

The Housing Finance Corporation

# Investing in Social Housing

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A Guide to the Development of the Affordable Housing  
Sector

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## Executive Summary: Investing in social housing

### Why housing associations?

- Housing associations (HAs) are independent private sector, not-for-profit bodies that provide rented homes at sub-market rents. They also offer the chance to gain access to home ownership and provide other neighbourhood and community services.
- HAs are perhaps the most successful public private partnership in the UK. They are well governed, and subject to strong regulation to safeguard effective governance and financial viability.
- Lenders to the sector can take full security against housing assets valued according to a conservative valuation methodology.
- Private investment in England totals £58 billion and c. £62 billion across the UK.
- Data refers to England only unless otherwise stated; there are 1700 HAs managing 2.4 million homes in England.

### HA activity

- 79% of HA income comes from renting general needs housing at sub-market rents. 70% of rents are paid directly to Landlords from Housing Benefit.
- HAs also undertake development for low cost home ownership principally shared ownership. This helps meet government objectives to extend home ownership and has cross-subsidised development of general needs housing.
- HAs also provide specialist services under the Supporting People programme and undertake regeneration and a range of community activities.

### The history; traditional HAs, stock transfer and private finance

- HAs developed out of the almshouse movement, founded as early as the 10<sup>th</sup> century.
- In the 19<sup>th</sup> century philanthropists invested in improvement of living conditions via housing associations such as Peabody, founded in 1862.
- Concern about housing conditions in the 1960's as evidenced by the BBC drama *Cathy Come Home* led to the founding of more inner city HAs such as Notting Hill Housing Trust.
- The 1980's saw the introduction of mixed funding based on grant and private finance as government sought an alternative to council housing, and limits on public expenditure. HAs were well placed to lead this new phase with their independent not-for profit status and the ability to borrow outside public borrowing constraints.
- The right to buy, introduced by the Conservatives in 1980, transferred 2.2 million homes from social renting to home ownership over the following 30 years. It re-enforced pressure to find a new approach to developing and holding social rented stock.
- The Housing Act 1988 laid the foundations for present practice by allowing lenders to take a first charge against HA properties that ranks ahead of public grant. It also allowed payment of rent via housing benefit.
- The present mixed funding regime has bi-partisan support, although originally introduced by a Conservative Government.
- Traditional HAs have used private finance to fund repair and improvement to existing stock, and to develop new stock; much of it for shared ownership which amounted to 1/3 of HA completions in 2005/06.

- Large Scale Voluntary Stock Transfer (LSVT) has been the single largest source of new HA stock over the past 20 years. 1.1 million homes have been transferred with associated private finance facilities of c. £17.5 billion.
- LSVTs have been promoted by the need to tackle local authority backlogs of repairs and improvements, the desire of government to reduce public expenditure by introducing private finance, and the ability of HAs to borrow outside the PSBR.
- The pace of transfer has slackened in England and Scotland, but Wales has a viable programme that is attracting lender interest.
- As transfer HAs mature, some of them can generate enough additional asset cover to support a new development programme. The distinction between “traditional” and “LSVT” associations is eroding over time.

## Tenants and tenancies

- Tenant involvement in HA decisions has long been a feature of the sector. Tenant satisfaction with HA landlords is consistently higher than with local authority landlords.
- Tenants tend to be drawn from those on lower incomes with vulnerable and disadvantaged groups well-represented. Housing Benefit plays a key role in ensuring that rents are paid, and HA income streams are secured.
- Most HA properties are let on an assured tenancy. These offer security of tenure, but allow the landlord to gain possession in certain circumstances, such as non-payment of rent.
- HA general needs rents are regulated by government. Regulated rents rise by RPI plus ½%. This provides stability and facilitates long-term business planning.
- Some HA tenants may have the right to buy and others may have the right to acquire. In neither case have numbers of sales been significant in recent years.
- Future government proposals include legislation to facilitate tenants’ mobility between social landlords.

## Legal status of HAs

- HAs are private sector organisations. The majority are Industrial and Provident Societies registered by the FSA but some are companies limited by guarantee.
- The majority of HAs have charitable status.
- Financial and other information on Industrial and Provident Societies [I & Ps] can be found in the FSA register, and information on all HAs can be found on the website of the regulator, the Tenant Services Authority (TSA).

## The importance of regulation

- Regulation provides assurance for lenders and investors about standards of governance and promotes financial viability.
- It also secures private finance for HAs on terms that reflect the lower risk, and provides safeguards for government and protection for tenants.
- The presence of regulation is one of the major reasons why there has been no default in the sector that has resulted in loss for lenders or investors.
- The regulator until 2008 was the Housing Corporation, but since 2008 it has been the TSA with the Homes and Communities Agency (HCA) as the investment authority.

- The TSA is committed to co-regulation involving some self-regulation and tenant input. Nevertheless the TSA has clear objectives to secure sound governance and financial viability of HAs, and strong powers to ensure that these objectives are achieved.
- Introduced in April 2010 the TSA's new regulatory framework has six core standards including a specific standard on financial viability and governance.
- The regulator has consistently intervened over many years to facilitate solutions to problems that have financial implications for the sector, and to promote solutions such as mergers where individual HAs face financial difficulties.
- While there has been discussion of possible institutional changes to the regulator, lenders to the sector are more concerned with the content of the regulatory regime, and with the level of resources to enforce it. It is believed that government is well aware of the importance of maintaining the integrity of regulation.

### **Governance arrangements of HAs**

- HAs are required by the regulator to adopt an appropriate code of governance and to review their arrangements annually.
- HAs are governed by non-executive boards which usually co-opt members of the executive management team.
- Tenants are usually represented on HA boards and receive appropriate training to enable them to fulfil their role. Tenants are not usually in a majority on HA boards.
- An increasing proportion of HAs pay their board members in order to help them gain access to appropriate skills and experience, although the majority of board members are still unpaid.

### **Income, turnover and assets**

- In spite of diversification, HAs still derive c. 79% of their income from rents. This proportion has changed little over the past decade.
- Housing benefit, a quasi –government income stream, is a key stabilising factor. It contributes c. 70% of rent paid, and tenants agree that it be paid direct to landlords, waiving their own right to direct payment in almost all cases.
- The bond markets place strong reliance on the current housing benefit formula with its effective link to the RPI. Dismantling of the formula is typically a re-scheduling event in their loan documentation.
- Turnover in the sector was up 15% at £11.6 billion in 2009. In spite of a reduction in profit from property sales, HAs turned in an increased operating surplus in 2009. The Gross Book Value of the sector's assets stands at £96.4 billion.
- The TSA estimate that the HA sector still has £24 billion in unused security for new loans.

### **Funding new HA investment**

- The Homes and Communities Agency is the grant distributing body to HAs.
- Grant is subordinated to a lender 1<sup>st</sup> charge over HA assets.
- Falling rates of grant over a period have led to private finance becoming the main source of investment. In 2008-09 accumulated grant totalled £37 billion while drawn-down private finance totalled £40 billion.
- Five lenders provide around 85% of all HA private finance.

- Capital markets finance total c. £8 billion.
- The biggest proportion of HA loans are long or short-term fixed rate.
- Lending is normally fully secured on the basis of a conservative valuation methodology applied to value HA assets.
- Bond issuance has risen dramatically since the onset of the banking crisis.
- Credit spreads have increased since the banking crisis began and the capital markets are believed by many HAs to be more willing to offer long maturities going forward.
- The TSA believes that HAs will require £20 billion of additional private finance over the five years to 2013-14. They predict that £5-10 billion could be raised in the capital markets.

### **THFC: what we can do for investors**

- THFC is the foremost aggregating funder to the HA sector.
- Founded in 1987 through a joint initiative of the Housing Corporation and the National Housing Federation, THFC has a close long-term relationship with the sector.
- THFC is an I & P and its nine-strong board has a wealth of experience from the banking, financial and commercial sectors. It also includes representation from the TSA and National Housing Federation, which helps keep THFC focussed on the needs and risks of the HA sector.
- THFC's A+/A-1 rating was re-affirmed in December 2009.
- THFC acts as principal and borrows in its own name. It on-lends immediately and only to registered providers.
- Funds borrowed are on-lent on similar interest and repayment terms thus ensuring that THFC is protected against interest rate risk.
- THFC does not take foreign currency risk.
- We always make our own credit assessment of potential borrowers.
- Our loans are fully secured and we are legally bound to conservatively set covenants.
- Investors to THFC benefit from a floating charge over THFC's assets; primarily our secured loans to HAs and our reserves.
- All THFC stocks and loans rank pari passu and are further protected by a negative pledge.
- THFC covenants to investors that its operating expenditure will remain within total income on a rolling three year basis.
- THFC takes out a combination of fixed and floating charges in respect of loans.
- Asset cover requirements are underpinned by a conservative valuation methodology.

### **Postscript: the wider picture**

- Local authorities could represent a significant investment opportunity going forward, although HAs will probably always be the main outlet for private finance to the social rented sector.
- Against the backdrop of public expenditure constraints, government has not yet addressed how future development is to be funded in the HA sector in the future. It is likely that building homes for market renting will form a larger component of future development.
- Scotland, Wales and Northern Ireland also have fully regulated HA sectors that offer significant investment opportunities for private finance.

## Why housing associations?

### What are housing associations?

Housing associations (HAs) are independent, private sector not for profit bodies that provide rented homes at sub-market rents. They also offer those on modest means the chance to gain access to home ownership and provide a range of other community and neighbourhood services.

The housing association (HA) sector is a diverse sector dedicated to meeting the needs of communities across the length and breadth of the United Kingdom (UK). Though HAs are private bodies, independent of government, their range of activity represents perhaps the most successful public private partnership in the UK. HAs are well governed and managed, they are subject to strong regulation to safeguard effective governance and financial viability. Crucially, lenders to the sector are able to take full security in the form of fixed or floating charges against the housing assets, utilising a conservative valuation methodology. All in all they represent a low risk investment opportunity that has already attracted an estimated £62 billion of bank and capital markets finance across the UK as a whole, over £58 billion of that in England alone. There are currently c. 1700 regulated HAs in England, 212 in Scotland, 142 in Wales and 40 in Northern Ireland. They provide a total of around 2.8 million homes of which 2.4 million are in England.

Because of the relative dominance of England in terms of HA stock and investment, references will be to English HAs unless otherwise stated.

### A diverse sector

The HA sector is diverse. England has 1700 HAs providing circa 2.4 million homes but these bare figures in no way capture the complete picture. The smallest HA controls less than ten homes, the largest, over 50,000. In fact fewer than 400 HAs own more than 1,000 homes, yet the largest 20 HAs own 31% of the entire stock held by the sector.

The sector has grown steadily over the past twenty years through development of new homes, and through transfer from local authorities. New development of social rented housing has been focussed on HAs since the 1980's with local authorities effectively unable to build new homes. Government policy, and in particular the desire to lever in private finance that will not count as public borrowing, has been the driver of this expansion. While government has recently modified its policy on building by local authorities the HA sector, with its ability to access private finance outside the public borrowing regime, is likely to be a significant developer in the future.

### HA activity

There is significant diversity in terms of activity also:

#### *Homes for rent*

The main activity of HAs continues to be the provision of affordable housing for rent. The overwhelming proportion of such housing is known as "general needs" housing. This is housing let out at rents that are lower than those prevailing in the private rental market. This is achieved by providing HAs with a subsidy on the build cost of these houses via a grant from central government. Alternatively these homes have been subject to historic subsidy while in local authority ownership and have subsequently been transferred to HAs under the Large Scale Voluntary Stock Transfer

(LSVT) programme (see below). In addition to general needs housing HAs also manage a small stock of homes let at market rents and some at “intermediate” rent; with a degree of subsidy enabling rents to be set at a level between market rents and general needs. Rental receipts on general needs housing make up c. 79% of total HA income. The stability of this income is underpinned by housing benefit, which contributes around 70% of general needs rents and is paid by government direct to landlords in respect of tenants on low incomes.

Much of the requirement for private finance has centred on the need to bring general needs stock up to the government’s decent homes standard by 2010. The Standard was introduced by the government to address an estimated £19 billion backlog in repairs and improvements across the social rented sector. Meeting this target has involved very substantial investment by HAs. Although much of this investment has now been implemented the decent homes programme will not be finally complete until 2015. Beyond that, the work of improving and updating existing stock will continue. HAs are already developing “decent homes plus” standards to focus the next generation of investment.

### ***Development/low cost-home ownership***

Only a small minority of larger HAs have consistently achieved the status of developer. In recent years grant for development of general needs housing has been focussed on a limited number of development partners driven by the desire of government to achieve maximum efficiencies for public funds disbursed as grant. In addition the regulator has scrutinised development plans with increasing care in order to ensure that plans do not create unacceptable risks for the HAs concerned. This has been particularly true since the onset of the banking crisis and economic and housing market downturns.

As well as developing general needs housing, HAs have increasingly integrated development for low-cost home ownership into their plans. This has been driven by two key factors:

- The aspiration of successive governments to increase the levels of home ownership and to develop purchase schemes for those on modest incomes to facilitate this.
- The desire of government to maximise the output of new development per unit of public grant by requiring HAs to “cross subsidise” general needs development by profits from open market development with funds for the latter supplied by private finance.

A number of Government schemes have been developed to encourage full or part purchase of homes for owner occupation. These have involved both the provision of equity loans and shared ownership and are currently marketed under the Homebuy banner. Shared ownership has been an option offered by HAs for over 25 years with over 80,000 such homes currently existing. As the name implies, shared ownership involves a buyer purchasing 50% or less of a property from an HA with the HA retaining the residual share and renting it to the purchaser at subsidised rent. Shared ownership has been the predominant form of open market development for HAs for many years.

Since the banking crisis shared ownership has become a less viable option however, with problems over mortgage availability for purchasers and with falling prices making cross subsidy problematic. Numbers of new-build shared ownership are likely to drop sharply as a component of HA development plans in the future. It appears likely that HA development will focus more on general

needs housing plus intermediate and market renting over the medium term, with general needs development aspirations trimmed to reflect the likelihood of diminished grant availability due to public expenditure constraints. Given that affordability will continue to be a problem for potential shared owners in the future, and against the backdrop of a more austere economic climate, the demand for sub-market (intermediate and general needs) renting is almost certain to strengthen over the medium term, and this will underpin overall HA cash flows.

### ***Supported housing***

In addition to managing general needs rented housing, many HAs also provide specialist services for groups such as the elderly and those with disabilities, mainly under the Government Supporting People regime. While this is a substantial activity it has not been as significant as other areas of HA activity in attracting private investment. It is often characterised as a low margin service offered by HAs and is becoming more specialised as certain HAs (such as Hanover) focus their activities in this area. Supported housing has not been seen by lenders as attractive for loan security purposes.

### ***Regeneration***

HAs have worked with other private and public partners in a number of major regeneration projects in cities such as Liverpool, Birmingham, Glasgow and London in recent years. Regeneration draws on the expertise and experience of HAs in caring for communities and developing neighbourhoods. It involves looking at the strands that make a successful and diverse neighbourhood, including employment, housing, health, transport, education and training. Regeneration has attracted very significant sums of public and private finance, often structured in innovative ways involving consideration of the partnership nature of successful regeneration initiatives.

### ***Serving the wider community***

HAs play a major part in tackling the needs of the homeless and those with urgent temporary housing requirements, including ex-offenders and other groups with specialised needs. Initiatives such as hostels and the leasing of rented accommodation from the private sector are common to many HAs. In addition HAs have increasingly recognised their centrality in fostering communities, with involvement in childcare, training, employment, financial inclusion and various other co-operative and community initiatives. These are a testament to the extension of HA activity beyond the traditional role of general needs landlord.

## **The history; traditional housing associations, stock transfer and private finance**

### ***Early origins***

HAs have a long and distinguished history. Their genesis is usually accepted to be in the almshouse movement by which housing was provided for the needy by various foundations. Almshouses date back to the 10<sup>th</sup> century, and the earliest continuously surviving almshouse is the Hospital of St Cross in Winchester, which was founded around 1133.

### ***19th century; philanthropy rules***

Housing associations as more commonly recognised today began to develop during the nineteenth century as entrepreneurs benefiting from the period of industrial and commercial expansion initiated by the industrial revolution chose to plough back some of their wealth in philanthropic projects, including the provision of housing. A good example is Peabody, still flourishing but originally founded in 1862 by George Peabody, who donated a total of £500,000 to the Trust.

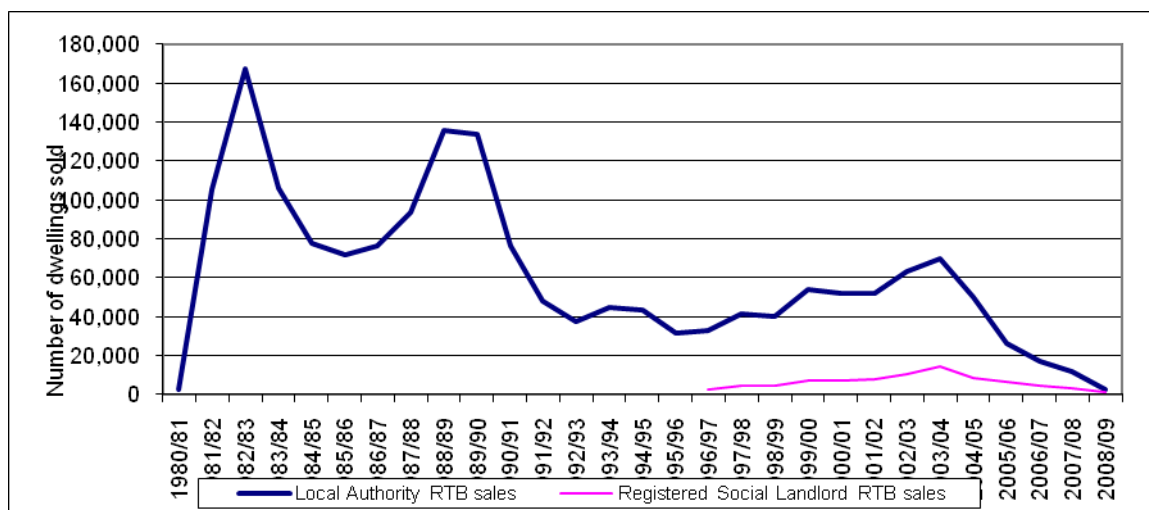
### ***20<sup>th</sup> century developments***

Increased awareness of inner city housing issues in the 1960's, as evidenced by the famous BBC drama *Cathy Come Home*, and by the founding of the charity Shelter in 1966, led to the establishment of a new generation of urban housing associations. The Notting Hill Housing Trust is a good example, having been founded in 1963 to address concerns about local housing conditions.

### ***1980's: the right to buy and a new role for private finance***

Until the 1980's virtually all social rented housing was provided through direct government subsidy whether the developer was an HA or a local authority. The election of the Conservative Government under Margaret Thatcher in 1979 led to a re-appraisal of the provision of social housing going forward. Underpinned by a strong commitment to free market economic liberalism the Conservatives aimed to reduce public borrowing, increase efficiency and expand the role of private finance.

Another key factor putting pressure on government to find ways of funding new social housing for the future was the introduction of the right to buy for local authority tenants under the Housing Act 1980. Under the scheme, tenants could purchase their homes at substantial discounts and, subject to certain conditions, could subsequently sell the property on the open market. The scheme was revolutionary in conception and dramatic in effect. Since 1980/81 over 2.2 million homes were sold under the right to buy. The scheme was the single most important factor in increasing the proportion of home ownership during the 1980's and 1990's. Although the discounts under the scheme have been cut back, and volumes are now very much reduced the impact of the scheme is still controversial. The right to buy substantially reduced the stock of social rented housing, (although experts argue as to exactly by how much effect this had in practice), and arguably contributed to the residualisation of the tenure to one that could be accessed only by those in greatest need. Given that the Government had given a clear signal that expansion of local authority housing was not the way forward, there was a clear need not only to find an alternative institutional form for large scale housing management, but renewed pressure to build new stock to replace that leaving the social sector.



Right to buy sales England 1980-2009, source CLG.

HAs, as independent bodies, and standing outside the public borrowing and accounting regime, were well placed to become the focus for future development. The fact that they were already regulated by the Housing Corporation was an additional advantage, allowing scrutiny of their financial viability and governance, and reducing the risk to both the public purse and to providers of private finance. HAs had raised limited amounts of private finance with the assistance of the Housing Corporation from the late 1970's but the situation was somewhat chaotic, with a number of key issues unresolved.

An important development in the period was the introduction of shared ownership by which HAs (and some local authorities) were able to offer tenants and others part shares in properties whose unsold share would be retained by the landlord and rented to the purchaser. This provided HAs with the opportunity to develop new homes for the open market and further undermined the permanent monolithic characteristics of social renting as a tenure against the backdrop of a Government sponsored drive to create a "property owning democracy".

### ***The Housing Act 1988***

The Housing Act 1988 can be seen as laying the foundations for the large scale introduction of private finance for housing associations and as facilitating the expansion of the Large Scale Voluntary Stock Transfer programme, by which stock moved from local authorities to (usually) newly-created housing associations. It formalised a regime that has endured in its essentials until the present time.

Amongst its provisions the Act:

- Modernised the grant regime and allowed HAs to combine grant with private finance,
- Allowed development risk to be borne by HAs,
- Enabled lenders to take a first charge over HA assets and subordinated public grant to that first charge.
- Crucially the Act made possible the continued availability of housing benefit to cover rent payments as needed.

Although the 1988 Act was passed by a Conservative Government, mixed funded development and investment in existing stock by HAs has received the support of both major parties and much expansion has taken place since Labour took power in 1997. With public expenditure certain to be constrained for some years to come, future governments of either party are likely to wish to take advantage of the full access to private finance offered by the HA sector.

### ***The 90's to the present day; expansion of HAs, repairs and improvements and private finance***

Since the 1988 Act came into force the expansion in the role of private finance has been prodigious. By 1991, over £2 billion of private finance had been raised by HAs. Over the following two decades this has increased to over £58 billion in England and to c. £62 billion UK-wide, as analogous developments have taken place in Scotland, Wales and Northern Ireland.

Traditional (non stock transfer) HAs have used private finance for two main purposes; repair and improvement of existing housing stock and development of new stock.

Spending on repairs and improvements has been driven by a number of factors over and above the need to provide for routine maintenance:

- The need to meet national standards and regulatory requirements, including the decent homes standard (see above.)
- Enhanced awareness of environmental standards and the indirect influence of enhanced standards for new-build, such as the Eco Homes rating first introduced in 2000 and since upgraded.

New development by HAs has increasingly focussed on shared ownership properties as the cross subsidy model has allowed grant levels to fall on new-build social rented (general needs) housing. HAs owned less than 40,000 shared ownership properties in 1992, a figure which had risen to over 100,000 by 2007, by which time shared ownership comprised almost 7% of the entire English housing stock. It has been estimated that shared ownership properties amounted to around 1/3 of HA completions in 2005/06. Interestingly, shared ownership has increasingly drawn its clientelle from first time buyers outside the social rented sector. In 2005/06 only 7% of new shared owners were existing HA tenants.

HAs have also been prominent users of the Government equity loan schemes first developed in the 1990's and now collectively marketed under the Homebuy brand. Equity loans, and in particular Open Market Homebuy, have been expanded to help underpin the new-build market during the recession and housing market downturn in the wake of the banking crisis. They are favoured by retail mortgage lenders over shared ownership because of the perceived complexity and higher default rates associated with the latter. Nevertheless, mortgage finance for shared ownership has been less curtailed than finance for the wider mortgage market since the onset of the banking crisis, albeit that borrowers are now normally required to put down a significant deposit.

### ***Stock transfer***

Large Scale Voluntary Stock Transfer (LSVT) has been the single largest source of growth in the HA sector during the past 20 years. 1988 saw the first stock transfer of 4,400 homes to the newly created Chiltern Hundreds Housing Association. Since then over 1/3 of English local authority

housing comprising some 1.1 million homes has been transferred to the HA sector, most of it to newly created HAs but with some partial transfers to existing organisations. Total private finance facilities generated by LSVT in England had reached £17.5 billion by 2008 and are now in excess of £20 billion across the UK as a whole.

There are a number of factors behind the promotion of LSTVs:

- The need for local authorities to tackle large accumulated backlogs in repairs and improvements and to meet the Decent Homes Standard.
- The desire of Government to reduce public expenditure by bringing in private finance and to promote private sector efficiencies.
- The private sector status of HAs, keeping their borrowing outside the Public Sector Borrowing Requirement (PSBR)

Transfer, which can only take place following a ballot of individual tenants, and on the basis of an agreed programme of repairs and improvements, has contributed very substantially to improving the lives of those same tenants, through facilitating improvements to stock that would not have occurred within normal public expenditure constraints. In the early stages much of the transferred stock was in the South and comprised rural and semi-rural estates. As time has gone on however, inner city homes have been subject to transfer as has much poorer stock including some of negative value, which has been transferred with the aid of “gap funding” from Government to make the transactions viable. Negative value transfers generated over £1.5 billion in new private finance facilities in 2007-08

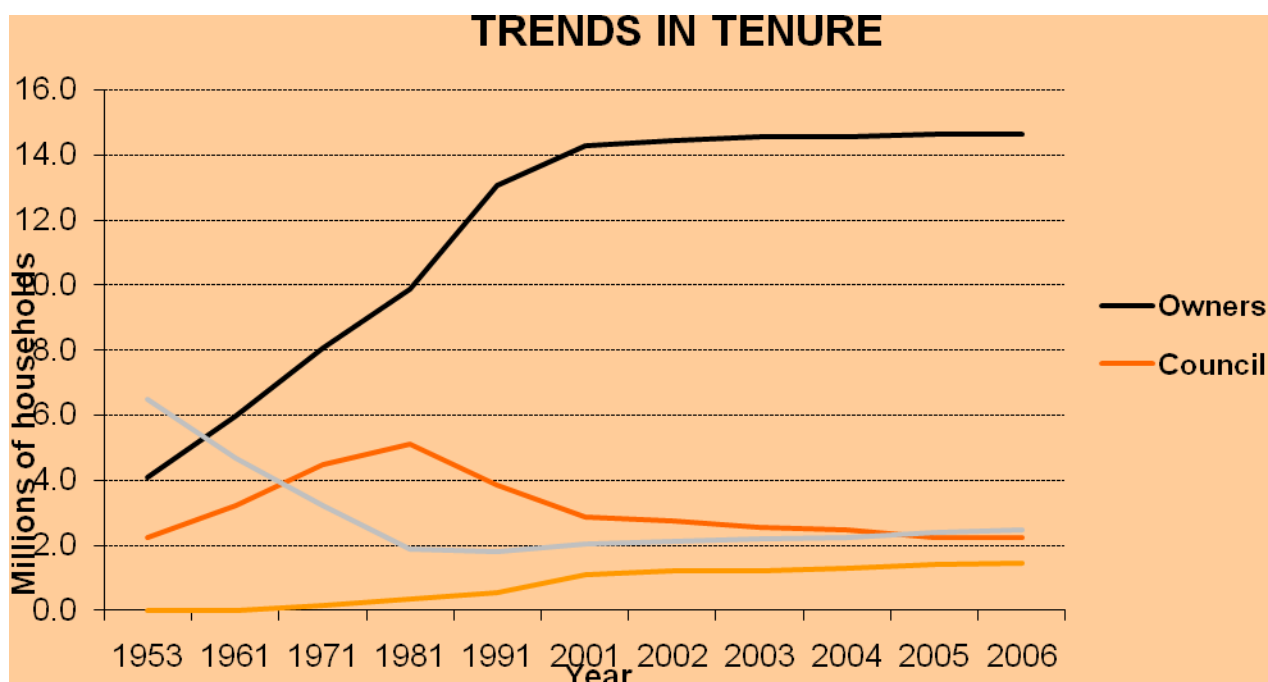
A number of factors have led to the slackening of the impetus for transfer in recent years. The fact that much of the better stock has been transferred is one. In addition, the ability of local authorities to create Arms Length Management Organisations (ALMOs) as an option to fund and manage the improvement in their stock has provided a viable alternative to transfer for some. Recent promises of enhanced prudential borrowing capacity for local authorities and other other additional funding has also allowed some to retain their stock.

Although the pace of transfer has slackened in England, Wales, which did not complete its first transfer until 2003, still has a viable programme which has attracted significant interest from lenders and investors in recent years.

In spite of their being 100% debt funded at foundation, strong regulation and sound governance have ensured that there has been no incident of financial default amongst LSVT HAs. A number of LSVTs have managed their assets and cash flows successfully enough that having completed their initial programmes of improvements they have been able to secure further funds for development. Chiltern Hundreds HA, the first transfer association to be founded is one such example, Bedfordshire Pilgrims and Chelmer Housing Partnership are others. The maturing of transfer organisations, partial transfers to existing HAs, and mergers and acquisitions involving existing and transfer associations, have meant that the distinction between “traditional” and “LSVT” associations, still used by the TSA for statistical purposes is becoming less relevant.

### ***The HA sector; two decades of rapid growth***

Overall, the effects of new development fuelled by private finance and of LSVT have led to significant growth of the sector. The stock of HA homes has more than doubled since 1990. As the table below shows, growth in the sector has contributed to a changed balance between HA and local authority tenures and to a significant increase in HA sector in terms of overall tenure balance, although from a low base.



Source: Survey of English Housing (Owners-black, Local Authority- orange, Private renting-blue, HA-yellow)

### **Tenants and tenancies**

#### ***Tenants and tenant satisfaction***

Whatever diverse activities are undertaken by an HA, its tenants still form the heart of the association and its main organisational focus.

HAs have long been required by the Housing Corporation, the previous regulator, to consult tenants and involve them in decision making. Many HAs have well-developed mechanisms for bringing tenants together for consultation and to represent them on their management boards. The new regulatory framework introduced by the regulator, the Tenant Services Authority (TSA) on 1 April 2010 sets out a new Tenant Involvement and Empowerment Standard requiring HAs to:

- “Provide choices, information and communication that are appropriate to the diverse needs of their tenants in the delivery of all standards.”

- “Have an approach to complaints that is clear, simple, and accessible that ensures that complaints are resolved promptly, politely and fairly.”<sup>1</sup>

In fact, HA tenant satisfaction with their landlord is consistently higher than for local authorities, while the new English Housing Survey indicates that 80% of HA tenants are very satisfied or fairly satisfied with their properties against 76% for tenants of local authorities.

HA tenants, are, not surprisingly, largely made up of those on lower incomes. Vulnerable and disadvantaged groups are well represented, with lone adults making up 35% of households and with a high percentage of lone parents with children. 31% of tenants are aged 65 and over. Only 25% of tenants are in full-time employment, with a further 16% described as job seekers. Housing benefit is of key importance in meeting rent payments for those groups who are economically inactive or on low incomes and helps ensure that the rental income stream is secure.

### ***Tenancy types***

Inevitably there are some variations in tenancy type but the overall picture is reasonably clear:

- **Assured tenancies.** Most tenants hold their properties under an assured tenancy. Established under the Housing Act 1988 assured tenancies offer considerable security of tenure. Nevertheless a landlord can gain right of possession from the courts on a number of important grounds, which include non-payment of rent, causing damage to the property and creating a nuisance to other residents.
- **Assured shorthold tenancies.** These are used in cases where needs are temporary and where a more secure tenancy would be inappropriate. Under these tenancies the landlord can gain possession without having to demonstrate specific grounds, once an initial term (usually six months) has passed.
- **Secure tenancies.** A small proportion of tenants will have secure tenancies in line with those offered by local authorities. Since such tenancies must have been offered prior to 15 January 1989, and historically HA tenancies have tended to last around five years, this tenancy type is steadily diminishing in significance.

### ***Rent regulation***

Since the 1990’s the Government has regulated HA and local authority rents in England. The aims have been twofold; to gain a hold on escalating levels of housing benefit to the social rented sector, and to bring about a restructuring of social rents leading to a convergence between HA and local authority rent levels. Currently local authority rents tend to be lower than for equivalent HA accommodation. Rent regulation, which does not apply to market rented properties, currently allows rents to rise by RPI plus ½% per annum. While this has on occasions caused problems for individual HAs, who can claim some flexibility in certain circumstances, the regime does provide stability and predictability to the income stream for HAs. This in turn has made long-term business planning easier and has facilitated meeting of loan covenants and calculating of asset values for loan security purposes.

### ***Right to buy and right to acquire***

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<sup>1</sup> Tenant Services Authority, *The Regulatory Framework for Social Housing in April 2010*, TSA London, 2010.

Tenants whose homes have been transferred to a housing association from a local authority will have a preserved right to buy on terms similar to that of local authority tenants though HAs are protected in respect of certain costs they have incurred on those properties.

Since 1996 there has also been a right to acquire for some tenants under which they can purchase their properties though under less favourable terms than the right to buy.

While these rights have been seen as a problem for landlords they should be put into perspective. Due to successive changes to the conditions of the scheme, the right to buy has been in numerical decline, and recent difficult market conditions have strengthened this trend. In 2008-09 there were only 1,000 right to buy sales involving HA properties. The right to acquire is even less significant with only 180 sales recorded for 2008-09.

### ***Future developments***

The Conservative/Liberal Democrat coalition is believed to be planning a Bill that could offer tenants more opportunities to move between social landlords by requiring landlords to maintain some homes empty to facilitate tenants moving into their area. No details are yet available.

### **Legal status of HAs**

HAs are private sector organisations. Although they may receive grant aid from government and are regulated by a Non Departmental Public Body, the TSA, HA finances stand outside the public income and expenditure regime and their borrowing does not contribute to public debt. This is, of course a key factor in the continuing commitment of Government to provide grant for development by HAs, since private finance can be invested on a scale that has not been possible with local authorities. It should also be noted that while the regulator has, in practice stepped in to facilitate resolution where HAs have encountered financial problems, there is no state underwriting of HA finances; they are, and must remain, independent if they are to continue as a focus for private investment going forward.

In terms of their legal structures, the majority of HAs are Industrial and Provident Societies (I & Ps), registered with the Financial Services Authority under the Industrial and Provident Society Act 1965. The FSA operates a publically available register of these HAs, which includes a range of information on each registered HA including their rules, the annual return and accounts, and details of floating charges.

HAs may also be established as companies limited by guarantee, and this is common where HAs have been set up to receive a transfer of former local authority housing stock. These associations will, of course be registered with Companies House and are subject to company legislation.

Whether they are I & Ps or companies HAs can have charitable status, and this is the case for the majority. While charitable status can confer certain tax advantages, it does also place certain restrictions on how an HA carries out its business.

Though HAs are registered with the FSA or with Companies House these bodies do not regulate HAs. Their regulator, since December 2008, is the TSA. Regulation is described in more detail below.

Investors may wish to note that the TSA provides publically available information on all regulated HAs (known as “regulated providers”) on its website. The information includes information about performance against regulatory standards, regulatory judgements and a range of benchmarking and statistical data.

## **The importance of regulation**

### **Key benefits of regulation**

A great strength of the HA sector is that it is regulated. While HAs, “regulated providers” themselves, sometimes complain that regulation is over bureaucratic, regulation has delivered a number of key benefits:

- Comfort to lenders and investors through ensuring minimum standards of governance and promoting financial viability, thus lessening the probability of financial default.
- Access to private finance for regulated providers at rates that reflect the perception that the sector constitutes a low-risk long term investment.
- Safeguards for government as a major investor, and in terms of its key objectives for the affordable housing sector.
- Protection for tenants in terms of the quality of provision and their ability to influence decisions that affect their lives.

From the perspective of investors it is important to note that the presence of regulation is one of the major reasons that there has been no incident of default by a regulated provider that resulted in loss to the lenders or investors involved.

### **Developments and changes**

Regulation has been a long term feature of the HA sector. Until December 2008 the regulator was the Housing Corporation, a Non-Departmental Public Body (NDPB) reporting annually to Parliament. The Corporation regulated HAs only; local authorities were subject to different arrangements.

The Housing Corporation combined its regulatory role with that of distributing grant, thus undertaking both the regulatory and investment function. Although this worked satisfactorily for many years the system was subject to a number of criticisms, notably that:

- The Housing Corporation was seen as over bureaucratic and prescriptive from the perspective of HA boards and managers.
- There was insufficient focus on the interests of tenants.
- Combining regulation and investment in one body created potential conflicts of interest for the regulator.

The Government established the Cave Review in 2006 to examine the issues surrounding regulation of social housing. The Review reported in 2007 and its conclusions formed the basis of major changes that were embodied in the Housing Act 2008.

The 2008 Act made provision for abolition of the Housing Corporation and establishment of two new bodies, the Tenant Services Authority (TSA) as regulator, and the Homes and Communities Agency as the investment authority.

## The TSA

Since December 2008 the TSA has been the new regulator for HAs, and from April 2010 for local authorities and ALMOs also. Physical inspection of regulated providers is undertaken by the Audit Commission.

As a regulator the TSA aims to be more tenant-focussed than the Housing Corporation. In addition, the TSA is committed to co-regulation, by which HAs can undertake significant elements of self-regulation with heightened tenant involvement. Although co-regulation was initially the subject of a degree of suspicion amongst lenders, it is clear that the TSA is committed to ensuring that key standards are met and that it has the powers to do so.

In contrast to the copious detailed guidance issued by the Housing Corporation, the TSA sees itself as a setter of standards, leaving regulated providers with discretion to achieve required outputs in the most appropriate ways. It is hoped that this approach will go some way towards lifting what some HAs have seen as a bureaucratic stranglehold, whilst maintaining the rigour of the regulatory safeguard from the perspective of other stakeholders, including lenders and investors.

The TSA has six standards covering the full range of social housing activity:

- Tenant involvement and empowerment.
- Home; quality of accommodation, repairs and maintenance.
- Tenancy; allocations, rents and tenure.
- Neighbourhood and community; includes local co-operation and anti-social behaviour.
- Value for money.
- Governance and financial viability. (See sub- section below)

Though the TSA may be seen as less bureaucratic than its predecessor it certainly does not lack the powers to ensure that the HA sector is financially viable, efficient and well-governed. The powers of the TSA are derived from the Housing and Regeneration Act 2008. The Act specifies the 10 key objectives of the TSA in Section 86; investors will particularly wish to note the following:

- “Objective 4 is to ensure that registered providers of social housing perform their functions efficiently, effectively and economically”
- “Objective 5 is to ensure that registered providers of social housing are financially viable and properly managed.”
- “Objective 7 is to encourage investment in social housing (including by promoting the availability of financial services to registered providers of social housing)”

Section 93 of the Act gives the TSA its powers in no uncertain terms:

93.1 “The regulator may do anything it thinks necessary or expedient for the purpose of, or in connection with, the performance of a function conferred on it by this Part or another enactment.”

93.2 “In particular, the regulator may do anything it thinks appropriate for advancing its fundamental objectives.”

The Act then goes on to specify specifically certain powers that the regulator can exercise including offering HAs financial assistance, paying individuals and borrowing money from the Secretary of State.

In conclusion; while “co-regulation” may mean flexibility to achieve the best performance co-regulation certainly does not mean “no-regulation”.

### **Governance, financial viability and the regulator**

Sound governance is a prominent feature of the HA movement. This is in large part due to the influence of successive regulators. Until December 2008 the Housing Corporation had this role and consistently explored governance issues, producing guidance and research in the process. The Housing Corporation, lenders and HAs themselves subscribed to the view that sound governance was the key to financial viability. It has become a truism of the sector that financial difficulties or poor performance within an HA are almost always preceded by problems of governance.

The Tenant Services Authority (TSA), as the new regulator has continued this tradition. TSA officials have always made it clear to stakeholders that governance and financial viability underpin the other benefits to be delivered to tenants. Because of its perceived influence on financial viability, promotion of sound governance is seen as a key safeguard offered by the regulator to tenants, government and investors.

The TSA introduced its new Regulatory framework in April 2010. The TSA regulatory standard on governance and financial viability states:

“Registered providers shall ensure effective governance arrangements that deliver their aims, objectives and intended outcomes for tenants and potential tenants in an effective, transparent and accountable manner. Governance arrangements shall ensure that they:

- Adhere to all relevant legislation.
- Comply with their governing documents and all regulatory requests.
- Are accountable to tenants, the TSA, and relevant stakeholders.
- Safeguard taxpayers’ interests and the reputation of the sector.
- Have an effective risk management framework.

The financial viability aspect states:

“Registered providers shall manage their resources effectively to ensure their viability is maintained.”

Both aspects of the standard are underpinned by specific expectations to ensure that the broad objectives are achieved.

## Regulation; tested in practice

There can be no guarantee that HAs as private sector bodies can be underpinned by Government in the event of financial failure. Such a guarantee would fatally undermine the private sector status of HAs, and hence their ability to borrow outside of public expenditure rules and constraints.

Nevertheless, as already indicated, the regulator has consistently intervened to ensure that financial difficulties and risks facing HAs individually and collectively do not result in loss for lenders and investors or prejudice the interests of tenants. Such intervention can be informal and pre-emptive, building on the close relationships forged between the regulator and HAs:

- The Housing Corporation has consistently intervened to promote mergers and takeovers of HAs in difficulties and has used grant to ensure that such arrangements are viable. The best known example of this is the case of Ujima, an association that became insolvent due to management and governance problems in late 2007. The Housing Corporation used its powers to organise the major creditors to agree to a takeover of Ujima by London and Quadrant with no loss to creditors.
- In 2006 the Housing Corporation moved swiftly to influence the Government to pass emergency legislation to deal with a situation where there were doubts that lender security arrangements for loans were valid due to failure by the Corporation to document that proper consent had been given to HAs to offer properties as security for these loans. No losses for lenders or disruption to HA activity occurred.
- As already indicated, during the period 2008 to 2009 the HCA diverted very large amounts of grant to enable developer HAs to retain properties built for open market sale, but which did not reach predicted sale values, or which could not be sold. Intervention by the HCA assisted HAs to cope with, and substantially reduce, a back log of over 10,000 unsold new-build properties.
- In early 2009, due to falling interest rates unexpected margin calls by lenders on standalone swaps taken out by HAs as part of their hedging arrangements threatened to cause financial problems for a number of associations. The TSA met with lenders and was able to reach an understanding that resulted in those lenders exercising sufficient flexibility that HAs were able to deal successfully with a difficult situation.

The comfort for investors to be found in a well-regulated sector has been proved in the HA sector over several decades. While there has been discussion of possible government moves to make institutional changes to regulation, including possible abolition of the TSA, lenders to the HA sector are more concerned that the rigour of the regulatory regime itself is maintained together with adequate resources to enforce that regime. It is believed that Government fully understands the importance of maintaining the integrity of regulation.

## **The governance and financial characteristics of HAs**

### **Governance arrangements of HAs**

As already indicated, the influence of the regulator has led to sustained pre-occupation with achieving sound governance across the HA sector. Under the new TSA regime this concern with governance is maintained with all HAs required to adopt an appropriate code of governance and to review their governance arrangements and accountabilities annually.

In organisational terms HAs are governed by non-executive boards. In many cases HAs will also usually co-opt members of their executive management team including the Chief Executive and Finance Director as board members. Most HAs have tenant board members and stock transfer associations are required to have tenant board representation as well as board members drawn from local authorities whose stock has been acquired. Tenant board members are normally elected by tenants and HAs will have a programme of training to ensure that they are able to discharge their responsibilities properly. In the majority of HAs tenant members do not constitute a voting majority on the board.

HAs are expected to ensure that they have an appropriate range of skills and experience on their boards to enable them to properly oversee their activities. Board members were traditionally unpaid. On occasions there were problems in attracting potential members with appropriate skills. As HAs have become larger more complex organisations, and as their diverse activities, notably in development, have exposed them to new risks, this problem has become more serious. In 2003 the Housing Corporation took the decision to allow HAs to pay board members. A survey conducted in succeeding years suggests that the proportion of associations paying board members is steadily increasing, particularly amongst the large HAs. Nevertheless, the majority of boards still do not pay their members.

An increasing number of HAs are now part of group structures that are intended to provide economies of scale and to facilitate certain activities such as new development.

It is often said that HA governance tends to be over bureaucratic and over reliant on a plethora of detailed written policies and plans produced in response to Housing Corporation guidance. It will be interesting to see how the approach of the new TSA regime contrasts with that of the Corporation over time. In spite of the frustrations that the above administrative tendencies may cause, they do at least have the advantage of ensuring that HA boards are fully aware of their aims and objectives, and the required attention to longer term planning- particularly for those undertaking significant development and refurbishment programmes does provide genuine comfort to investors. HAs may not always be agile decision makers, but their attention to detail does tend towards lowering their risk profile and lessening the chances of default against covenants.

### **Income, turnover and assets**

In spite of the diversification of HA activity over some years, associations remain predominantly dependent on rents for income. In 2009 rents and service charges amounted to c. 79% of the turnover for the sector. As already suggested, the government rent regime makes this income stable and predictable, with annual rises of RPI plus 0.5% on average.

The existence of Housing Benefit is another key stabilising factor for the HA sector. Housing Benefit contributes some 70% of rents collected by HAs. Housing Benefit has been considered a quasi-government income stream, which is secure and which ensures that rent levels are affordable for tenants. Housing Benefit in the social rented sector covers the whole rent payable if means testing finds this to be necessary. It is also usually paid directly to the landlord, thus reducing rent arrears and keeping the costs of collection down. This is facilitated by the tenant waiving their right to receive housing benefit personally at the time they first claim it. Almost all tenants are happy to subscribe to an arrangement that offers them convenience and the knowledge that the rent will be met regardless of financial problems that may arise. While Housing Benefit has been reformed in the private sector with benefit now being paid directly to tenants, government has taken a cautious approach in relation to the social rented sector, recognising that large scale private investment is in part underpinned by the comfort offered by the present housing benefit regime. The bond investors in particular place strong reliance on the current housing benefit formula and its effective link to RPI. Dismantling of key elements in the formula is typically a rescheduling event in their loan documentation.

Turnover for the sector continues to increase, in spite of the current economic, financial and housing market climate. In 2009 turnover was up 15% to £11.6 billion. The sector has not been immune to the recent problems; profits from property sales were down from £577 million in 2008 to £336 million in 2009. Nevertheless, the sector turned on an operating surplus of £1.64 billion in 2009, up from £1.57 billion in 2008. Overall the gross Book Value (GBV) of the sectors assets increased by £9 billion to £96.4 billion in 2009<sup>2</sup>

With the TSA estimating that the sector still has £24 billion in unused security for loans there is clearly still significant capacity to attract investment.

The TSA as regulator gave this positive assessment on the basis of the 2009 Housing Association Global Accounts:

“The global economic downturn, tightening of credit markets and decline in the housing market placed severe pressure on the property sector during 2008-09. While not immune from these pressures the HA sector has demonstrated its basic strength and largely maintained its operating performance during the period... the sector continues to be a secure investment for private finance and a valuable delivery partner for government.”

## **Funding new HA investment**

In the absence of conventional equity investment two main sources of funding are available to HAs for investment.

### **Grant**

The Homes and Communities Agency (HCA) has essentially taken on the investment and regeneration roles of both the Housing Corporation and English Partnerships. It is the agency which

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<sup>2</sup> Tenant Services Authority, *Housing Association Global Accounts 2009*, TSA, London 2010.

distributes social housing grant to HAs. As a single investment agency with a broad remit, the HCA also undertakes the full range of investment related activities from land assembly for development to administration of the Homebuy/shared ownership home purchase schemes. As Government will need to rely more heavily on private finance going forward in the context of post-banking crisis restraints on public expenditure it is clear that the HCA intends to use grant as an equity type resource, which can be flexibly deployed to maximise the leverage of other investment and where the HCA can take a share in the uplift of value created by grant sponsored development. It is clear however, that the HCA does not see it as in its interest to prejudice HA viability through ill-considered action in respect of grant. Since the onset of the banking crisis the HCA has effectively used grant to repair the capital base and secure the viability of some developing HAs caught by falling property values and slow sales on their open market developments. This encouraging approach suggests that the long tradition of the regulator/investment agency stepping in to assist rescue of HAs in financial difficulty is alive and well.

Social housing grant was, historically, the most important source of investment funding for HAs, a position maintained until relatively recently. As already described, the Housing Act 1988, formalised the structures of a mixed funding, grant/private finance regime. Grant is subordinated to the private lender 1<sup>st</sup> charge against HA assets (fixed or floating). In the early days therefore, private finance essentially had the status of a “top up” to grant funding. Social Housing Grant levels were at 75% in the early 1990’s. The main exception to this position were the wholly debt funded LSVTs.

Government has increasingly seen gearing private finance against grant as a way of maximising outputs from any given level of public expenditure so that over the past two decades grant levels have fallen, initially in England but later in Scotland and Wales, although to a lesser extent. The culmination of this process may be seen as the publication in February 2007, (with hindsight, on the eve of the banking crisis,) of the Housing Corporation paper *Unlocking the door-delivering more homes from the Comprehensive Spending Review 2007*. The paper envisaged further reducing grant rates from their prevailing levels of 44% to 34% or even less and maintaining HA build rates of up to 50,000 units a year.

In the event, the housing market downturn forced the HCA to pump in large amounts of grant in 2008-09 and the stringent public expenditure constraints on the UK Government going forward place real questions about the extent to which grant can form part of future development plans. This in turn raises questions about the future supply of social rented housing, which has required grant subsidy to maintain subsidised rent levels as well as a cross subsidy from the profits of open market development. It is certain that the HCA will, in future, treat grant as quasi-equity, accepting gains and losses from development and moving grant to where it can have the most effect. Lenders are confident however that this new flexibility will not be used in ways that will prejudice individual HA viability, and the position is closely monitored by the TSA who are in close contact with the HCA.

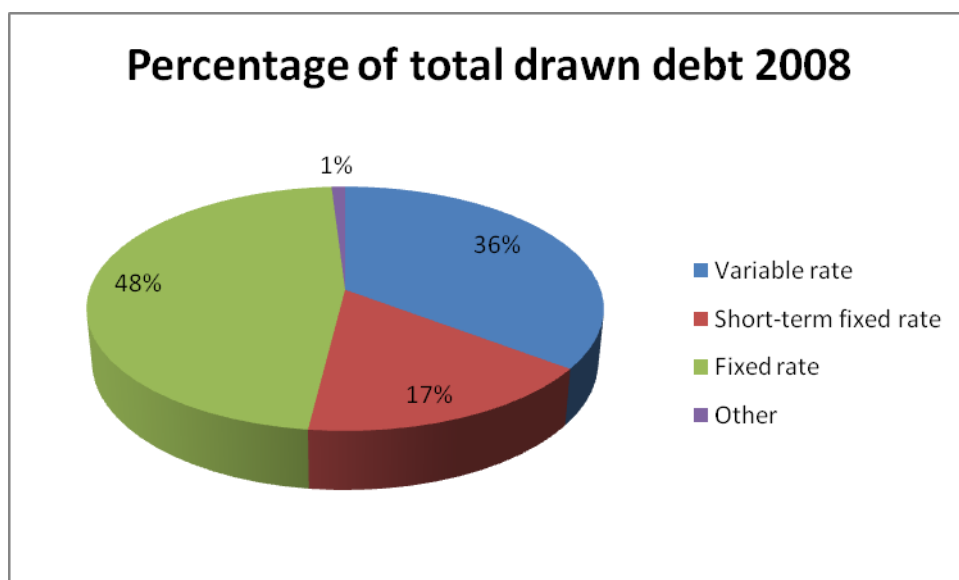
What is clear is that falling rates of grant over a sustained period have led to private finance taking on the pre-eminent funding role over the past few years. Accumulated grant investment in properties increased by £3 billion in 2008-09 to a total of £37 billion, and in the same period drawn down private investment increased by £5.1 billion to £40 billion.

## Private finance

Total private finance facilities for HAs had reached £58 billion by 2009<sup>3</sup>, of which some £45 billion had been drawn down, according to the TSA *Private Finance Strategy 2009 (Nov 2009)*. 85-90% of this is in the form of loans finance; 86% of all finance has been supplied by the following banks and building society:

Bank Financial Institution	Share of market
Lloyds Banking group	£13.6 billion
Barclays	£10.7 billion
Nationwide	£9.3 billion
Santander	£8.2 billion
Royal Bank of Scotland	£8.0 billion
<b>Total</b>	<b>£49.8 billion</b>

In 2008 the breakdown of drawn finance by loan type was as follows:



Source: *Annual Review of Housing Association Private Finance 2008*, TSA.

Lending has mostly been fully secured, with assets valued by a conservative valuation methodology, which usually involves general needs housing being valued by a combination of two prudent approaches. Existing Use Value- Social Housing (EUV-SH) values on the assumption that a property will remain tenanted at a subsidised rent after disposal. Open Market Valuation (OMV)-Tenanted values properties on the basis that they continue to be rented after disposal but at market rents.

The Capital Markets have always had a significant place as providers of HA investment with current capital markets finance to the sector estimated at c. £8 billion. Investment has involved single name bonds issuance via a number of arrangers including Royal Bank of Canada, Barclays, Royal Bank of Scotland, Morgan Stanley and Credit Suisse and Lloyds. In addition smaller HAs have been able to access the capital markets via aggregating bodies who have grouped requirements together. THFC is

<sup>3</sup> England only.

the pre-eminent body in this category, with a history that stretches back to the dawn of the present mix-funding finance regime.

Bond issuance has risen dramatically in value since the onset of the banking crisis. The cost of funds to banks has risen and allowed capital markets investment to compete effectively on price. Credit spreads for HAs have increased from the 20-30 basis points offered immediately before the banking crisis to around 125-200 bps today. In addition, the fear of many HAs that the banking crisis would leave them short of funding has led to a greater degree of interest in a plurality of funding sources.

There has, in addition been a perception amongst HAs that banks are and will continue to be less willing to offer long maturities (up to 30 years) traditionally demanded by the sector, against the context of recently introduced stringent prudential requirements. While the evidence for this is not conclusive, it has made HAs look beyond their traditional horizons for new funds. The strong relationship of THFC with the regulator and with the HA sector itself has ensured that THFC has taken full advantage of this upturn in capital markets activity:

#### Value of bonds issued 2008-2010

Issuer	Value of bonds	Date issued	Cost
THFC	£80 million	Aug-08	5.96%
Affinity Sutton	£250 million	Sep-08	5.98%
Circle Anglia	£275 million	Oct-08	7.25%
PfP	£180 million	Dec-08	6.92%
Sanctuary	£200 million	Mar-09	6.64%
THFC	£191 million	Jul-09	6.35%
Sovereign	£175 million	Sep-09	5.71%
Genesis	£250 million	Dec-09	6.04%
London & Quadrant	£300 million	Jan-10	5.50%
THFC	£72 million	Mar-10	5.58%
<b>Total</b>	<b>£1,973 million</b>		

Source: various

The TSA has analysed what it considers to be the funding requirement for HAs over the next five years and this is set out in the table below. While the present state of the economy, the uncertain outlook for the housing market and the constraints of public expenditure mean that this forecast must be treated with caution the requirement will clearly offer opportunities for investors:

<b>Forecast private finance requirement 2009-10 to 2013-14</b>						
	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>Total</b>
	(£ billion)	(£ billion)	(£ billion)	(£ billion)	(£ billion)	(£ billion)
Payments to acquire and develop housing	7.05	5.61	4.49	3.74	3.56	24.45
<i>Less sales receipts</i>	-0.89	-0.92	-0.82	-0.82	-0.75	-4.20
<i>Grants received</i>	-2.81	-2.51	-2.14	-1.79	-1.56	-10.81
Net cost of new development	3.35	2.18	1.53	1.13	1.25	9.44
Major repairs expenditure	0.47	0.49	0.57	0.68	0.82	3.03
Loan repayments	0.82	1.07	1.12	1.22	1.01	5.24
Stock transfers	0.30	0.20	0.20	0.20	0.20	1.10
Other housing association funding	0.20	0.20	0.20	0.20	0.20	1.00

<b>Private finance requirement</b>	<b>5.14</b>	<b>4.14</b>	<b>3.62</b>	<b>3.43</b>	<b>3.48</b>	<b>19.81</b>
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Primary source: 2009 Capacity Models submitted to TSA for *Private Finance Strategy 2009*

The TSA has also forecast where it believes those funds will come from. In doing so it predicts that the capital markets will supply £1-2 billion of finance per year to 2014:

Forecast funding capacity for HA sector 2009-2014

Source	Amount
Banking market	£20 billion
Capital markets	£5-10 billion
<b>Total</b>	<b>£25-30 billion</b>

Source TSA 2009.

## THFC: what we can do for investors

### Who we are

THFC is the foremost provider of aggregating funding services to the HA sector. We specialise in aggregating the private finance requirements of HAs in order to enable those associations to gain access to financial markets on the most competitive terms.

THFC obtains funds from bond issues, (public issuance and private placements) and bank loans including funding from the European Investment Bank (EIB). We raise funds for new HA development, for repairs and improvements to existing stock, for regeneration and for other related purposes.

Established in 1987 through a joint initiative of the Housing Corporation, the National Housing Federation (NHF)- the trade body for housing associations, and the private sector, THFC has had, from its inception, a close and creative relationship with the HA sector.

### What we are

As an Industrial and Provident Society (I & P) we have a common legal status with the majority of our clients. As an I & P we are of course, registered with the Financial Services Authority and our key financial information is publically available from the FSA as well as from ourselves.

Our nine-strong Board of Directors includes a wealth of experience from the banking, financial and commercial sectors but crucially also includes representation from the TSA and the NHF. This ensures that our strategy and organisational focus is centred on our clients and informed by a strong awareness of their operating environment including risks, opportunities and the long-term trends.

THFC currently has a total loan book of £2.1 billion and declared an annual operating surplus of £1.16 million in March 2009.

Share equity in THFC is purely nominal, but the Group had accumulated reserves of £8.5 million at March 2009.

While not completely immune to the fallout from the banking crisis, throughout its 23 year history THFC has demonstrated that it is a counter-cyclical credit. THFC is a well-managed organisation, with strong risk assessment and a conservative approach to the setting of loan covenants, which were not relaxed in the boom years before 2007. Unlike many of its bank and building society competitors THFC did not need to receive public funds to shore up either liquidity or capital during the crisis. THFC has remained profitable throughout the period 2007 to the present and indeed has been in surplus since its inception in 1987. We are poised to take an expanding role in funding the HA sector going forward. Our A+/A-1 credit rating was re-affirmed in December 2009.

## How we operate; THFC and Investors

### ***Funding mechanisms***

Over the years we have used a variety of financing instruments including zero coupon, deep discounted, index-linked and conventional public debenture stocks, private placements and fixed and variable rate bank loans. In spite of our flexibility we adhere to some fundamental principles:

- THFC acts as principal and borrows in its own name. It on-lends immediately and only to registered providers.
- Funds borrowed are on-lent on similar interest and repayment terms thus ensuring that THFC is protected against interest rate risk.
- THFC does not take foreign currency risk.
- We always make our own credit assessment of potential borrowers.
- Our loans are fully secured and we are legally bound to conservatively set covenants.
- Investors to THFC benefit from a floating charge over THFC's assets; primarily our secured loans to HAs and our reserves.
- All THFC stocks and loans rank *pari passu* and are further protected by a negative pledge.
- THFC covenants to investors that its operating expenditure will remain within total income on a rolling three year basis.

Overall, THFC offers investors flexibility, a secure long-term investment and guaranteed return through participation in the affordable housing sector; a well regulated and low risk environment representing one of the most successful long-term private public partnerships in the UK.

### **THFC and borrowers**

HAs wishing to access the services of THFC benefit from our unrivalled links with the HA sector and our role as a specialised lender, we *only* lend for affordable housing. With both the TSA and NHF represented on our board, THFC is well-placed to look at an HA in the round and within the context

of the broader sector. That means we understand HA aspirations and the risks they face; we are keen to help, but not in ways that ultimately rebound on the borrower, the investor or the HA sector as a whole.

### ***Credit appraisal***

We undertake rigorous credit appraisal of our borrowers prior to loans being approved by our Credit Committee. Over its entire 23 year history THFC has had a 100% record of timely payment of interest and principal.

As might be expected, THFC examines key financial ratios and performance indicators drawing on our own well-developed credit criteria.

Our two stage assessment process does not discriminate in favour of larger associations. All applicants are assessed in terms of their individual financial strength and the existing exposure of THFC and other lenders to the organisation.

### ***Asset cover***

THFC takes a conservative view of asset cover; our loan security must be valued at 150% of the loan secured. Security is provided by land (including housing on land and development land), depreciated at cost in the balance sheet or independently valued at less 1.5 times the value of all loans already secured against that land.

THFC either takes a floating charge over the entire assets of the borrowing association, or a fixed charge over specific properties owned by the association. Floating charges offer greater flexibility to dispose of properties in the normal course of business, but also assist investors to achieve recovery in the unlikely event of a default by the association.

When an association's security is based only on fixed charges THFC 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. THFC's secured loan must accordingly represent not more than 2/3 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, THFC 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.

THFC has to date typically required that associations providing floating charge security also give fixed charges in favour of THFC over the properties on which THFC's loan is utilised. This is, however, not an obligation required by the terms of the Trust Deeds under which THFC operates. HAs have the

option to switch from floating to fixed charge-only security and vice versa with THFC'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 more efficient use of assets.

The conservative approach to asset cover ratios and in particular to valuation methodology offers investors working through THFC real comfort in terms of reduced risk.

#### ***Income cover***

THFC requires that loan documentation sets appropriate conditions to ensure that all associations are able to meet loan specific interest payments. With fixed charges as security, the net income from the properties charged must least provide 100% income cover. For floating charges, at least 100% cover must be available from within the income and expenditure account of the association.

### **So what does THFC offer investors?**

- **The services of the pre-eminent aggregating lender to the HA sector.**
- **Unrivalled knowledge and experience of the HA sector, through our status as a specialist lender and our direct links to HAs and the regulator.**
- **A well-managed loan book with strong covenants and sound risk management.**
- **A track record of continuous independent profitability and viability from inception, through the banking crisis and beyond.**
- **A proven funding methodology that minimises risks to investors and to THFC itself.**
- **A flexible approach that combines fully secured lending based on conservative valuation methodology, with the ability to meet the needs of different groups of investors and borrowers.**

## Postscript: the wider picture

### Local authorities: a future investment opportunity?

Local authorities have seen their housing stock decline over a 30 year period from a peak of 4.99 million to 2.08 million. HAs numbers increased from 281,000 to 2.4 million during the same period. Much of this remaining local authority stock has been placed within semi-independent Arms Length Management Organisations (ALMOs) for purposes of bringing stock up to the Decent Homes Standard. Local authority stock has declined for three main reasons:

- The impact of the Right to Buy, with some 2.2 million homes lost
- LSVT, which has accounted for c. 1 million lost to HAs, and;
- The inability to develop new council homes, due to inability to access private finance or government grant.

There are some signs that this picture may be changing. A degree of prudential borrowing capability is being introduced, under which local authorities will have some flexibility to access private finance. The Government also appears to be prepared to countenance some new development by local authorities with certain authorities receiving grant funding for the first time in many years.

The Government is also reforming the complex inter- authority subsidy arrangements existing under the Housing Revenue Account (HRA) system of local authority housing finance with authorities likely to leave the HRA and keep greater control of receipts derived from assets.

There has been speculation that local authorities could build up to 10,000 new homes a year. While this figure may well prove over optimistic, local authorities may well be in the market for funding in

a way that they have not been before. With local authorities subject to a common regulatory regime with HAs under the TSA they could generate a significant private finance requirement going forward.

HAs, as private sector bodies outside the constraints of public sector borrowing, are likely to remain the main driver for new development going forward, nevertheless the potential investment opportunity represented by local authorities should not be overlooked.

### **Housing, housing markets and government**

As we have seen, there has been significant movement within the social rented tenure, with HAs increasing their stock rapidly since 1990, but with local authorities losing over half their stock. HAs now hold more stock than local authorities. The reasons are not hard to find, the right to buy, which has transferred over 2.2 million homes out of the sector entirely, stock transfer from local authorities to HAs and lack of new development by local authorities.

However, the bigger picture is more complex. Of the three main tenures, the past two decades have seen home ownership rise but lately fall back. After a long period of decline in the period up to 1988 private renting has increased more rapidly than other tenures in percentage terms, and social renting as a whole has seen a relative and absolute contraction, although within that, HAs have seen their relative share of households grow along with a rapid growth in the total number of dwellings under their control. The overall drop in the level of social renting can be ascribed principally to the right to buy. Development of new housing by HAs has simply not kept pace with the total of some 2.2 million homes that have left the sector for owner occupation.

#### **Trends in housing tenure 1991 to 2008-09 (Percentage)**

	Owner occupation	Social Renting	Private renting	Total %
1991	67.6	23.0	9.4	100
2001	70.4	19.5	10.1	100
2008-09	67.9	17.8	14.2	100

Source: English Housing Survey/Survey of English Housing.

The factors that have led to owner occupation subsiding back to 1991 levels while private renting has expanded reflect both long and short term changes. It can be argued that many of the factors that promoted home ownership in the post-war period have been subject to change:

- Full-time secure employment is less prevalent.
- Labour mobility is greater, impacting on home ownership as a relatively inflexible tenure for those on the move.
- The tax system, no longer provides fiscal incentives for home owners
- Pension provision has been undermined in recent years, leading to downsizing or exiting the sector by older owners.

- State support for those unable to pay their mortgage in the form of Income Support for Mortgage Interest (ISMI) has been less comprehensive since 1995 in spite of some recent improvement.
- Affordability has been stretched by a shortage in housing supply.

Commentators have noted that without the right to buy the relative decline in home ownership would have been identified significantly earlier.

Long term trends away from home ownership have been exacerbated by the effects of the banking crisis and the housing market downturn. Nevertheless many commentators believe that the mortgage market will not return to the heady days of 2000-07. It appears that banks will remain more cautious about their liquidity, capital and the quality of their assets going forward. This caution is being re-enforced by changes in prudential and consumer-facing regulation. These changes may be observed at national, European and international levels. In the UK the FSA is overseeing regulatory change whose consequence is likely to be a more conservative mortgage market in terms of loan to value, affordability and a less accepting stance to those with impaired credit histories. While the present lack of mortgage finance will undoubtedly ease, it is likely that the new restrained market will support more restricted access to home ownership than was the case prior to the crisis.

The story of private renting over the past 20 years is in many ways the converse of that of home ownership. The 1988 Housing Act reformed tenancy arrangements by introducing the assured shorthold tenancy. This gave landlords the ability to regain control over their properties and to charge market rents. Thereafter a number of factors came into play:

- Increasing immigration leading to a need for rented housing for those newly entering the UK.
- Increasing student numbers.
- Greater labour mobility
- A higher incidence of relationship breakdown, single person and single parent households, all giving rise to the need for the flexibility of private renting.
- The development of a strata of young affluent professionals putting off home ownership until later than had been customary.
- The easy availability of Buy-to-Let mortgage finance since the mid-90's allowing increased investment in the sector, improving the quality as well as the quantity of private rented stock.

Government has increasingly seen an expanding private rented sector as necessary to meet the challenges posed by demographic and social change. The reputation of the sector has also improved with the recent government commissioned Rugg Report pointing to a sector where by and large, the needs of its households are met in a satisfactory way.

The banking crisis has had its effect on the private rented sector. Buy-to-let lending has been reduced even further than that to the mainstream housing market due to the greater reliance of buy-to-let lenders on the capital markets for their own funding. While this market will recover, like the mainstream market it will almost certainly be on a more conservative basis. Private institutional investment has traditionally found the returns on investment in private renting to be insufficient.

The above changes pose real challenges for government, which arguably have yet to be fully acknowledged let alone addressed in policy terms. Successive governments have seen home ownership as the tenure of choice and have encouraged it as a way to promote social cohesion, to transfer responsibility for housing from the state to the individual household and to give wider access to what was until very recently seen as a permanently appreciating asset.

In spite of government commitment to home ownership the longer term social, economic and demographic trends have tended to militate against further expansion. While governments have created schemes to boost ownership at the margins they have done little to reverse the effects of long term social change. However, politically a public move away from the objective of extending home ownership would be very difficult for any government.

Government has taken an increasing interest in private renting, bringing in licensing schemes of various kinds and with universal registration now under discussion. In February 2010 HM Treasury published an important consultation paper *Investment in the Private Rented Sector*. The paper simultaneously highlights the growing importance of the private rented sector while pointing out the difficulties as to who will fund future investment.

The bigger picture presents challenges and opportunities for HAs. With public expenditure likely to be constrained for many years to come, the easy options of grant funded development are likely to become harder to come by. If home ownership is in relative decline and mortgage finance constrained then large-scale promotion of low-cost homeownership becomes more problematic. Yet the need for social rented housing is likely to increase in a time of austerity. This means that rental demand will remain buoyant. The big issue for HAs is what to develop going forward and how to fund it. It may well be that we shall see a rebalancing of the three main tenures within HA development plans; lower levels of open market sales, a continuing programme of subsidised social rented housing at whatever level government grant will facilitate, and a larger foothold in the private rented sector. The latter development would take advantage of HAs ability to operate successfully on modest margins to develop good quality homes for market renting. Whatever the shape of future development, it is clear that HAs will remain significant players.

## **Social housing in Scotland, Wales and Northern Ireland**

### ***Scotland***

Scotland has traditionally had a proportionately larger social rented sector than England with 26.1% of all Scottish homes in the social rented sector. Of these the majority remain in local authority hands, with 212 registered HAs holding a total of 252,000 homes or 10.5% of all stock.

Scotland has had some 20% of social rented stock transferred from local authorities to HAs including over 80,000 homes transferred from Glasgow City Council to the newly formed Glasgow Housing Association in 2003. Nevertheless, the LSVT programme was never as popular as in England, and appears to have come to a halt.

Scottish associations tend to be smaller on average, (with the exception of Glasgow), than English HAs. Scotland has its own regulator The Scottish Housing Regulator, which undertakes a similar role to that of the TSA. Regulated HAs are known as Registered Social Landlords (RSLs)

Although grant levels in Scotland remain higher than in England, Scottish HAs had attracted over £2.1 billion of private finance at March 2009 - an increase of 18% over the previous year. 23 RSLs have 51% of private debt finance.

### ***Wales***

In Wales, HAs hold c. 107,000 homes or 8% of Welsh housing stock. The social rented sector as a whole in Wales comprises some 222,000 properties or 17% of the total stock.

In Wales the LSVT programme was delayed for a number of years due to political factors. It is now underway with 7 transfers so far, and a number planned. With the LSVT programme in England slowing, there has been significant interest from lenders in the Welsh transfer programme.

In Wales the HA regulator is the Welsh Assembly Government. A new and improved regulatory framework will be in place for 1010/11 following some criticism from lenders and others about the quality of regulation in Wales hitherto.

With a sizable development programme, and with HAs required to reach the Welsh Housing Quality Standard by 2012, Wales represents a valuable investment opportunity.

### ***Northern Ireland***

Northern Ireland has a different structure for social renting to the rest of the UK. In the 1970's in a move to remove sectarianism from public housing provision, all local authority housing was placed within a new organisation, the Northern Ireland Housing Executive (NIHE). At one time the NIHE was the largest landlord in Europe. In spite of erosion of stock due to the Right to Buy the NIHE still holds some 99,000 properties.

HAs in Northern Ireland hold around 23,000 properties i.e. 3.3% of the total housing stock. Because of fears of a return to sectarianism and the popularity of the NIHE there has as yet been no LSVT programme in Northern Ireland. Northern Ireland continued to have relatively high levels of public expenditure compared to the rest of the UK, and this has staved off the need to lever in private finance to the same extent as elsewhere in the UK. However, Northern Ireland now faces significant cut backs in public expenditure. This and a demanding housing development target has contributed to a heightened interest in private finance amongst Northern Ireland Housing Associations, with a number of significant deals being completed during the past two to three years. There has also been debate about the possibility that the NIHE might change its public sector status or be broken up in order to facilitate a larger role for private finance although nothing has yet occurred on this front.

Northern Ireland HAs are regulated by the Department for Social Development (DSD) within the Northern Ireland Executive.