

Briefing paper



Affordable housing – New models under the microscope

Briefing paper from CIH Scotland

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The Chartered Institute of Housing

The Chartered Institute of Housing (CIH) is the professional body for people involved in housing and communities. We are a registered charity and not-for-profit organisation. We have a diverse and growing membership of over 22,000 people worldwide, with over 2,800 in Scotland. Our members work in both the public and private sectors. We exist to maximise the contribution that housing professionals make to the wellbeing of communities. We also represent the interests of our members in the development of strategic and national housing policy and aim to be the first point of contact for anyone involved or interested in housing.

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Introduction

At CIH Scotland's May 2011 event on Affordable Housing, the scale of the challenge for housing bodies still wanting to develop was apparent. The event was about coming to terms with, and trying to understand the new reality of how social rented and other affordable housing will be funded in the future.

The Scottish Government remains committed to social housing, but as highlighted in the policy paper "[Homes fit for the 21st Century](#)"¹, there will be less funding available and new housing will need to be built with far less Government subsidy per house.

For housing providers who still want to develop, this will mean a change from current business models to provide a mix of homes including market and mid market rent or shared equity, which the Scottish Government anticipates will cross subsidise the provision of social rented housing. New governance structures may also be required to set up special purpose vehicles to manage new funding arrangements.

Bond and pension fund markets are to be explored, but the Scottish Government used the event to warn providers to be realistic about the motivation driving finance providers: who are they and what are their expectations?

All of these new funding models come with an element of risk and whether they can work or not will depend on how much risk an individual organisation is prepared to be exposed to and how they manage that risk. For some of the models, the Scottish Government may be prepared to take on some of the risk through Government backed guarantee schemes, but in most cases the risk will be with the provider. The Scottish Housing Regulator will also be developing its thinking around acceptable levels of risk in the new funding process.

This briefing paper will look at what we have learned so far about the funding mechanisms themselves and highlight any pitfalls or issues that need further consideration. What is clear is that these new funding mechanisms or ideas are not a short term solution, but are likely to become the long term reality.

The funding mechanisms covered in this briefing paper include:

- Scottish Government overview of alternative funding methods
- Mortgage Indemnity Guarantee
- Mid market rent initiatives (MMR) including National Housing Trust
- Bond finance
- JESSICA funding

¹ <http://www.scotland.gov.uk/Publications/2011/02/03132933/0>

Scottish Government overview of alternative funding methods

Set in the context of 21st Century Homes, the Scottish Government has begun outlining new initiatives for the funding of affordable housing that will be encouraged as alternatives to Government subsidy. For many RSLs wishing to develop, this will mean a change to their current business models and cross subsidising social rented housing with mid market rent (MMR) and shared equity models. New governance structures may also be needed to access new sources of finance.

Pension funds

Suggested as a real alternative to conventional bank lending, pension fund investment in affordable housing in Scotland is slowly gaining momentum. There is tentative but growing interest from pension funds which see affordable housing as a less risky investment than commercial property. To date, interest has been from the smaller Scottish based Strathclyde and Calmac pension funds. Future UK wide pension deals could see anything between £20m to £200m being invested in affordable housing. Pension funds will be looking to invest in a mix of stock as the returns from social rents alone would be insufficient. Other tenures such as mid market rent and shared equity would be needed to enable the provision of social rented housing.

Issues could arise, however, if the proposed tenure mix does not fit with the Local Housing Strategy. Concerns have also been raised as to how this type of investment could be accessed in areas where there is little or no demand for mid market and shared equity properties.

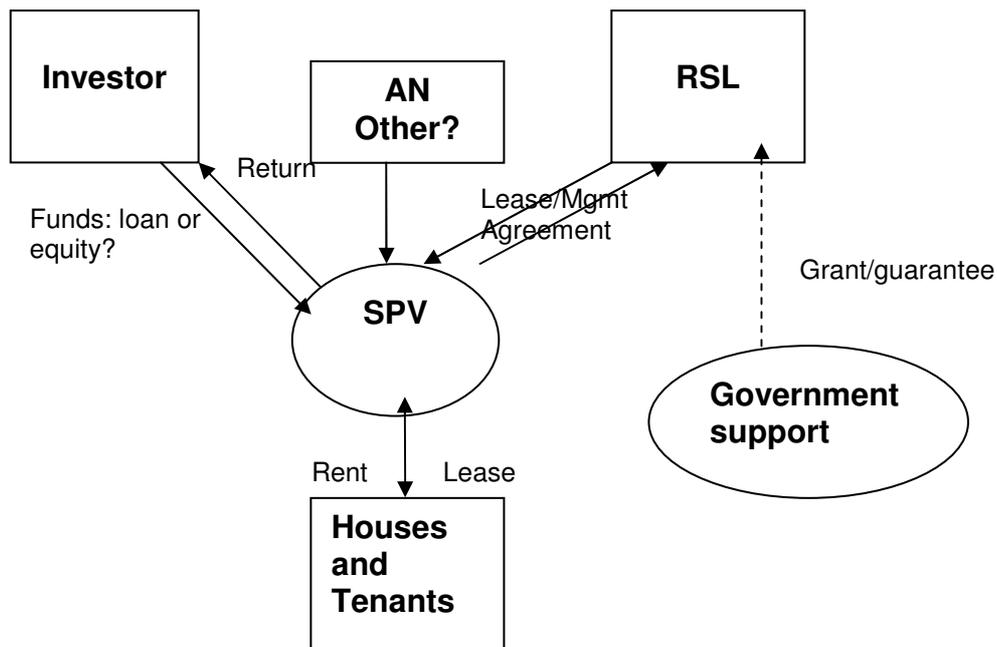
Although the Scottish Housing Regulator has so far made no objections to pension fund investment, landlords will need to look carefully at who is providing the money and what they want in return to ensure an acceptable level of risk.

Special Purpose Vehicles (SPV) and Lease models

The Scottish Government has also indicated that investment from life companies, institutional investors and private wealth funds would all be alternatives to conventional bank lending, but would require new governance structures. Below are a series of models demonstrating how the various investment models could work.

“Classic” SPV

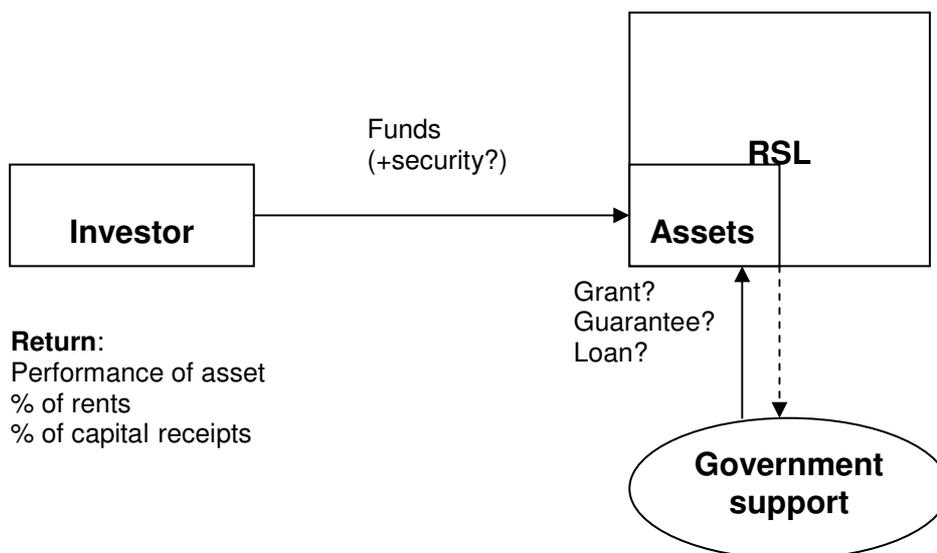
The following flow chart demonstrates how the classic SPV model might work



- Funding provided by a private investor and RSL
- RSL loan is backed by a Government guarantee to ring fence the risk
- The SPV will be a not for profit Governance arrangement
- Options for a third investor
- Classic SPV more likely to provide MMR and shared equity to ensure sufficient returns for the investor

“Virtual” SPV

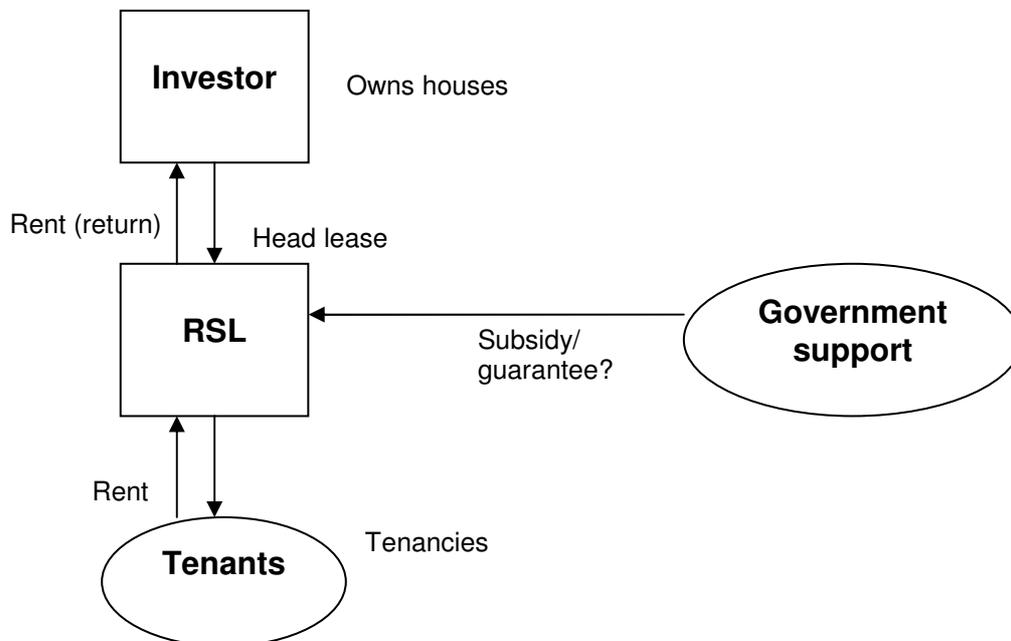
The following flow chart demonstrates the less complex Virtual SPV



- A less complicated model which is focussed on direct investment in the RSL with more straightforward governance arrangements similar to how The Housing Finance Corporation (THFC) arrange funding

- The investor could be a small pension fund or private investor
- Model can work with or without Government support, but the Government could take an equity stake or provide a guarantee to remove some of the risk from the RSL

Lease model



- The Housing (Scotland) Act 2010 made this possible with the removal of the rules restricting long term loan agreements
- Properties owned by investor and leased by the RSL or an SPV depending on the relationship with the investor
- Model favoured by some pension funds and investors due to greater control of the assets
- Properties will be run and managed by the RSL
- Government support would be in the form of subsidy or guarantee to the RSL
- Lease is a long term arrangement for more than 20 years with index linked interest payments due every six months
- RSL must have a firm assessment and understanding of the risk as this is not like a bank loan and cannot be easily refinanced
- The long term nature of the model could have governance and business planning implications
- Careful thought would need to be given to who pays for planned maintenance and making sure this is factored in from the outset

These new funding and delivery models will mean the sector has to adapt its current business model and become familiar with new governance structures. The Government's message is clear in that a firm understanding and assessment of the risk involved in all of these models is the only way to make them a reality.

Unblocking the first time buyer market

Mortgage indemnity schemes

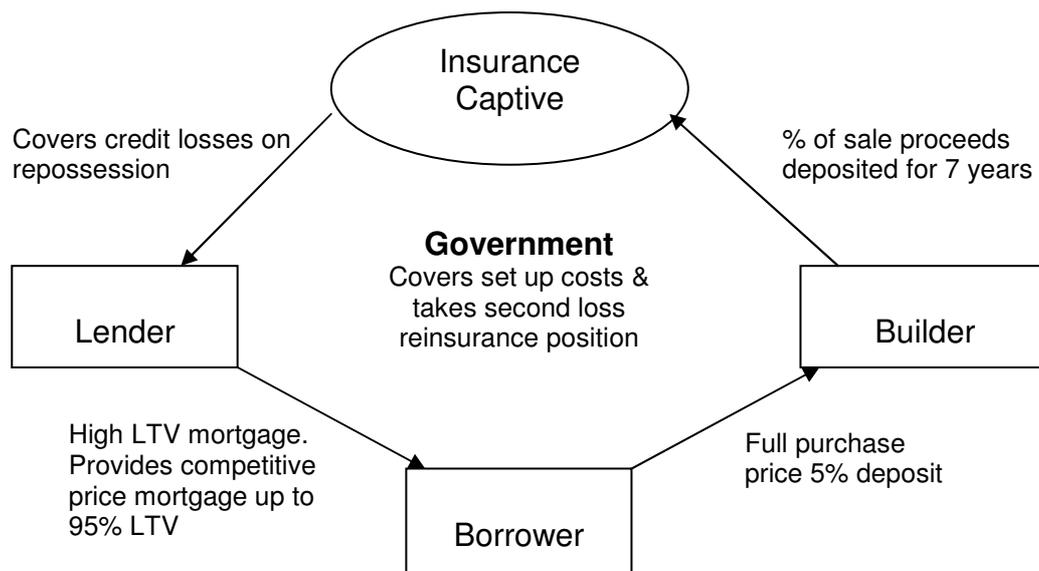
There may be some light at the end of the tunnel for first time buyers in Scotland with the emergence of Mortgage Indemnity Schemes for new build property. The Scottish Government highlighted in Homes fit for the 21st Century its intention to work closely with Homes for Scotland and lenders to develop this initiative and to look at addressing the barriers to their wider use.

With limited availability of low deposit mortgage products, many house builders are currently funding capital intensive shared equity schemes to enable people to buy a new build home. Homes for Scotland are warning, however, that this model as a tenure solution could prove unsustainable with house builders unable to set aside the cash required to fund the equity stakes. If capital is tied up in shared equity for an indeterminate length of time then the house builder will not have money to reinvest.

The Mortgage Indemnity Guarantee (MIG) scheme could provide an alternative to shared equity which would help to unlock the first time buyer market and be more financially beneficial for the house builder.

A MIG scheme works on a captive insurance basis whereby the developer puts a percentage of any sale proceeds, typically 15%, into a captive insurance fund for a period of 7 years. This fund is then used to underwrite the lender against any losses occurring through repossession in the first seven years, and therefore enables the lender to provide the borrower with a high loan to value (LTV) mortgage of up to 95%.

A MIG scheme can be developed with or without Government support. The following flow chart demonstrates how a Government supported scheme would work:



- Captive fund still has protection level of 15% of sales proceeds

- The first 5% is provided by the house builder as cash. In the event of any losses this 5% would be utilised first
- Government provides a sovereign guarantee, that if the losses exceed the 5% from the builder, second losses will be met to a further 10% of sales amount
- Providing lenders agree, the Government does not need to provide up front cash as the sovereign guarantee should be sufficient assurance
- If losses exceed the builder and Government contributions then these revert to the lender
- The Government and not the builder would cover set up costs

A MIG scheme with Government support has obvious benefits for house builders who only need to tie up 5% of their proceeds, leaving more capital to reinvest. Unlike the shared equity scheme, if house prices fall the builder does not automatically suffer losses.

As with any new scheme there are risks and benefits for all parties involved. The greatest risk is repossession, but given that repossession rates in the UK are historically low, with less than 1% of all loans, this would imply a modest risk for both the Government and the house builder.

Based on lessons learned from a similar scheme, Homes for Scotland have said that marketing a MIG scheme will be the key to its success. The Government would need to encourage lenders to participate to justify the initial high set up costs and make the scheme viable.

First steps were taken towards honouring the commitment in Homes fit for the 21st Century, when the [Scottish Government](#)² announced at the end of June 2011 an award of £250,000 to Homes for Scotland who will work with lenders and builders to take the initiative forward and hopefully develop a mortgage indemnity guarantee scheme.

Once a scheme is developed, it is hoped that the Scottish Government will provide additional support to the industry as a way to kick start development and inject liquidity into a flat mortgage market.

Mid market rent variations on a theme

National Housing Trust (NHT)

The National Housing Trust (NHT) initiative was officially launched in September 2010 to help create homes for mid market/intermediate rent. The Scottish Government views this initiative as another tool in the box, complimenting existing approaches to increase the supply of affordable housing.

Local authorities are key to the initiative at phase one. It is anticipated that they will borrow between 65% and 70% of the property price from the public works loan board at relatively low interest costs. The remainder of the money (30-35%) will come from private finance sources. Scottish Government involvement is in the form of a

² <http://www.scotland.gov.uk/News/Releases/2011/06/29103915>

guarantee for the local authority loan and offers protection should there be a shortfall at the point of sale.

A special purpose vehicle (SPV) is required due to the public/private interface and will purchase the properties on completion. A management company is also appointed to deal with day to day management and maintenance of the properties.

NHT properties are rented under a short assured tenancy and aimed at households on low to moderate incomes. The homes will be available for rent for 5-10 years, after which the developer can choose to sell. Sale proceeds then pay back the local authority loan and provide a return to the private investor.

This initiative is not without its challenges and the Scottish Government and Scottish Futures Trust has published a [lessons learned discussion paper](#)³ to provide the basis for further dialogue. The paper identifies, among other things, the need for a more streamlined procurement process and the importance of allowing enough flexibility around rent levels and unit types to reflect local circumstances.

Interest in the scheme has so far been positive with seven local authorities currently going through the procurement process. Scottish Borders Council has already signed for 51 units across two sites and hopes to start work over the summer of 2011. The Government also expects a further two local authorities to sign in the coming months.

Location is also a key ingredient and it is widely understood that this concept will work well in some areas and not in others. To be successful, it will need demand from tenants as well as interest from investors. For local authorities it will be a case of assessing local demand for mid market rent as well as their prudential borrowing capacities.

It has so far been a long process, but the Scottish Government is keen to press on with NHT phase two for local authorities as well as a new variant aimed at RSLs. Phase two will also look at more proactive ways of helping tenants stair case to ownership.

HAG funded mid market rent: Dunedin Canmore Housing Association

Dunedin Canmore Housing Association has been developing properties for MMR through a subsidiary, Malcom Homes. Developed in Edinburgh, the MMR properties are helping to address the huge demand that exists for affordable housing and help those on low to middle incomes who have little chance of obtaining a socially rented property and for whom home ownership is not viable.

To enable development of MMR, the funding shortfall has been met through 40% HAG from the Scottish Government. In cases where there are no land costs under the affordable housing policy, a Government grant is not required. The rents are set in accordance with the affordable housing policy, but are not tied to LHA levels as

³ <http://www.scotland.gov.uk/Topics/Built-Environment/Housing/supply-demand/nht/discussion/lessonsdiscussion>

this does not offer enough flexibility. Service charges are also factored in and cost depends on the amount of services provided.

The properties are aimed at those on low to middle incomes usually with a local connection either through work or family. As part of the allocations criteria, prospective tenants will also be assessed in terms of their ability to purchase the property in the future.

MMR rent is provided as part of mixed tenure developments, and as with the NHT model, location and property size is key to ensuring demand for this tenure. MMR properties are offered on a one year short assured tenancy (SAT). Experience so far has shown that prospective tenants are not deterred by the type of tenancy and once in the property tend not to move on as they feel it offers stability.

Dunedin Canmore intend to consider including MMR in all future development projects with the aim of further diversifying tenure and providing affordable housing to ease the pressure on waiting lists.

MMR - The Resonance model

The Resonance model has been developed by Rettie&Co and is presented as a new approach to providing MMR and an opportunity to break down barriers between RSLs and the private sector. This model has so far been used at a development in Joppa in Edinburgh in partnership with Dunedin Canmore Housing Association.

This model is based on an occupancy risk rather than a sales risk which avoids speculation and relies on accommodation need and the existence of a good rental market. The RSL take on the occupancy risk.

As a working example of the resonance model, a developer builds 15 units which are then sold on to the RSL at £80k per unit. The RSL funds the purchase through a 10 year interest only finance package and owns, manages and maintains the properties which are let as MMR. The immediate benefit to the developer is clear in terms of the quick release of capital.

The developer retains a call option on 13 of the 15 units which means they can call for the sale of the units at any time over a 10 year period. The proceeds from the eventual sale of the properties are used to repay the debt on 13 of the units as well as the deferred land costs. Any remaining profit retained by the developer depends largely on the open market value of the properties at the point of sale.

Unlike the NHT phase one model where all of the properties are eventually sold, the Resonance model enables 2 of the 15 units to be kept in perpetuity for affordable rent owned by the RSL. Any units kept by the RSL would usually be units acquired through section 75. In exchange for leaving these units behind the developer can decide to sell the units from day one. Should the RSL wish to retain the 2 units as social rented housing, then they would require a Government grant of around £35k per unit to meet the shortfall. The amount of grant required to bridge the funding gap is much smaller than that usually required for a social rented property.

The following summarises what Rettie see as some of the main benefits of the Resonance model:

- Permanent social dividend of two units for zero grant (at MMR)
- Straight forward and limited procurement process
- No requirement for SPV and no running or set up costs
- Simple cost effective contracts
- No debt accruing on the developer's balance sheet as in other models
- Creates mixed tenure communities
- Capital is released quickly to developer for reinvestment

One of the main issues or challenges with this model for RSLs is around the cost of the debt to the association and their ability to access competitive finance deals.

Rettie suggests that this could be overcome through a variation of the Resonance model which uses Government or local authority backed guarantee to lower the cost of borrowing to the association. This also has the potential to release sites for development with higher build costs and infrastructure. Rettie believes that the cost to the Government for underwriting the debt would be minimal and enable more units to be developed than under the HAG system.

As with other MMR models the success will be demand led and only work on developments which have a robust sales exit strategy.

NHT variant for RSLs

In December 2010, the Scottish Government announced its intention to develop a variant of the NHT model for housing associations. In a [discussion paper](#)⁴ published on 7 July 2011, the Scottish Government set out three main variants that are being considered. It intends for these variants to work alongside, rather than replace the existing NHT model or other innovative approaches.

Variant 1: Land in RSL ownership

- RSL owns or acquires the land through a section 75 agreement and uses this to develop
- RSL borrows to fund construction
- Once units are completed as affordable housing then Government may provide a guarantee in the event that income is insufficient to repay borrowing
- Homes are sold off over time, although, under this option, a proportion of the homes would be expected to be able to be retained in perpetuity by the RSL

Variant 2: Public sector land

- Land is provided by a public sector land owner (e.g. LA or NHS) for a deferred receipt
- RSL borrows money to fund construction
- A subsidiary of the RSL owns and manages the completed units
- Scottish Government could provide a guarantee to underwrite the borrowing

⁴ <http://www.scotland.gov.uk/Topics/Built-Environment/Housing/supply-demand/nht/discussion/nhtvariants>

- Units are sold off gradually and receipts then used to repay the cost of the land

Variant 3: RSL and private sector

- Similar to existing NHT model
- Developer provides land and develops homes
- Homes are purchased by a special purpose vehicle (SPV)
- RSL would be primary lender to SPV, but equity funding would also be shared with the developer (approximately 30% of purchase price)
- RSL to provide management and maintenance services and the homes would be available for five to ten years

It is hoped that there will be provision of a Government guarantee as outlined in variants one and two which will encourage RSLs to participate in the scheme and ensure they can secure loans at a favourable interest rate. The terms and scope of the guarantee still need to be developed further.

The Scottish Government has already sought feedback from RSLs and identified a small number who at present are most likely to have the expertise, borrowing capacity and access to suitable sites to enable them to help the Government develop the variants.

Initial feedback indicated the following issues potentially facing RSLs in relation to the variants:

- Management – RSL would need to have or set up a subsidiary company due to the type of tenancy
- Borrowing – RSLs not able to access funds at rates that LA's can through the PWLB
- The guarantee – RSLs need to know whether or not they require a guarantee through a value for money exercise
- Legal contracts – need to be less complicated than NHT phase one
- Market research – location and demand for MMR
- Risk model sales exit strategy
- Delivering homes without a special purpose vehicle

The discussion paper also highlights a number of issues which will need to be considered including:

- Making sure that rent levels are affordable and sustainable
- Cost and quality of the units – this is of fundamental importance when considering a sales exit strategy

RSLs and developers will also need to be sensitive to the local housing market and aware of any other initiatives being taken forward in deciding when to sell the units on.

Further information on the three variants including any issues for further discussion is available in the Scottish Government's discussion paper. The discussion paper is available for comment until 19 August 2011 and also invites housing associations to indicate their desire to participate in this new strand of NHT.

Getting the most out of private finance

Bond finance – Case study: Glenoaks Housing Association

A recent change in the law under the Housing (Scotland) Act 2010 has paved the way for RSLs to access longer term financial deals such as Bond finance. Until now, lenders had been prevented from fixing interest rates for loans secured on existing stock for more than 20 years. This means investors have been reluctant to invest in long fixed-rate deals as they fear losing part of their return. This change in the law now exempts social landlords from the 20 year rule and means they can attract bond finance on more favourable rates.

Glenoaks Housing Association became the first in Scotland to raise money through bond finance. Glenoaks pursued this option in the face of funding challenges and the pressures of meeting the Scottish Housing Quality Standard (SHQS), in particular relating to former Scottish Homes stock.

Taking advantage of the legislation change, Glenoaks was able to raise £14.3m through a bond issue from The Housing Finance Corporation on a 28.5 year deal. The money will enable Glenoaks to refinance existing loans and continue to invest in their housing stock. It also means that they are fully financed over the short to medium term.

Glenoaks was keen to stress that although this provides financial certainty in the short to medium term, the terms of the loan are less flexible and covenants more onerous. Bond finance therefore needs to be combined with an element of traditional funding.

Glenoaks has also highlighted the importance of setting up a sinking fund to ensure that the loan can be repaid after the 28.5 year term. This should be factored into a business plan and approved by the Regulator.

The Scottish Government is keen for Glenoaks to lead by example and wish to work with the sector to look at further funding opportunities through bond finance.

Joint European support for sustainable investment in city areas (JESSICA)

JESSICA is a new European fund model to support revenue generating regeneration projects. It has been developed by the European Commission and the European Investment Bank and is currently being rolled out across Europe. Scotland has already accessed a £50m fund through JESSICA and identified thirteen areas in Scotland eligible for structural funds, including Edinburgh, Fife, Glasgow and Inverclyde. The fund will be run by a specialist fund manager and investment decisions will not be taken by the Scottish Government.

The fund should be up and running by the end of 2011 and will be topped up by a £15m Big Lottery Trust to fund community led regeneration. The Scottish

Government has said that eligible activities for the fund include business and transport infrastructure and energy, but not housing. The projects must be part of an integrated urban development capable of generating revenue and investment return.

So far eligible projects in Scotland include:

- Decontamination and servicing of brown field and land gap sites
- Industrial sites and business facilities to support employment and training
- Support for renewable energy production and low carbon technologies
- Innovative energy efficiency approaches, in particular targeting the retrofit of existing social housing stock

Looking forward

It is clear that those landlords who wish to continue developing will need to come to terms with what is the new reality of how social rented and other affordable housing will be funded in the future. Each of the mechanisms comes with its own challenges and landlords will most likely need to carry out feasibility work to determine what could work for them.

CIH Scotland will closely follow the progress of each of these new funding mechanisms including the outcome of the bids for the innovation and investment fund, and will issue further information through briefings and events in due course.