Chapter 2

Funding housing associations: changing models for changing times?

Peter Williams, Piers Williamson and Samuel Marlow-Stevens

Readers of the *UK Housing Review* over the last two decades or more will be familiar with the case repeatedly made for a stronger government commitment to funding higher levels of social rented housebuilding. The call for more government support has perhaps overshadowed the fundamental changes that have taken place in the same period in the core funding models operated by housing associations across the UK. In the main the adjustments have been driven by the need to secure more funding at a cost and on terms commensurate with delivering social and now affordable housing. In so doing we have seen an evolution in the funding market itself, in terms of who provides funding and how, and that process continues. This chapter provides an overview and assessment of the observed changes. Although the detail is about English associations the agenda it covers is UK-wide.

In the beginning

The story is broadly one of a 'long march' from the late 1980s, leaving behind a predominantly grant-led framework[1] and arriving at a mixed-funding regime comprising reduced grant alongside private finance.[2]

It is worth remembering that in 1981 the social sector provided around a third of all housing in the UK; local authorities were still the dominant providers with 29 per cent of the total UK housing stock while associations had just two per cent (see Compendium Table 17). The social sector was of course a bigger proportion in Scotland with 54 per cent in total and in Northern Ireland with 39 per cent. However, local authority borrowing counted as public sector borrowing and was thus subject to Treasury cash limits. Associations were not bound in the same way and could borrow freely, a distinction seized upon by the Conservative government with the passing of the Housing Act 1988, and a fact now accepted by all political parties. The new legislation paved the way for reduced grant rates while at the same time allowing associations to access private finance and set their own rents to cover costs up to market levels.[3]

Crucially, this was underpinned by the continued provision of housing benefit. In a debate on housing association rents in January 1991, housing minister Sir George Young responded to a question from the shadow minister Clive Soley, as follows (Hansard, 1991):

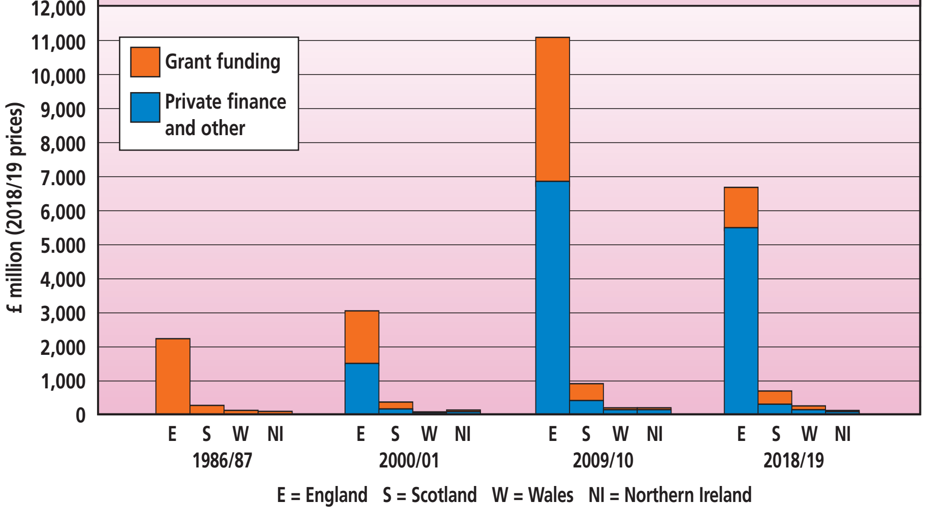
> *I do not accept the premise on which the hon. Gentleman based his question. Housing benefit will underpin market rents[4] – we have made that absolutely clear. If people cannot afford to pay that market rent, housing benefit will take the strain.... I repeat that the housing benefit system exists to enable people to pay their rent. There can be no question of people losing their homes because they cannot afford to pay reasonable rents.*

The Housing Corporation (HC) was founded in 1964 to oversee a mix of cost-rent and co-ownership societies plus a mix of other associations and trusts in what was still a small niche in housing policy and provision.[5] The 'sector' typically worked through local authorities with varying degrees of success and enthusiasm on both sides. At this point the government was providing 100 per cent development finance through the Public Works Loan Board with a focus on cost-rent schemes, though in practice co-ownership schemes found more favour, not least because building societies were also willing to provide funding. The Housing Act 1974 introduced the registration of housing associations and provision of housing association grant (HAG), aimed at bridging the gap between development costs and 'fair rents.'

Private finance

As noted earlier, experiments with private finance had begun in the 1970s, stimulated not least by cutbacks in public expenditure after the 1976 IMF intervention in the UK. From 1985 onwards, part of the development programme was devoted to schemes where HAG was fixed at 30 per cent, aided by free land, index-linked finance and revenue grants to keep rents low. By 1988/9 some 80 different funders had been approached by the HC and the new era of private finance was truly underway. Private finance for the whole of Great Britain totalled only £33 million in the year 1987/88. At today's prices, by 1997/8 it reached £1.8 billion, peaked at almost £8 billion in 2009/10 and, forty years from inception, was £6 billion in 2018/19. By that same year total drawn facilities stood at £77 billion in England and £6 billion in Scotland; in 2017/18 they stood at £3.4 billion in Wales and £1 billion in Northern Ireland. Figure 1.2.1 gives the broad picture of how housing association finance has evolved by showing total investment and how it was financed (by grant funding or by private finance or other funding sources), for selective years.

Figure 1.2.1 **Gross UK housing association investment by country – real terms**



Source: Compendium Table 60.

The mixed funding model took off, and by 1989/90 some 69 per cent of the English social rental programme was mixed-funded (alongside 100 per cent of shared ownership), with an average grant rate of 75 per cent. Throughout the 1990s grant levels were eroded and there was increased reliance on private finance and housing benefit: the number (and percentage) of housing association tenants in receipt of benefit rose from 320,000 (and 54 per cent) in 1988 to 1,752,000 (70 per cent) in 2018. This contributed in part to an ever-greater emphasis on mergers and the search for cost reductions in these larger organisations.

LSVT organisations turned to 'high street' lenders for private finance in this period. While conventional HAs continued to use secured-mortgage finance, usually with multiple creditors lending on generally similar terms, LSVT organisations operated on a model closer to project finance, with stock secured to a single bank to achieve long-term, low fixed-rate debt to fund the improvement work to the stock that was their initial priority.

The significance of stock transfer in the growth of the sector

Over 200 large scale voluntary transfer (LSVT) associations were established, with stock holdings exceeding those of the traditional housing association sector, some financed by the Estates Renewal Challenge Fund. Over 40 per cent of those set up as independent associations have subsequently established or joined together with others to form group structure arrangements.

By 2007, over half of the transfer associations operating as subsidiaries (over a quarter of all transfer HAs) were members of groups which also involved traditional (non-transfer) associations. Such mergers widened association's geographic base and scope as well as bringing new land and financial capacity.[6]

See Compendium Table 68 for details of transfers in England up to the present day.

Pioneered by The Housing Finance Corporation, 1998 marked the entry of the European Investment Bank (EIB) into the UK social housing finance sector. By 2018 it had lent more than £4 billion to UK social housing. The EIB provided almost half of the £3.2 billion of funding under the last Affordable Homes Guarantee Scheme through £1.5 billion of long-dated loans and has begun to embark on direct deals with housing associations, with around £1 billion of deals so far in both England and Scotland. Despite Brexit the UK government hopes to continue working with the EU's non-profit bank.

Underlying business models

Until two decades ago most but not all associations were solely focussed on the provision of rental housing. A small but significant minority also provided shared ownership, which gave them access to a regular stream of capital receipts from first-tranche sales along with uplifted values when the shared owners 'staircased out' into full ownership. This in turn reduced reliance on long-term debt. These two relatively simple models dominated the housing association landscape up to the early 2000s.

The surge in merger activity in England following the 1988 Act and LSVT initiatives was repeated after 2004 when sector restructuring was triggered by reforms which concentrated development funding on the 70 or so 'best developing associations' under the Investment Partnering procurement initiative. Subsequently we have seen a number of ‘mega’ mergers between large associations e.g. the 2016 mergers between L&Q and East Thames, and between Affinity Sutton and Circle to form two ‘FTSE 100-sized behemoths’[7] as well as mergers between medium-sized associations recognising the need for scale. There were 42 mergers between housing associations in England in 2018, and a total of 171 such deals in the five years from 2013; a clear indication of the intensity of activity on this front.[8] Alongside mergers (and group structures) we have seen other forms of collaboration e.g. joint ventures, procurement consortia, shared services and private/public partnerships, all of which can increase development capacity, secure cost savings and in theory at least reduce risk.[9]

The 2007/08 Global Financial Crisis (GFC) had particular significance for the funding of the housing association sector across the UK. The aftermath saw a rapid shift away from what had been a well-established market for long-term bank debt, as well as further cuts to grant funding and welfare support. As banks sought to reduce loan terms and renegotiate existing lending there was a progressive shift back towards bond finance, including private placements and retail bonds (and in a small minority of cases unsecured debt). To illustrate the scale of the switch, in total since 2008 there have been approximately 140 public bond finance issues, compared to an average of one or two per year before 2008.[10]

With a renewed focus on building as the ‘housing crisis’ took political form and importance, the government developed the 2013 Affordable Homes Guarantee Scheme to stimulate housing association activity through guaranteed bond-financed loans. As this suggests, bond issuance dominated the post-crisis landscape, but by 2013 shorter-term bank debt was back in first place at around 60 per cent of total new funding in the year. By mid-2019 roughly £100 billion of private finance (drawn and undrawn) was in place in England, £61 billion of which was bank debt and £37 billion from the capital markets. Private finance enabled housing associations to weather the post-crisis years, leading to Greg Clark, then Secretary of State of Communities and Local Government praising the sector for its ‘keep calm and carry on’ attitude.[11]

Yet the shift in the funding base and the grant regime naturally impacted business models and treasury management. Associations recognised that there was considerably more uncertainty in their markets than had perhaps been appreciated. This led to rethinking about business models and their reliance upon grant or bank debt. Over time we have seen more associations building up their activity in the shared-ownership market and most recently in the private sales and rental markets so as to meet what were seen as legitimate needs, as well as diversifying their business model. The shift from first grant and then rental subsidy to cross-subsidy through development of market-sale properties became notable in this period. Some associations have gone further, moving into other areas such as care provision, employment initiatives and housebuilding. This type of activity has increased over the years albeit with variable outcomes in terms of profitability. In addition, as the *Review* has chronicled, we have seen the rise in provision of homes at Affordable Rents whether as new build or conversion from the existing stock (see Commentary Chapter 4).

In 2014 in England non-core social housing activity[12] increased by 25 per cent to £2.3 billion with 34 social landlords generating a fifth of their turnover from this area. In 2018 income from non-social housing and shared ownership increased to £4.75 billion for the period, up over ten per cent on the year. Cross-subsidy had become a very important component of overall funding capacity. However, this model itself is now coming under pressure, partly because of the slow-down in prices and transactions, and rising costs.[13] The 2015-2019 rent cuts, coupled with the shift in the rental uplift basis from RPI+ to CPI linked, added another layer of constraint, especially given that housing association rents are a key assumption for long-term lenders to the sector. If the flow of subsidy from sales is reduced, housing associations may have to reduce output. Indeed, the new liabilities emerging around leaseholders and landlords in terms of upgrade costs to apartment blocks following the Grenfell fire are now generating very considerable new pressures.

Although every effort is being made to expand output, it can be argued that the underlying capacity of the housing association sector to build new homes (especially some of the larger associations on which so much depends) has the potential to weaken as a consequence not just of reduced grant but also because of reduced cross-subsidy income and increased borrowing. This can result in higher gearing and reducing interest cover. The evidence does suggest that slowly more associations will be edging towards practical limits as the scale of borrowing begins to outstrip the generation of assets and income which would normally compensate for that.[14] Clearly this will not be a universal truth – much will depend upon individual expansion plans, borrowings and reserves. However, it is still fundamentally a debt-funded market and, with constrained grant, borrowing stands at the heart of the business.

And now?

Housing associations now have significant assets in the form of their housing stock and alongside this a substantial rental and sales income (see Compendium Table 71). They are substantial businesses. The 2018/19 global accounts for England note:[15]

> *The total value of housing assets held by the sector increased by £7.9 billion to £164.1 billion. This includes £150.8 billion of social housing properties held for rent, £6.2 billion of investment properties (predominantly market rent) and £7.1 billion of properties held for sale (mainly land and properties under construction).*

Little wonder then that the sector and indeed the business streams it represents have attracted ever more attention from the private sector.[16] As a recent Savills report on private money and affordable housing comments:[17]

> *The affordable housing sector has the same favourable long-term structural demand drivers, liability matching return characteristics, potential for growth and insulation from volatility that has drawn investors to other residential sub-sectors. It also offers the best opportunity for social impact and long-term investors are increasingly looking for ethical opportunities.*

Private investors have begun to buy into housing association shared ownership, as well as buying into the associations and then leasing the properties back.

For-profit registered providers (FPRPs) were first permitted by the Housing and Regeneration Act 2008 and the first was registered in 2010. By 2019, 46 FPRPs provided data to the Regulator of Social Housing, holding in total around 6,000 homes (of which about 45 per cent were shared-ownership). To date most FPRPs have acquired homes through section 106 agreements, leading to concerns that they are bidding up prices. Major players such as Legal and General have entered the market with a FPRP and the Blackstone equity fund-owned Sage has set an ambition to provide 20,000 homes. To date most of the management has been outsourced – mainly to existing housing associations. In addition, a small number have bought into supported housing – buying up homes and then leasing them back to associations. A recent regulatory report exposed failures of governance and conflicts of interest which suggests this might be a more problematic investment than first appeared.[18] Its intervention caused the share price of real estate investment trusts linked to the social housing sector to fall. At present for-profit associations do not operate in Scotland, Wales or Northern Ireland.

As the squeeze on the resources of not-for-profit providers continues so the pressure to unlock some of their existing capacity may grow, e.g. from the sale of shared-ownership portfolios, thus giving further momentum to the FPRP sector.

Where next?

The result of the 2019 general election provided a hitherto absent degree of political certainty. The new government appears committed to homeownership as the heart of its housing policy, much like the Cameron administration. Notwithstanding the recently recorded small increases in homeownership bolstered by Help to Buy, the tenure now stands at levels comparable to the early eighties while the mainstream PRS market has largely been built around homes acquired from other tenures (rather than new build). Although new supply has increased overall, it is the shortage of affordable homes in all sectors that is most evident: thus the search for new sources of funding.[19] Little wonder that we have seen the emergence of homelessness as a key political issue and with continued low revenue support to local authorities, highly subsided areas like homelessness services became increasingly difficult to sustain.

Since the Grenfell fire there has been ever-greater recognition of the urgent need for and the spiralling costs of remedial fire-safety works across the sector. This looks set to be a growing factor in the financial appraisal of housing associations, and together with homelessness has highlighted once more the question of whether grant levels are adequate given the sector's attempts to both develop new homes and provide for existing tenants.

A new Affordable Homes Guarantee Scheme is due to arrive in 2020, cementing government-guaranteed bond-financed loans as a fixture of housing association funding for the foreseeable future. With no increase in grant on the horizon,[20] the potential arrival of the long-mooted shared-ownership 'right to buy' and the coming rise in housing association rents after four years of reductions (rising by CPI plus one per cent for five years in England, with different rules applying in the other UK countries), it seems evident that the government's approach to the sector will perpetuate the mixed-funding model. This follows on from all post-2010 governments who have emphasised 'building and selling' as the future of the sector, with the added benefit of private finance not counting as public sector borrowing.

Having said that, it is clear that private equity in one form or another is likely to play an ever-bigger part in the picture. It was recently announced that both L&Q and Hyde are exploring bringing more private equity into their commercial subsidiaries and strategic partnerships. Homes England has also moved closer to such arrangements alongside building its relationships with the private sector, e.g. having its own housing delivery fund in partnership with Barclays.[21]

In the wider world there is a new investment focus on environmental, social and governance (ESG) criteria related to climate change, innovation and social purpose. Evidence of ESG activity is now seen as vital to understanding corporate purpose, strategy and the management quality of companies and this has become a key assessment marker for investors to the extent that around a quarter of the world's professionally-managed investment funds now only invest in companies that demonstrate solid ESG credentials.

Whether the sector's ESG performance could attract new investors and investments which in turn might impact the cost of private finance is unclear at this stage. However, with decarbonisation targets for homes looming, along with the current need for fire safety works, there is much to highlight to investors. With continued pressure on budgets, ESG-related finance possibly has the potential to become an important feature of the future market.[22] Perhaps even more radically there would seem to be a recognition that vehicles that blend for-profit and not-for-profit sectors will emerge over time. The fact that large groups such as Places for People consist of 20 companies operating towards a common goal is indicative of what future models will look like.

Conclusions

As with all financial structures and business models there has been evolution over time. The housing association sector is focused on long-term arrangements that must cope with the economic cycle and not expose its tenants and residents to the risks that the cycle might generate. As the sector has moved forward since the 1980s so its exposure to the market has increased, not least through ever more mixed-funded and cross-subsidy arrangements. As the sector has matured, grant has diminished but its asset base has also grown, providing greater capacity to engineer new solutions. Overall, mixed funding is likely to remain the core model over the next decade, but for some of those who are increasing their gearing it may become a growing constraint, which in turn will require new solutions. All the evidence suggests that private equity will be one of those solutions.

Notes and references

1 At around 85% grant; see Lomax, G. (1996) 'Financing social housing in the United Kingdom', in *Housing Policy Debate*, 6(4), 849-865. For the purposes of this article we are setting aside earlier models, including the model dwelling and charitable trusts such as the Metropolitan Association for Improving the Dwellings of the Industrious Classes founded in 1841, the Peabody Donation Fund in 1862 and the Guinness Trust in 1890. The model dwelling organisations relied on raising share capital and loan stock from private investors expecting a rate of return. Charitable trusts were funded by rich individuals and probably accepted a slightly lower rate of return from the endowments they made.

2 For an overview, see Heywood, A. (2016) *Investing in affordable housing: an analysis of the affordable housing sector*. London: THFC; Williams, P. and Whitehead, C. (2015) 'Financing affordable social housing in the UK: building upon success', in *Housing Finance International*, Summer 2015, pp.14-19; Garnett, D. & Perry, J. (2005) *Housing Finance*. Coventry: CIH, Chapter 14.

3 There had been some 'experiments' with private finance in England and Wales in the preceding years which indicated there was appetite/ capacity in the private market to provide funding in a variety of forms, e.g. senior debt, index-linked bonds, guarantees. The first scheme was in 1986 at St Mellons in Wales where the Halifax provided funding and Cardiff City Council land and infrastructure, while Abbey National funded North British HA to buy 3,200 ex-GLC homes; the Housing Finance Corporation was launched to provide a permanent vehicle for raising such funds.

4 Rent allowances covered rents of benefit recipients in both the housing association and private rented sectors.

5 For an excellent and detailed account of the history of that body and the housing association movement over the period to 2008 when the HC was replaced by the Homes and Communities Agency, see Murie, A. (2008) *Moving Homes: The Housing Corporation 1964-2008*. London: Methuen.

6 Pawson, H. & Mullins, D. (2010) *After Council Housing: Britian's new social landlords*. Basingstoke: Palgrave Macmillan; Bortel, G. *et al* (2010) 'Change for the Better?'-Making sense of housing association mergers in the Netherlands and England,' in *Journal of Housing and the Built Environment* 25(3), 353-374.

7 See Morrison, N. & Szumilo, N. (2017) *Empire building? Analysing the drivers towards mega-mergers in the English housing association sector*, European Real Estate Society conference 28 June – 1 July 2017, Delft University.

8 See for example the merger of Radian and Yarlington (www.socialhousing.co.uk/news/merger-unlocks-100m-capacity-as-associations-tap-into-embedded-value-64163).

9 See Scanlon, K., Whitehead, C. and Le Blanc, F. (2017) *The future social housing provider*. Norwich: Flagship Group.

10 See www.lexisnexis.co.uk/blog/docs/default-source/loan-ranger-documents/jibfl_2019_vol34_issue1_jan_pp15-18.pdf

11 In a speech (2015) to Placeshapers, a HA network (see www.gov.uk/government/speeches/housing-associations-and-housebuilding).

12 Non-core is made up of diverse activities. Though the majority of this turnover comes from housing, e.g. building for sale, shared ownership, student accommodation and properties let at intermediate rents, a small part is also derived from rent of commercial property, including garages, and activities such as electricity generation, nursing care and facilities management.

13 At a recent conference on *Homes for Londoners* both the Mayor of London and the L&Q group director for development and sales described the cross-subsidy model as 'not working' and 'absolutely bust.' However, it is noted in the Regulator of Social Housing's April-June 2019 Quarterly Survey that despite challenging conditions 'the sector intends to pursue the cross-subsidy model at an increased scale in the next 12 to 18 months' (see www.gov.uk/government/collections/quarterly-survey-of-private-registered-providers).

14 See Wharfedale Associates (2016) *G15 Capital Structure and Gearing Study*, White Series #3 (www.wharfedaleassociates.com/white-series).

15 See Regulator of Social Housing (2019) *Global accounts of private registered providers* (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/852013/2019_Global_accounts_of_private_registered_providers.pdf). The English market is the most diversified in terms of income streams and least reliant upon grant: Compendium Table 71 gives details. For equivalent discussions in Wales, Northern Ireland and Scotland see: Community Housing Cymru (2019) *The 2018 Financial Statements of Welsh Housing Associations*. Cardiff: CHC; Northern Ireland Federation of Housing Associations (2019) *Sector Global Accounts*. Belfast: PWC and NIFHA; Scottish Housing Regulator (2019) *Summary of the findings of our analysis of RSL loan portfolio returns at 31 March 2019*. Glasgow: SHR.

16 See Riddy, A. (2018) 'Investment funds have found a new cash cow: social housing,' in *New Statesman*, 9 March.

17 Savills(2019) *Private Money and Affordable Housing*, Spotlight (see www.savills.co.uk/research_articles/229130/293448-0/spotlight—private-money-and-affordable-housing).

18 Regulator of Social Housing (2019) *Lease-based providers of specialised supported housing: Addendum to the Sector Risk Profile 2018*. London: RSH.

19 For a discussion of ideas, see Gibb, K. (2016) *Funding new social and affordable housing: Ideas, evidence and options*, CaCHE Social Housing Working Group Paper 05. Glasgow: University of Glasgow.

20 In an answer in the House of Commons on 13 January the Secretary of State commented 'In our manifesto, we said that we would create a successor to the affordable homes programme that is at least as generous.'

21 See www.home.barclays/content/dam/home-barclays/documents/news/2018/barclays-homes-england-fund.pdf; see also IPF (2015) *Prospects for Institutional Investment in Social Housing*, (www.ipf.org.uk/resourceLibrary/prospects-for-institutional-investment-in-social-housing—february-2015-major-report.html).

22 See the recent *Social Housing* interview with Hyde CEO, Peter Denton (see www.socialhousing.co.uk/insight/insight/hyde-ceo-physical-stock-is-the-biggest-challenge-facing-sector-64674).