenants would not otherwise be eligible under any of the other schemes described.



## **SECTION 4**

### **LOCAL AUTHORITIES AND TRANSFER ORGANISATIONS**

#### **BACKGROUND**

At April 2002 local authorities in England owned around 2.7 million dwellings, reduced from some 5.1 million in 1981 largely because of the statutory right to buy of tenants, but also because over 600,000 homes had transferred to housing associations. During the 1990s the funding available to local authorities to reinvest in their own housing has been severely limited by government policies. The ability to maintain properties in good repair and progressively to improve standards has been curtailed.

As a result over 120 local authorities have transferred all or part of their houses to housing associations between 1988 and 2002. Some 150 transfers of over 500 homes each have taken place and up to 170,000 further homes may transfer in 2002/03. The main advantage of transfer has been that private funding can be brought in, which is outside government borrowing constraints on local councils, so that large programmes of catch-up repair and improvement can take place. But there have been other benefits – more focused delivery of good quality services to local residents, and greater tenant participation in how delivery takes place.

In the 2000 Spending Review, government acknowledged that £19 billion would be required for major repairs and essential upgrades to local authority housing to bring it to decent modern standards. A target has since been set to bring all social housing to 'decent homes standard' by 2010, and to reduce the number of households living in housing that does not meet those standards by a third between 2001 and 2004.

Transfer to associations is only one option. The existing local authority finance systems are being reformed so that the revenue subsidies available provide for a major repairs allowance to stop future maintenance backlogs building up. Councils will also be given more freedom to borrow within prudential constraints. Councils may also set up Arms Length Management Organisations (ALMOs) which will ring fence the housing service into a separate company with its own board. More government resources will be available to high performing ALMOs. Finally there have been a number of pathfinder Private Finance Initiative housing schemes. These will establish a long term service contract between the Council and a special purpose vehicle in which a housing association may be a partner. The contracts will be long term and provide for major reinvestment in the stock.

#### **THE TRANSFER MODEL**

Despite these other options, some of which are recent, transfer is the best tried model and the one which has achieved most, with transfers valued at £4.9 billion and loan commitments covering this and a further £4.6 billion for works. Government has been prepared to support transfers of up to 200,000 homes a year, though prior to 2002/03 the highest single year total was just over 130,000 in 2000/01.

The processes for transfer are time consuming and, as a tenant ballot is in practice needed for the transfer to go ahead, early work can prove abortive. Three out of four ballots have however favoured transfer. Government establishes an annual transfer programme with a two-year time period for each transfer to complete.

Normally there should be no longer than six months between ballot and actual transfer, but in this period funding has to be agreed, staff appointed, registration achieved with the Corporation, and the business plan, policies and procedures all established.

The transfer may be either to an existing housing association or a new one set up for the purpose. Most single estate transfers have been to existing associations, and most full stock (i.e. the whole of a local authority's housing stock) transfers to new associations. Where more than 12,000 homes are being transferred the government expectation is that more than one association will be created, and this has led to group structures in a small number of urban and metropolitan areas.

Consultation with tenants and leaseholders is key to the process and should begin at the option appraisal stage. An independent tenant adviser paid for by the local authority will support the residents. As well as the ballot, tenants should be involved throughout the process and the board of the transfer landlord will include at least one-third tenant representation. Commitments will be given on future rents, the works to be carried out and expectations on service delivery.

The business plan of the new landlord has some unusual features, which have however become well accepted for funding. The price per home paid on transfer to the local authority has averaged approximately £8,500, based on the net present values of future expected income and expenditure cash flows. Some transfers, usually of inner city estates, have involved a 'dowry' in the form of government grant where this calculation has yielded a negative value (though such grants were no longer available in 2002/03). Other transfers, more often in predominantly rural district councils, have commanded a price of over £12,000 per home.

Early-year works costs add an average £7,500 to the loan requirement, and this spending means a rising debt profile for several years as cash flow overall is negative. The profiles however then begin to show a position which progressively improves, normally to allow full debt redemption within 25 to 30 years. Funding has been predominantly through the banks and building societies, but there has been capital market involvement in a major transfer in Sunderland and in other situations requiring a refinancing.



## SECTION 5

### HOUSING ASSOCIATION FUNDING

#### BACKGROUND

Associations' reputation for innovation and high standards led to the introduction of public funding for their programmes of housing for rent during the 1970s and 1980s. At the end of the 1980s it became possible under Government policies to use private sector finance in the production of homes without the total cost of the scheme being considered public expenditure. A 'mixed funded' programme was developed, with capital grants and private sector loans, which has become the norm for the provision of social housing through housing associations since the early 1990s.

As well as the 'bricks and mortar' capital grants receivable by associations, a high proportion of their tenants receive personal support through housing benefit to assist with or fully meet rental payments. Housing benefit therefore also underpins the association's revenue stream.

#### HOUSING ASSOCIATION CASH FLOWS

##### Rents

An association's rental income from property is its main revenue. Together with service charges, rents account for over 80% of the turnover of the sector. Since the introduction of assured tenancies in the 1988 Housing Act, associations can set rents for these tenancies without any reference to the Rent Officer who sets fair rents for the remaining secure tenancies.

In the late 1990s the Corporation was required by Government to have greater influence over association rents, and for a number of years rents overall for a particular association were expected not to increase by more than RPI plus 1% per annum. Exceptions were made where this would cause financial difficulty in maintaining properties in good condition for tenants, or in meeting funders' covenants. Transfer organisations had often previously been set up with 30 year business plans which assumed higher rent increases than this after an initial rent guarantee period, and so their cases had also to be considered.

After consultation with the sector and in line with Government policies for all social housing, including rents set by local authorities, the Government has introduced new rent restructuring measures which begin to apply from 2002. These seek to move social housing rents of different landlords along a convergence path over the ten years to 2012. Principles have been established and factors set which take account of property values, average earnings for the area and size of property, in order to arrive at rent relationships which will be fairer to tenants and reduce the significant anomalies which currently exist.

Associations and local authorities are expected to move towards target rents over the ten year period, but with restraints on the size of the increase in any year. In the case of associations this is RPI plus 0.5%, plus no more than a further £2 per week if rents need to move up to achieve the restructuring. As in the previous period, the Corporation will take account of any particular financial difficulties an association may have, e.g. if it is expected to restructure rents downwards. It remains the intention that social housing rents should remain, on average, below those in the private sector for similar properties.

**Cross tenure rent comparisons – England 2000/01 (£ per week)**

	Housing associations			Local authorities	Private rented sector
	All stock	New lets	Re-lets	All stock	Reference rents
Bedsits	52.14	51.42	46.87	Not avail.	58.77
One bedroom	54.16	55.07	51.63	41.67	76.35
Two bedroom	56.30	61.61	57.26	46.04	90.27
Three bedroom	61.00	67.86	63.73	49.26	97.40
Four+ bedroom	72.72	79.32	72.23	58.93	106.53
All types	57.33	63.53	56.57	46.35	85.42

**Notes :**

Rents are measured at different dates during 2000/01 because of the different databases used. Housing association rents are gross of service charges eligible for housing benefit, in order to give comparability with local authority rent data.

The housing association all stock figures include sheltered housing, but exclude supported housing. Housing association new let and re-let rents exclude both. Local authority data includes both.

Private sector data shows the local reference rent average for the type of property, which is the rent officers' estimate of the average level of local rents for all private assured lettings in the private rented sector.

There are substantial regional differentials between rents, not shown in this table.

Source: *Housing Corporation – Guide to local rents*

**Housing benefit**

Some 69% of all new housing association tenant households receive public support in meeting their rents through payment of housing benefit by the Department of Work and Pensions (DWP). Qualifying tenants will normally receive benefit according to their means up to the full amount of the rent. Many associations have arrangements (with the tenants' consent) whereby the housing benefit payments are made directly by the local authority as agent for the DWP to the housing association as landlord. Where the tenant is in arrears the association has the right to require direct payment of any housing benefit due to the tenant.

**Voids and arrears**

Overall demand for association properties significantly exceeds supply and associations normally have little difficulty in keeping rental losses from void properties to a minimum. Rent arrears are also kept well under control through the establishment of early contact with tenants in arrears, debt counseling and other forms of assistance. Associations typically operate well below 4% total rental losses for both bad debts and void properties.

### **Grants for higher support needs**

There has been special funding since the 1980s for supported housing where the residents have special needs. This has come most recently as supported housing management grant. A radical overhaul of the system is currently underway, and from April 2003 a supporting people grant will replace several funding mechanisms currently supporting organisations and also residents directly. The grant will go to local authorities for funding housing-related support services in their area, including those supplied by housing associations. Associations will receive payment under a formal service contract.

### **Other income**

Many associations generate additional income from other sources, such as contractual arrangements with local authorities to provide short term housing for homeless people, letting of commercial units acquired or developed with housing schemes and charitable fund-raising. In some cases group structures include associations or companies engaged in a more diverse range of activities, including residential and nursing homes or market renting.

### **Expenditure**

Associations' expenditure on their rented property includes maintenance, service costs and insurance, management staffing costs and overheads, depreciation and loan charges. Depreciation on housing properties has only been commonly applied since the introduction of the 1999 Statement of Recommended Practice (SORP) for registered housing association accounts. Many associations will also charge major repairs expenditure to their income and expenditure account, where it is not appropriate to capitalise this expenditure to the property. This expenditure is sometimes supported by grant from the Corporation, which will then be shown as an income item.

Non-charitable associations are liable for corporation tax (and virtually all associations are affected by the VAT regime). A grant was payable to offset corporation tax liabilities, but this has now been withdrawn, and associations have taken various steps to minimise tax liability, including use of gift aid.

### **Operating surpluses**

Associations are non profit-distributing entities and operate under a funding regime which was originally designed for them to break even. Since the 1990s, a level of surplus has been desirable, both to meet loan covenants and to provide liquid reserves for reinvestment in existing properties or to contribute to the funding of new ones.

The aggregate accounts of the sector published annually by the National Housing Federation and the Corporation showed accumulated reserves in 2001, excluding restricted and revaluation reserves, at £4.7 billion, slightly higher than rents receivable for that year. A high proportion of these had been reinvested, as net current assets were only £1.2 billion.

## **CAPITAL FUNDING AND ASSET BASE**

### **Public funding**

There have been three main stages in public support for housing associations to enable them to provide housing for low income people at rents they can afford:

- Prior to 1974 associations received most of their capital funding in the form of local authority loans. Some public revenue grants were available to help meet loan servicing costs. Supplemental capital funding could come from charitable sources and building societies. Repayment of many of these early loans and the growth in property values has resulted in older associations building up substantial equity;
- Following the 1974 Housing Act, capital funding was largely provided by central government and channelled through the Corporation or local authorities. Capital grants (known as Housing Association Grant) were set typically at over 80% of scheme costs, in order that the level of public residual loan could be serviced from rental income, at levels determined by the rent officer;
- The 1988 Housing Act opened the way for the third stage which has combined public grant (now known as Social Housing Grant) with private rather than public loan finance. In addition grant levels were set to enable associations to build up reserves for future major repairs, but this was offset by assumptions that rents could rise under the new assured tenancy regime.

The average grant rate declined from 75% in 1989 to 54% in 1998/99, but has subsequently risen to 68% for 2002/03 as new assumptions have been built in on affordable rents. The movement of interest rates and of land and building costs have been the other most important factors in causing changes to the rate over the years.

Higher rates mean that fewer new homes can be developed from a given total annual allocation of grant by government. Lower grant rates, dependent on other economic conditions, may mean that it is harder to attract the continued supply of private finance loans if tight net income flows and reduced loan asset coverage result.

The government's claim to repayment of social housing grant (or its predecessors) is subordinate to all secured lenders' claims in respect of their loans. In certain circumstances the grant may become repayable to the Corporation if the housing developed with its assistance is used for a different purpose or disposed of. However an association has three years to reinvest the net proceeds of a disposal in social housing projects before such claw-back applies.

The receipt of public grant has also meant since 1980 that associations have been obliged to account for surpluses, and at one stage repay a proportion of these to the Corporation. The treatment of surpluses became much less penal during the 1990s as private finance was increasingly used. Since 1997 there has just been a requirement that a high percentage of the calculated 'rent surplus fund' is applied to reinvestment in the association's housing stock with the balance being useable for any social housing activities.

### The private finance element

Once a scheme of social housing for rent or low cost home ownership has been approved for grant, associations need to ensure that borrowings can be put in place from a variety of private finance sources to fund the balance of the costs. These sources have been mainly banks, building societies and the capital markets. At the end of March 2001 £23.2 billion of private funding had been committed to the social housing sector in England, of which £17.4 billion had been drawn and was outstanding. These and the further figures below are taken from the Corporation and National Housing Federation Private Finance Monitoring Bulletin published in December 2001 (and available on their websites).

The total funding of stock transfer organisations, included in these global figures, was £9.7 billion committed and £6.5 billion drawn down.

57% of the drawn funding by all associations came from banks, 16% from building societies and 20% from the capital markets. Seven funders had committed more than £1 billion to the sector, and 19 more than £100 million. The five largest funders had together committed over 50% of the sector's total requirement.

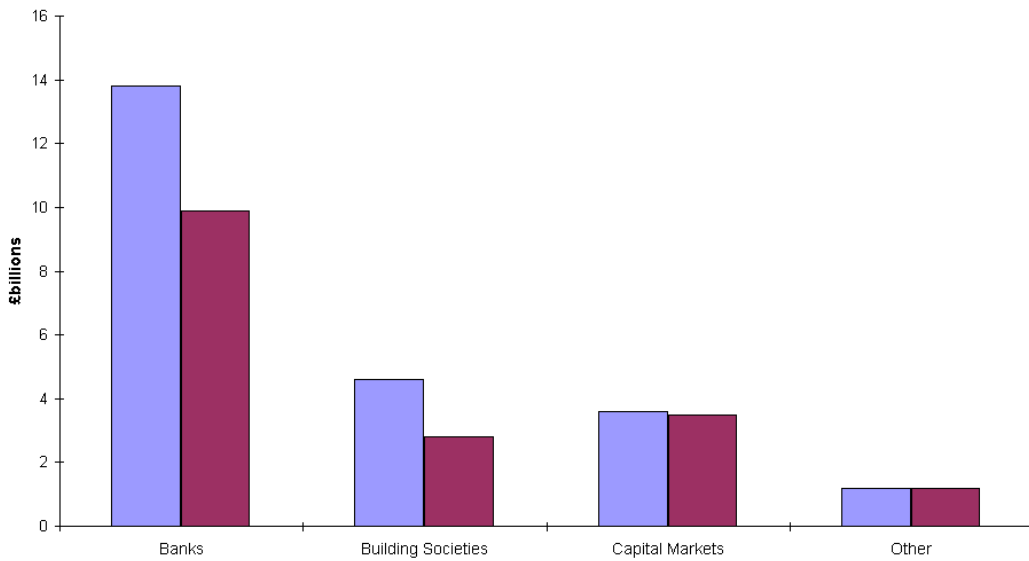
39% of all drawn borrowings were on fixed rates with a further 23% variable rate loans hedged by short to medium term fixings or by free-standing derivatives. Maturity profiles tend to be long – 80% of loans are at least notionally repayable in over 20 years. Almost 50% of these are on annuity or equal instalment of principal repayment terms, and a further growing proportion require no repayment in the early years but then periodic repayments towards the end of the loan.



**Private finance at 31 March 2001 by lender type**

	Facilities		Drawn	
	£ billion	%	£ billion	%
Banks	13.8	60	9.9	57
Building societies	4.6	20	2.8	16
Capital markets	3.6	15	3.5	20
Other	1.2	5	1.2	7
<b>Totals</b>	<b>23.2</b>	<b>100</b>	<b>17.4</b>	<b>100</b>
Drawn as % of facilities				75

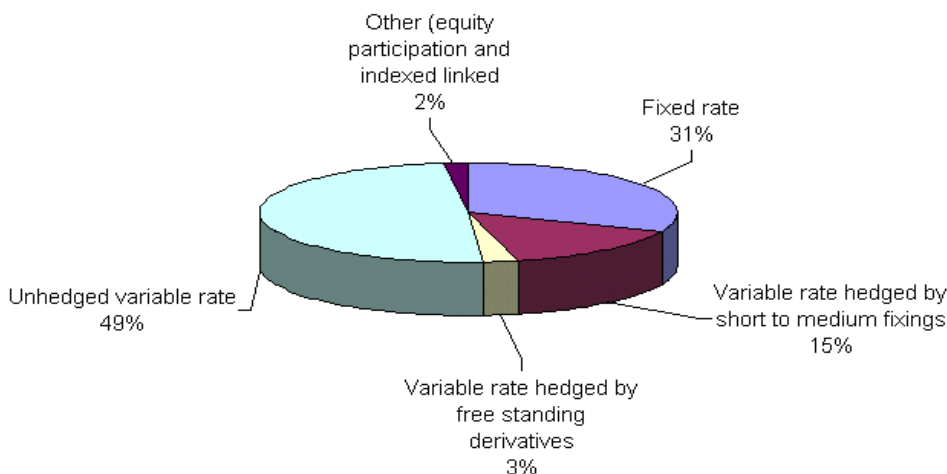
**Private Finance committed/drawn down by lender type (£billions)**



**Private finance at 31 March 2001 by loan type**

	Facilities		Drawn	
	£ billion	%	£ billion	%
Fixed rate	7.2	31	6.8	39
Variable rate hedged by short to medium term fixings	3.5	15	3.3	19
Variable rate hedged by free-standing derivatives	0.7	3	0.7	4
Unhedged variable rate	11.3	49	6.1	35
Other (equity participation and index linked)	0.5	2	0.5	3
<b>Totals</b>	<b>23.2</b>	<b>100</b>	<b>17.4</b>	<b>100</b>

**Proportion of total private finance commitment by loan type**



Source: National Housing Federation and Housing Corporation – Private Finance Monitoring Bulletin Issue 12

Estimates of private finance requirements published in the above Bulletin for the three years from 2002/03 were in the region of £11.1 billion, of which just over £6 billion was estimated to be required for stock transfers. This latter figure is now likely to be reduced, but the private funding requirements of the sector remain very considerable.

**Housing association property valuations**

Tenanted property carries a market value which is lower than the vacant possession value of the property. The value of housing association properties let under assured tenancies can be assessed either in terms of the present value of their rental income stream assuming continued social housing use (EUV, i.e. existing use value), or alternatively in terms of their value as loan security with the flexibility that a mortgagee in possession would have to increase rents or sell vacant properties (OMV, i.e. open market value – tenanted). Most lenders adopt the latter approach when considering asset cover covenants.

## **SECTION 6**

### **THE HOUSING CORPORATION**

#### **CONSTITUTION AND ACCOUNTABILITY**

The Corporation was established in 1964. Its functions were expanded in 1974 to include the registration, funding and supervision of housing associations. Its current constitution and powers are substantially laid down in the Housing Associations Act 1985 and in the Housing Acts 1988 and 1996.

The Deputy Prime Minister appoints the Corporation's board and the Office of Deputy Prime Minister's Permanent Secretary designates the Chief Executive as Accounting Officer. Each year the Corporation is required to produce an annual report to the Deputy Prime Minister which is then formally presented to Parliament. The Public Accounts Committee, acting on reports compiled by the Comptroller and Auditor General, has the right to call the Chief Executive as the Corporation's Accounting Officer to appear before it to give evidence.

The primary objectives of the Corporation are (Annual Review 2001/02):

- to regulate to promote a viable, properly governed and properly managed sector;
- to invest in the creation and maintenance of safe and sustainable communities;
- to champion a tenant focus among associations;
- to be a modern, customer-focused and forward looking organisation, leading change in the sector.

#### **REGULATION**

The Corporation has developed various regulatory approaches over the years, and from 2002 introduced a new Regulatory Code and accompanying guidance. It has had regard to the five principles of good regulation described by the better regulation task force- transparency, accountability, proportionality, consistency and targeting.

The approach is intended to be:

- outcome-focused, with the responsibility on associations to demonstrate how they meet and exceed expected standards;
- based on an expectation of work towards continuous improvement;
- based on objective judgements, formed on available knowledge;
- tailored, appropriate and proportionate to the risks associations face;
- consistent and transparent about the Corporation's judgements.

This is a move away from detailed scrutiny towards a responsibility placed on associations to monitor their own compliance. Boards are expected to consider an annual compliance statement. A regulatory plan is agreed between the associations with more than 250 homes and the Corporation. This leads to an annual and public assessment of the association's performance.

The Corporation expects to see a wide range of information from associations it regulates, some of which such as the business plan, will be produced for the association's own business purposes, some of which will be in specified formats and to specified timetables, such as financial forecast returns and continuous records of lettings and sales (CORE data). Corporation staff may, under the plans agreed, attend board meetings, carry out structured visits on particular subjects or seek more information after desktop review.

Inspection forms part of overall regulation, and focuses on service on the ground and the consumers' experience. A three yearly inspection cycle is intended. There are parallels with the inspection regime carried out by the Audit Commission with local authorities. Government has announced in summer 2002 that it intends to create a single inspection regime for local authority and housing association social housing.

The Regulatory Code itself has three main sections:

- **viability**, with expectations on adequate recourse to financial resources based on robust business plans and fulfilling loan agreement covenants, and on an effective framework for identifying and managing risk;
- **proper governance**, covering statutory and regulatory requirements, effective boards, probity, protection of public investment, responsiveness to residents' views and priorities, openness and cooperation in dealings with the Corporation and commitment to equal opportunity;
- **proper management** (see Section 3 – property management and resident services).

## REGISTRATION

Registration provides the framework within which the Corporation may exercise its statutory powers which are extensive. Statutorily, associations registered with the Corporation are described as registered social landlords. Registration is necessary in order for an association to receive transfer of social housing from a local authority or to access public funding, irrespective of source.

The registration process includes meetings, completion of application forms and a formal pre-registration visit before the application goes to the Corporation's Registration committee. Criteria include independence of the organisation, financial requirements, board control and managerial efficiency, general conduct and equal opportunities.

## STATUTORY INTERVENTION AND ENFORCEMENT

If an association runs into financial or managerial problems the Corporation has wide powers to act, and it uses these. The Corporation can order removal of a board member or employee of an association or suspend them for up to six months, and appoint new board members. It may appoint a person to conduct an inquiry into an association's affairs, bring proceedings for non-submission of annual accounts, require the production of books, accounts, documents, etc., freeze the finances of the association and direct the transfer of land to another association (with the consent of the Secretary of State). Under the Housing Act 1996 it can seek agreement of secured lenders, in the event for example of a default, to impose a moratorium of 28 days whilst solutions are found.

Intervention applies where serious concerns have been identified, and where the Corporation believes that an arrangement can be reached to deliver the necessary action to remedy the problem within an acceptable timetable.

Enforcement applies to associations where serious concerns have been identified and the Corporation believes the association is either unwilling or unable to deal with them satisfactorily. It is then likely that the Corporation would use its statutory powers.

The Corporation's regulatory activities have successfully ensured that, as stated by the recent National Audit Office report on the Corporation, "over the last ten years no lender has lost any money to a registered social landlord".

## **INVESTMENT**

The Corporation acts as the agent of government in distributing an annual allocation of resources to provide new affordable housing in areas of economic and demographic growth, to assist in the regeneration of deprived areas and to fund the provision of new supported housing. Each year it is given more specific targets by government, e.g. on rural housing provision and on ensuring that a high proportion of the construction cost element of new approvals are Egan compliant.

Regional, sub-regional and local authority priorities are agreed with a range of partners and stakeholders and published in regional housing statements and investment strategies. The Corporation funds housing for rent, including temporary social housing and works to existing stock. It also funds home ownership through a variety of schemes. In 2001/02 it spent £736 million on rented homes, and £90 million on home ownership. In addition it paid grant of £410 million on schemes which local authorities funded from their own capital provision, which were mainly rented schemes. Rental completions from both sources amounted to just over 26,000 homes, and about 4,500 home ownership properties were funded.

More details can be found at [www.housingcorp.gov.uk](http://www.housingcorp.gov.uk).

## Investing in Social Housing

### **SECTION 7**

#### **THE HOUSING FINANCE CORPORATION**

##### **HISTORY AND ROLE OF T.H.F.C.**

T.H.F.C. was established in 1987 as a result of a joint initiative between the Housing Corporation, the National Housing Federation (“NHF”) and the private sector. It specialises exclusively in raising private sector finance for registered housing associations (i.e. registered social landlords). As an independent financing vehicle T.H.F.C. raises funds by a variety of means including public secured bond issues, private placements and bank loans. By aggregating the requirements of individual housing associations it aims to achieve economies of scale for associations whilst providing a broadly based security portfolio for investors.

##### **CONSTITUTION**

T.H.F.C. is incorporated under the Industrial and Provident Societies Acts 1965-1972 as a not-for-profit corporate body with limited liability operating under Rules registered and approved by the Registrar of Friendly Societies (now part of the Financial Services Authority). It is controlled by a six person Board of Directors. The Housing Corporation and the National Housing Federation are both represented on the Board by their respective nominees. The other four members of the Board are selected to represent the private financial and commercial sectors. The Housing Corporation, the NHF and the four independent Board members each hold one fully paid share of £1, in T.H.F.C. These represent the entire share capital of T.H.F.C. although accumulated reserves now amount to £5.6 million.

The Rules of T.H.F.C. state that on a liquidation all the assets remaining after all liabilities have been met must be paid back to T.H.F.C.’s borrowers, past and present, on a basis to be determined by the Board.

##### **SUBSIDIARIES**

T.H.F.C. has established a subsidiary service company, T.H.F.C. (Services) Limited which provides all management and administrative services to T.H.F.C. and to its other subsidiaries. These are separately constituted entities, wholly owned by T.H.F.C. as non-charging subsidiaries and established to cater for the differing requirements of borrowers and investors.

##### **MANAGEMENT**

The senior team responsible for the daily management of the Group consists of professionals with housing, banking, treasury and accountancy backgrounds and qualifications. T.H.F.C. has appointed Trowers & Hamlins as Legal Advisers and PricewaterhouseCoopers as Auditors.

## PRINCIPLES OF FINANCINGS

T.H.F.C. has used a wide range of financing instruments including zero coupon, deep-discounted, index-linked, and conventional public debenture stocks; stepped and par coupon private placements; and fixed and variable rate bank loans. Without significant exception they have adhered to the following fundamental principles:

- T.H.F.C. has acted as principal, borrowing in its own name and on-lending the proceeds only to registered housing associations; Funds raised have been on-lent immediately;
- Funds have been on-lent on a similar interest and repayment profile thus ensuring that T.H.F.C. takes no risk on interest rate movements;
- No currency risk in relation to its funds has been taken either by T.H.F.C. or its borrowers;
- T.H.F.C. makes its own independent credit assessment of its borrowers and accepts or refuses applications accordingly;
- T.H.F.C.'s loans are fully secured and covenanted to an agreed minimum level, to which T.H.F.C. is legally bound. As an Industrial and Provident Society T.H.F.C. makes interest payments to UK registered investors without deduction of tax.

## CREDIT APPRAISAL

The creditworthiness of T.H.F.C.'s borrowers is carefully assessed prior to each loan being approved by the Credit Committee. This process seeks to ensure that T.H.F.C. can maintain its 100% record of full and timely payment of interest and principal to its investors. T.H.F.C. has developed its own credit criteria including a detailed analysis of its borrowers' accounts drawing out key financial ratios and performance indicators. The credit assessment is carried out in two stages. Firstly when an association first applies to be accepted on to the Approved Association Register its accounts are fully analysed, its rules checked and its latest Corporation monitoring report scrutinised. A meeting with T.H.F.C.'s Business Development Manager will normally take place at this point where management issues and business plans can be fully discussed. The second stage of appraisal takes place before a loan to the association is approved. This involves an updating check on the association, as above, together with an assessment of the viability of the schemes to be funded, consideration of the impact of the proposed loan on the association's overall finances and on its ability to offer adequate asset and income cover to T.H.F.C. and other lenders. T.H.F.C.'s level of exposure to individual associations is also taken into account. T.H.F.C. does not consider that size should be a determining factor in an association's ability to attract and support private finance. T.H.F.C.'s analysis of associations' creditworthiness has demonstrated no direct correlation between the size of the association and its financial strength. Many medium-sized and smaller associations have modest development programmes well within their managerial and financial capacity. They add geographical and asset diversity to the T.H.F.C. portfolio which encompasses associations ranging from those with over 20,000 homes in management to those with less than 500.

## **SECURITY REQUIRED BY T.H.F.C. FROM ITS BORROWERS**

### **Asset cover**

T.H.F.C. requires that a minimum of 150% asset cover is maintained for all its loans throughout their life, i.e. its loans are one and a half times covered by net assets. Asset cover is defined as housing land and buildings at depreciated cost in the balance sheet (or at valuation by a T.H.F.C. approved valuer) less 1.5 times all secured loans other than those made by T.H.F.C.

T.H.F.C. lends on two forms of asset security. Either T.H.F.C.'s loan is secured by a floating charge, i.e. a charge over all the assets of the borrowing association, and the association can dispose of charged property in the normal course of business provided that covenanted asset cover levels are maintained, or T.H.F.C.'s loan is secured by fixed charges over specific properties of the borrowing association and the association may only remove charged assets provided substitute security (where necessary) is provided in the form of property or cash.

Where an association's security is based only on fixed charges T.H.F.C. requires a current open market valuation of the charged property in its tenanted state. Typically this will produce a valuation of between 50% and 70% of the vacant possession value of the same property. T.H.F.C.'s secured loan must accordingly represent not more than 2/3rds of the tenanted value of the charged property. Within 18 months of loan draw down 90% of the associated fixed charges must be provided through fixed charges on property.

In cases where floating charges are provided as security, T.H.F.C. requires a similar tenanted valuation of the charged property if the asset cover for the loan in question calculated by reference to balance sheet values falls below 300%. The balance sheet calculation of assets for this cover test includes housing land and buildings at cost, adds net current assets and deducts both provisions and 150% of all other secured loans.

T.H.F.C. has to date typically required that associations providing floating charge security also give fixed charges in favour of T.H.F.C. over the properties on which T.H.F.C.'s loan is utilised. This is, however, not an obligation required by the terms of the Trust Deeds under which T.H.F.C. operates. Associations have the option to switch from floating to fixed charge-only security and vice versa with T.H.F.C.'s consent and subject to fulfilment of the appropriate covenants, including execution of any necessary deeds of variation to change the borrower's loan agreement.

Following amendment to THFC's trust deed arrangements, in certain circumstances, THFC is now able to offer borrowers who have taken out loans derived from the same stock, globalisation of security arrangements. This enables borrowers to aggregate security portfolios, allowing for greater asset efficiency.

### **Income cover**

T.H.F.C.'s loan documentation incorporates a number of provisions to ensure that all associations are able to make full and timely payments of principal and interest. Where fixed charges provide the sole security, at least 100% income cover must be certified on the basis of the rental income from the charged schemes after deductions for management and maintenance costs. Where floating charges are granted, at least 100% income cover must be available from within the income and expenditure account of the association.

### **Timing of payments**

In order to provide a further cushion, for example against possible administrative delays in payments, T.H.F.C. requires its borrowers to make interest payments to T.H.F.C. one month ahead of T.H.F.C.'s own obligations to pay interest to investors. T.H.F.C. retains the interest earned on the cash during the month as an additional source of income and future reserves.

### **Other T.H.F.C. on-going monitoring requirements**

T.H.F.C. requires that regular financial and operating information is made available by borrowing associations. This includes monthly reports on utilisation of loan funds, copies of performance assessment reports by the Corporation, annual reports and accounts, annual auditor's certification of asset and income cover and semi-annual certificates of compliance with non-financial loan covenants.

Five yearly revaluations of properties are required to ensure income and asset cover requirements are met.

### **SECURITY REQUIRED BY T.H.F.C. (SOCIAL HOUSING FINANCE) LIMITED**

As is the case with T.H.F.C., borrowers with T.H.F.C. (Social Housing Finance) Limited ('SHF') may give security by way of either a fixed charge or a floating charge.

A floating charge borrower must give a floating charge over all its undertakings and assets, present and future. Underlying fixed charges must be created by the second anniversary of the signing date of the loan over real property with an annual gross income equal to the interest due under the loan.

Where the fixed charge route is taken, the borrower may elect to value the fixed charge security portfolio on either an Open Market Value ('OMV') or Existing Use value ('EUV-SH') basis. Whichever basis is chosen must then apply for the total security package for the relevant loan facility. It is not permissible for a blend of OMB and EUV-SH basis to be used within the same security package. The valuation must provide for a minimum of 1.35 times asset cover for OMV valuations and 1.15 times for EUV-SH basis. Where any units are removed from the fixed charge security portfolio, substitute security (either in the form of cash or property) must be provided where the asset cover is below the permitted security withdrawal threshold.

### **SECURITY REQUIRED BY OTHER SUBSIDIARIES**

In order to offer flexibility to investors and borrowers, other subsidiary entities of T.H.F.C. were created as industrial and provident societies, limited liability companies and public limited companies, as appropriate. Borrowers from each of these entities have to meet the specific asset cover, income cover or cash flow obligations set out in their loan agreements. Potential borrowers from, and lenders to, T.H.F.C. and its subsidiaries can access full details of these requirements by contacting T.H.F.C.'s offices at [enquiries@thfcorp.com](mailto:enquiries@thfcorp.com)

## SECURITY OFFERED TO INVESTORS

Lenders to T.H.F.C. benefit from a floating charge over T.H.F.C.'s assets which are primarily its secured loans to associations but which also include its reserves. Thus investors' ultimate security is derived from the asset coverage provided by the borrowing associations as described above. All T.H.F.C. stocks and loans rank pari passu and are further protected by a negative pledge. T.H.F.C. covenants to its investors that it will maintain total operating expenditure within total income on a rolling three year basis.

T.H.F.C. is prevented by the terms of its Trust Deeds from on-lending to associations on weaker covenants than those specified. This form of security was designed to enable all investors to spread their risk across the whole range of instruments and borrowers who are widely distributed both geographically and by size.

## RISK WEIGHTING

The security offered by T.H.F.C. has enabled it to attract a 50% risk capital weighting from the Bank of England in line with the 50% weighting on direct secured lending to housing associations.

## OPERATING INCOME AND EXPENDITURE

T.H.F.C. covers its own administrative costs by charging fees on its lending operations. It has successfully operated in surplus since its incorporation in 1987.

At 31 March 2002 T.H.F.C. had accumulated consolidated reserves of £5.6 million and because of its not-for-profit status these remain as non-distributable liquid reserves.