RESIDENTIAL RESEARCH

2009

AFFORDABLE HOUSING

Review

Knight Frank

HIGHLIGHTS

- The affordable housing sector has not escaped the recession and credit drought that have turned the UK housing market upside down over the past two years.
- Despite lower house prices, affordability is still a serious issue. When we consider the availability of mortgage finance, the housing market is arguably more unaffordable and inaccessible for new entrants now than at the 2007 market peak.
- How we deliver affordable housing in the future will be very different from how we did in the past – the nature of grant aid, products and tenure range are all undergoing review. This is a critical period for setting policy for the next decade.
- In this review we examine how the recession has changed the market for affordable housing, and how wider political changes are beginning to impact on thinking and activity in the sector. We identify the key issues for developers, investors, housing associations and policy makers.

AFFORDABLE HOUSING WILL COME OUT OF THIS RECESSION AS A MORE SIGNIFICANT FORCE

The recession will change everything

The affordable housing world will be changed for good by the current recession. The established certainties about how land, housing and subsidy were provided to the sector are over. Even the apparent consensus regarding who has a right to subsidised housing, and for how long, is breaking down.

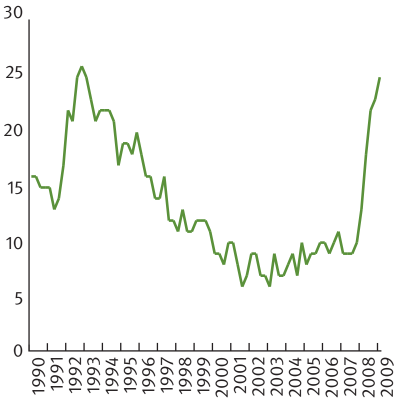
So why the radical change? In a nutshell – lack of money. The private sector will not have significant spare money for several years to subsidise new development and the public purse is empty. The sector needs to do more with less, meaning that affordable housing providers will need to become far more self reliant, and will need to work their existing assets harder (in some cases by implementing more aggressive asset management strategies in respect of their existing holdings) to support more development.

If the above comments sound apocalyptic they shouldn't – there is better news from the immediate aftermath of the downturn. As in previous recessions, the affordable sector has remained relatively resilient and its contribution to construction levels has increased. Whereas private sector new-build starts in England fell by nearly 65% in the first half of 2009 compared with the same period during 2007, starts in the affordable sector actually rose by 11% over the same period. In fact, the annual rate of completions of affordable units in England hit a ten-year high in the first half of 2009 at more than 26,000 units.

The divergent fortunes between the private and affordable sectors can be partially explained by emergency government funding for development schemes. This has led to the transfer of private units to the affordable housing sector – and also to the greater financial security of housing associations compared to private developers.

The affordable housing sector will come out of this recession as a more significant force in the housing sector. In 2007 the private sector accounted for 91% of all housing starts, in mid 2009 the figure was 75% and shrinking (see Figure 1).

Figure 1
RSLs to the rescue
% of all new build starts attributable to RSLs and local authorities



Source: NHBC, CLG

The private sector will recover, but the opportunity for the affordable housing sector to influence the future of housing delivery – through site acquisition and the development of new products, especially intermediate and private sector rented housing, is significant.

Lower prices do not mean improved affordability

The recent long boom in UK house prices helped to create a crisis in housing affordability. Price falls since October 2007 have not led to an automatic improvement in this situation.

In mid 2007 the typical first time buyer bought a property priced at 5.4 times their annual salary. Falling prices since 2007 meant that by mid 2009 this ratio had fallen to 4.2. This is an improvement, but still represents a level well above the 3.3 long-run average (see Figure 2).

The house-price-to-earnings ratio is only a small part of the picture and for many first time buyers it remains almost academic. Their real concern is access to mortgage finance in the first place. By the summer of 2009 a typical deposit for a first time buyer was expected to be 25%. The difference between the mortgage rate awarded for a 10% rather than a 25% deposit was a full 200 basis points.

The impact of the creation of this two-tier market can be seen in the proportion of income a first time buyer needs to dedicate to servicing a mortgage – which peaked at 24% (according to the Halifax) in late 2007. Despite 15% to 20% price falls in the interim, the proportion of income spend on mortgage costs only slipped to 23% by mid 2009 – due to the more onerous cost of finance for equity-poor borrowers. The reality for most first time buyers is that the promise of a more affordable housing market following the market crash has not been realised. As we discuss in the next section – this lack of opportunity for those struggling to access the market is likely to get worse and not better over time.

Demand rises but supply crumbles

According to the most recent government projections, each year up to 2031 will see the formation of over 252,000 net additional new households in England.

While new housing supply increased over the last decade, the annual rate peaked at 175,000 in late 2007. This means that even before the current crisis housing demand significantly outstripped supply. Following the 2007 market crash, new-build delivery has collapsed (see Figure 3). It seems likely that fewer than 100,000 homes will be built in 2009, with only a slight increase in 2010 as a result of the very low number of starts in recent months.

Notwithstanding our comments on demand versus need, which are detailed in the box opposite, the fact remains that we are not building enough housing. This is especially true in the south of England, and the affordable housing sector is only able to bridge part of the gap.

Unpalatable issues: demand and need

It is useful to query the basis of official housing demand estimates. The disjuncture between apparent demand and actual supply is so vast that it seems barely credible that overcrowding and homelessness (admittedly larger issues than they were) are not much more visible.

There is a confusion in policy debate between housing demand and the very different concept of need. A bigger population needs more housing, record net inward migration translates into greater need for housing. But also we have more demand through higher consumption. We have record second home levels (250,000 in England), record numbers living alone (33% of all households in 2009), record separated and divorced couples and a record student population.

It is not just that we need more housing – but also that lifestyles dictate greater demand for housing. The resulting problem of high market demand is felt most strongly by low income households who exercise virtually no choice in the market – whereas higher income households consume evermore housing.

On the supply side, sufficient accommodation has not been provided for several decades, meaning that we do not build enough properties to meet demand - or at least at a rate that permits the market to set a clearing price accessible to all households.

No political party has felt able to articulate the problem caused by lifestyle demand because the logical solution, that the consumption of housing would need to be taxed sufficiently to reduce demand, is pretty much politically impossible. We should therefore accept that we will be forced to continue relying on ad-hoc solutions to ration available supply to particular groups who appear to have the greatest need.

THERE IS CONFUSION BETWEEN HOUSING DEMAND AND THE VERY DIFFERENT CONCEPT OF NEED

Unpalatable issues: the incredible expansion of affordable housing

One of the most notable changes in affordable housing policy has been the growth of the groups eligible to apply for subsidised housing. The growth of 'key worker' schemes since 1997, which initially targeted help at low paid public sector workers, morphed into schemes that were accessible to head-teachers and other senior and relatively well paid public sector employees.

In the UK £60,000 of household income has been the accepted limit for eligibility for access to most shared ownership schemes – there is talk of this limit being raised to £74,000 in the capital. In London Boris Johnson, the Mayor, has equated eligibility to cover everyone paying basic rate income tax.

Affordable and social housing policy has been designed to meet the needs of a far broader and wider demographic than that which it was first intended, and now which includes the relatively affluent and professional.

It is reasonable to ask – how on earth we arrived at this position where more than 90% of UK households are potentially eligible for state aid to cover their housing costs – and can the state afford the policies that it has set itself?

Housing support and development economics

A quick guide to grant

Housing support in England is provided in two ways. The first is 'revenue grant', aimed at supporting the monthly housing costs of occupiers, either direct to tenants in the form of housing benefit or, in certain circumstances, to providers of special needs housing. The remaining subsidy arrives in the sector via 'capital grant' – generally for the subsidised construction of housing. Capital grant is managed by the Homes and Communities Agency (HCA).

The type of affordable housing being developed dictates the level of capital grant required. Social rent is the most expensive, at £67,932 per unit on average, rising to £113,775 in London. Intermediate rent is noticeably more expensive than low-cost home ownership, at £44,023 per unit (£55,840 per unit in London). The two major forms of low-cost homeownership – NewBuild and OpenMarket HomeBuy – cost £30,829 and £34,960 per unit on average, respectively.

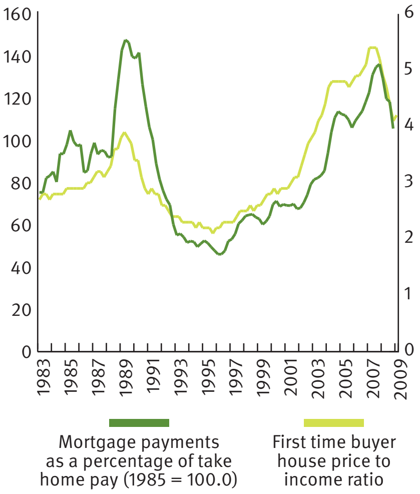
Given these relative costs, it is unsurprising that the government has increased the number of low-cost homeownership products over the past few years – put simply, two low cost homes can be provided for the same cost as one social rented unit (almost three in London). Most of these products offer some form of shared equity or ownership, where occupiers buy a percentage stake in the property, sometimes paying rent on the remainder.

Over recent months, a backlog of unsold homes has built up as many banks have become extremely averse to lending on what they see as a risky product. In response, the HCA and local authorities have tried to increase the amount of intermediate rental products they are offering. Their ability to do this is limited by the fact that, on average, 30% more grant is required.

Pressure on grant funding

As land and sales values have fallen, developers have increasingly found section

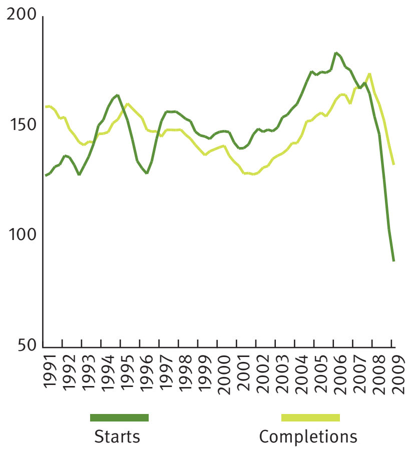
Figure 2
Affordability improves – slightly
House price to earnings ratio and mortgage payments



Source: Nationwide

106 agreements, which specify what level of community infrastructure ought to be provided as a condition of a planning consent, becoming impractical and in need of renegotiation. Meanwhile, planning consents for new schemes are unlikely to feature a similar level of non-grant-funded units. Consequently, the importance of grant as the major source of social housing support will increase. At the same time, the system will also come under scrutiny over the next few years as public spending is cut back.

Figure 3
New-build delivery in freefall.
Housing starts and completions in England



Source: NHBC, CLG

For example, the use of grants to fund intermediate housing, particularly low-cost homeownership, is likely to be questioned. Housing associations and other providers may have to seek ways of providing shared ownership or equity housing without grants. The private rented sector (PRS) is one alternative being considered.

As we discuss below, the HCA is looking closely at the potential of the institutionally backed PRS. This initiative, which may involve some form of rental guarantee or co-investment could prove a better model for the use of government funds than the intermediate sector, while helping to deliver much-needed new homes. Models along these lines may well help to provide housing for the vast increase in middle-income earners and families who will be unable to afford owner-occupation over the next few years.

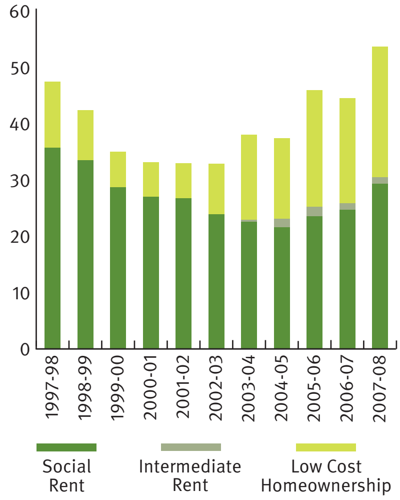
THE IMPORTANCE OF GRANTS AS THE MAJOR SOURCE OF SOCIAL HOUSING WILL INCREASE

New thoughts on grant funding

Some in the sector are calling for capital grants to be scaled back and replaced by a portable ‘revenue grant’, which those qualifying for social or affordable housing can use to fund or part-fund the accommodation of their choice. This could take the form of a sliding scale of benefit that varies according to income and location. Recipients could use it to contribute to the cost of a shared ownership or open market home, or even towards private rental costs.

Ultimately, this transfer of benefit from the home to the individual or family would lead to the accelerated decline of the traditional social housing model. The hope would be that developers and affordable housing providers would be incentivised to deliver a greater volume of homes in response to this

Figure 4
A more diverse sector
Affordable housing completions, England (000s)



Source: CLG

increase in ‘market’ demand. With control over the type of home transferred to the individual, the amount of choice in the marketplace should increase.

The change in grant policy, combined with the growing demand from middle-earners for affordable homes, will mean housing associations and developers will have to be far more flexible in terms of the tenure types offered. Rental homes would have to be offered on a much larger and more professional scale. In addition to traditional owner-occupation, these providers would have to offer forms of shared equity that respond to the buyer’s situation and ability to purchase (as well as, in some cases, the level of grants available).

Currently, many mortgage providers are unwilling to fund shared purchases as they believe these loans are inherently risky. There is a need to convince lenders that these packages potentially offer more security than traditional home loans, as housing associations or developers bear most of the risk. However, this risk could be further reduced if flexible models are more widely adopted in which occupiers could ‘staircase down’, selling some or all of their stakes back to the provider, and paying more rent in return, if personal circumstances change.

The existing policy framework

For those trying to understand the current framework for affordable housing in England – the starting point is the role of the Homes and Communities Agency (HCA) and its key projects.

HCA – The HCA is the body responsible for new housing delivery and regeneration in England. The body has a stated target to provide funding to aid the construction of a minimum of 180,000 new affordable homes between 2008 and 2011, provided by a mix of housing associations and private developers. In the financial year 2010-2011 the HCA's ambition is to see a total of 70,000 affordable homes constructed – with a minimum of 45,000 for social rent and 25,000 for sub-market price sale.

NAHP – The objective of the National Affordable Housing Programme (NAHP) is to increase the supply of new affordable homes in England. Between 2008-2011, the HCA intends to spend £8.4bn through housing associations and private developers to help deliver new intermediate and affordable tenure homes. Potential residential developer partners have to be awarded Investment Partner status before they are eligible for funding.

Kickstart – The Kickstart Housing Delivery programme has an objective to provide funding for stalled residential development sites or even new projects, and to bring housing development forward that would otherwise be delayed.

A figure of £400m was first announced in the 2009 Budget; all of this money has now been allocated. Additional funding of £660m was announced in June 2009, with most of this being directed at priority schemes also registering in the first round. There will be an additional bidding round, which could include support for schemes completing in 2011-2012.

PRSI – The HCA's Private Rented Sector Initiative (PRSI) was launched this year, with an objective to create an opportunity for investors, such as pension funds, to enter the private rented sector on a large scale. The HCA hopes that the private rental sector will be an attractive focus for investors and financial institutions, and that a long-term funding model for new private rental housing could be developed.

The objectives of the scheme appear two fold, firstly to persuade developers and investors to re-start housing schemes that stalled during the recession – thereby increasing housing supply – and, secondly, to improve the quality of management and properties offered in the private rented sector.

The principal focus for the HCA's initiative is to facilitate the building of new homes for rent, but with the potential to consider recently built homes as "seed assets". It is envisaged that such new funding will invest in homes predominantly for private rent, with the possibility of supporting a smaller component for intermediate rent.

Surplus public sector land – The HCA works with the government and local authorities to develop surplus public sector land for new and affordable housing. The government has set a target for 200,000 new homes to be developed on surplus public sector land by 2016. To meet this target, the HCA identifies surplus land assets and advises on how to move these into the private sector. As part of this process the HCA manages the Register of Surplus Public Sector Land on behalf of the Department of Communities and Local Government (DCLG).

Section 106 and CIL – The DCLG has stated that affordable housing will continue to be supported by section 106 agreements and not the Community Infrastructure Levy (CIL), which is being introduced in April 2010.

Although affordable housing developers may receive a discount on the charge. The charge will be levied by local authorities on developers, although there will be high flexibility on what local authorities include or exempt.

The future of affordable housing

One of the most significant changes to affordable housing policy will come if there is a change of government between now and June 2010. There is growing interest in understanding what future Conservative Party policy might be. The most useful guides are the party's green paper Strong Foundations, which was launched in April 2009, and the emerging London housing policy under Boris Johnson – which is the test-bed for Conservative thinking in this area.

The Conservative's housing green paper
Their principle objectives are to increase flexibility in the sector, the idea being that people ought not to consider social housing a tenure for life, and that entry and exit from the sector should become more common than at present.

The remaining proposals of note mainly deal with the objective of increasing the ability of social tenants to build equity shares in social rented property, and the related idea that shared ownership options could be strengthened by encouraging flexible equity stakes. There is mention of the need to attract greater private sector involvement in shared ownership to permit occupiers to staircase up and down with limited restrictions, and to ensure that shared ownership buyers are not treated as subprime borrowers.

Boris Johnson's housing policies
The London Mayor's (Boris Johnson) ambition is to help deliver 50,000 affordable homes in London by 2011, with a high proportion of these (40%) reserved for low cost home ownership and renting. To achieve this objective, the blanket 50% housing target is being removed as he believes this tends to discourage development of any tenure.

The new First Steps housing programme, which the Mayor launched in March 2009, will make more Londoners eligible for low cost home ownership. It proposes to raise the top of the income range for low cost home ownership to the equivalent of the joint salary of two basic rate tax payers in London. For people unable to buy on the open market it will develop new products more suited to London's specific needs, including rent to buy.

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Our view

There are several areas of emerging thinking that seem to make very good sense – especially in London where the Mayor is targeting the needs of the middle market. The shift from key worker eligibility status towards income-based assessments would seem to remove some bureaucracy from the process of allocation.

The weakness of the party's proposals seems to centre on the fact there are lots of areas where they are sure about what they will do – scrapping house-building targets, regional development agencies, HIPs and eco-towns, but they are short on detail on how they will secure funding for more development.

There is also limited information on how power will be devolved to local communities. Without clear thinking on this issue there is a risk that local communities could simply oppose new developments, and that the quantity of new supply simply falls across the board.

We raise the issue in this paper of the bizarre situation we find ourselves in - where the vast majority of households in a wealthy developed nation are theoretically eligible for a state subsidy towards their housing costs. This situation is particularly concerning at a time when government spending is increasingly under pressure.

This is unfortunately the point we are at, and the general drift of policy towards flexible tenure and a blurring of the boundaries between private, intermediate and affordable housing is the right decision to make. The different experience of the housing rich (older, affluent groups with high equity stakes in property) versus the housing poor (younger groups with limited savings) means there is no option but to consider intermediate housing as the future growth sector.

There is a real opportunity for developers, housing associations and investors to make money in this space and if we could ask for one policy change to aid this process, it would be that the HCA is given far more flexibility regarding subsidy allocation – to blur the boundaries between different housing sectors even more. This would be a key way to help build more housing, and to tackle the critical issue of under-supply.

Our experience

Knight Frank's Affordable Housing team's work covers both the affordable rent and intermediate housing sectors in the UK. A strong element of its work to date has been aimed at helping developers and house builders navigate section 106 discussions and advising public and private sector clients on development economics.

In recent months the team has built an enviable reputation for advising key government agencies on market intervention. In January 2009 it was appointed as National Affordable Property Advisor to the HCA. In addition, it has worked closely with a range of developers on their Kickstart bids.

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