UK affordable housing: public policy uncertainty vs assets in high demand

Private investor interest in the UK affordable housing market should continue to grow, given the sector's favorable credit fundamentals and likely efforts by the government to address significant demand in the wake of the macroeconomic challenges of Brexit and Covid-19. The most critical elements of Scope's credit analysis are enforceability, instrument seniority and refinancing risk.

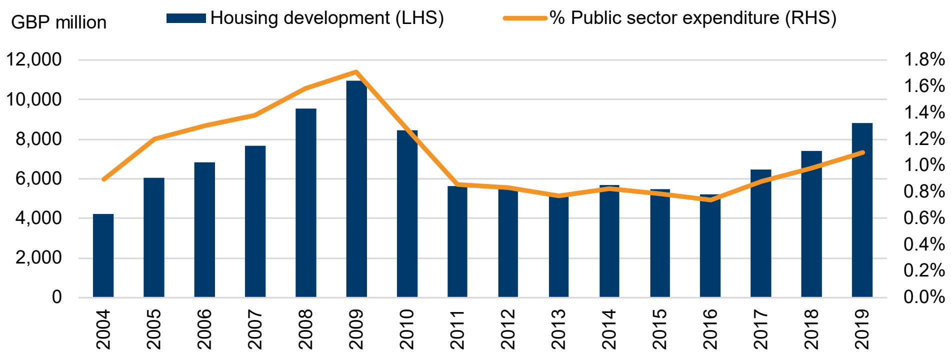
Introduction

UK affordable housing is in high demand, which is exacerbated by a significant supply shortage. Public funding alone does not have the capacity to close the current gap, which may widen further with numbers of households earning low incomes increasing. The expected high costs of Brexit and Covid-19 coupled with elevated public debt levels may lead to a further reduction of public funding allocated to the affordable housing sector, creating a need for more private-sector credit. The first large wave of affordable housing debt issuance and private investment followed the 2008 global financial crisis (GFC), which was largely driven by reduced government spending on social housing (**Figure 1**) and regulatory reforms.

The affordable housing sector accounts for roughly 17% of total UK housing stock, down slightly from 17.7% in 2009. This is very low compared to the 96.5% of UK households that meet income criteria for affordable housing. Additionally, post-GFC financial reforms increased capital charges on long-maturity loans, which suppressed the appetite of banks that had historically lent to the sector on terms that often exceeded 10 years.

Increasing capital allocated to the under-supplied affordable housing sector will be hugely beneficial to lower-middle-class households. To achieve this, the UK government needs to attract more private investment to the sector through the loosening of rent regulations and/or improving efficiencies in the approval process for development projects.

Figure 1. Public finance expenditure on housing development



Source: HM Treasury

This report focuses on credit opportunities in England's affordable housing sector and Scope's credit considerations for Affordable Rent and Shared Ownership properties, given their growth potential for private credit and secured lending[1]. Additionally, we provide a brief overview of recently proposed reforms in the UK that will impact the affordable housing sector. For a high-level overview that helps distinguish Social Rent, Affordable Rent and Shared Ownership, see Appendix I.

[1] Social housing, the third sector in low-income housing is fully government financed and shows limited attraction to private investors.

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Credit themes

Investments may meet environmental, social and governance standards

Debt financing in the affordable housing market is fundamentally attractive to private investors, such as pension funds and insurance companies. This is due to i) sound and stable debt yields, ii) high-demand collateral and iii) long-term investment opportunities that align with their respective investment horizons. Moreover, certain investments may meet relevant environmental, social and governance (ESG) standards that are becoming increasingly important to many categories of investors.

However, the complexity of regulation combined with administrative execution inefficiencies caused by public authorities can be challenging for investors, as they may reduce recovery prospects and prolong development beyond expected timelines. Government authorities have acknowledged such shortfalls and have proactively made efforts to address them. However, such efforts must consider local authorities' affordable housing imbalances, which are not uniform across England and require customisable solutions.

Credit financing for affordable-housing-linked collateral in the UK is straightforward.

At a high level, credit financing for affordable-housing-linked collateral in the UK is straightforward as long as loan-to-cost or loan-to-value ratios are carefully managed. Stable collateral values and low debt-service volatility anchor the attractiveness for debt financing in this space. Very low vacancy rates further underscore the fundamental supply-demand imbalance that provide a lever of support for property cashflows and, by extension, collateral values, and debt service. However, certain regulatory restrictions, for example in the form of rental caps (affordable rent is capped at 80% of comparable market rents) can constrain debt-service coverage ratios, along with public policy uncertainty.[2]

Strong investment sentiment

Investment sentiment in the sector is strong, with opportunities arising in the form of secured public bonds, as well as unsecured bonds and development projects. Bonds and private placements reached GPB 6.7bn in 2019 via 42 transactions, compared to only GBP 2.6bn in 2017[3].

[2] The Insolvency of Registered Providers of Social Housing Regulations 2018.https://www.legislation.gov.uk/ukdsi/2018/9780111165423 A new special administration regime. Regulators have the power to appoint administrators to insolvent housing associations. Naming one key risk in the resolution is the appointed administrators will aim to keep social housing stocks in the regulator sector.

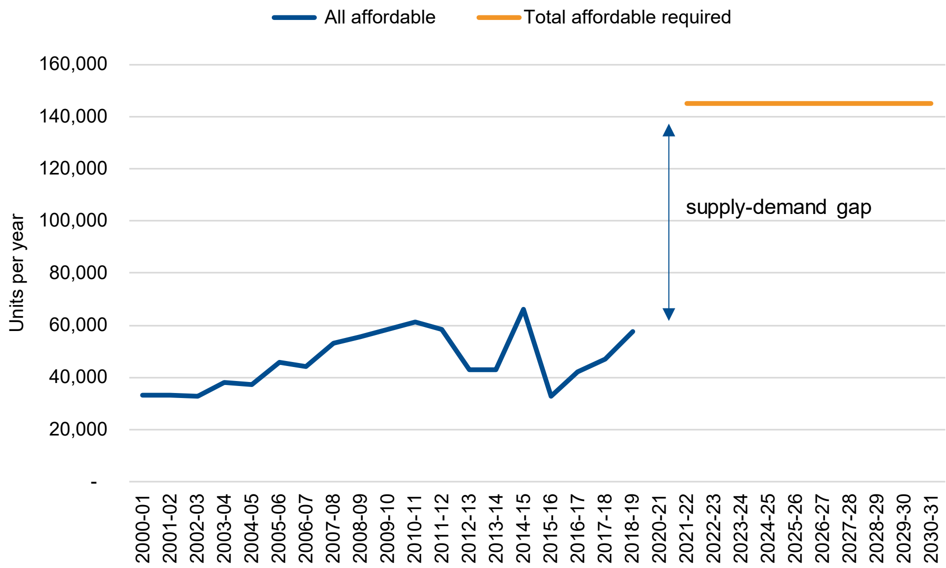
[3] Source: Regulator of Social Housing, 2019 Global Accounts of private registered providers, December 2019

The supply-demand gap

A supply shortage is the major driver of the sector's low vacancy rates.

A supply shortage is the major driver of the sector's low vacancy rates. The UK has been suffering from a significant undersupply of low-income housing for quite some time (**Figure 2**). And we believe this will persist in the future, given current funding levels and budget plans, coupled with the share of current and expected low-earning households.

Figure 2. England dwelling and affordable home additions per year

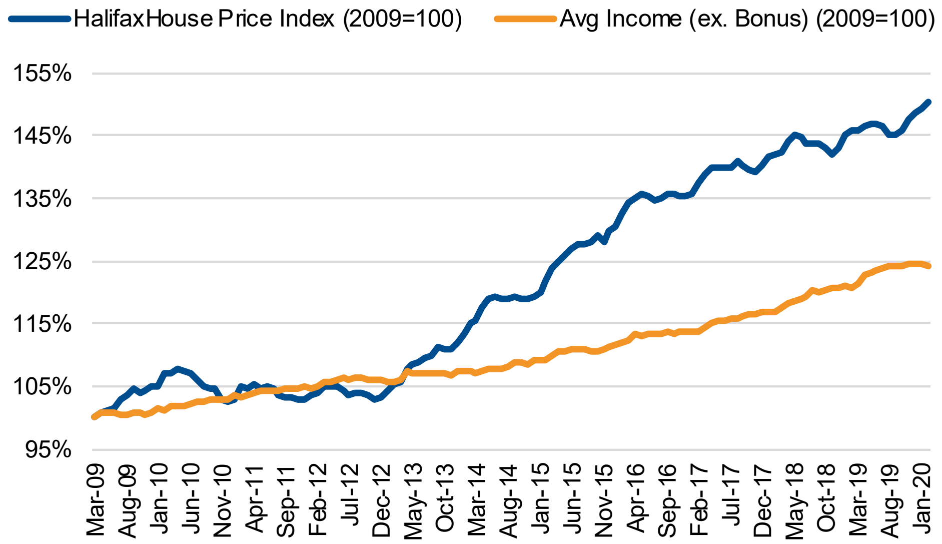


Source: Ministry of Housing, Communities & Local Government, National Housing Federation

The long waiting list is a result of significant house price increases in recent years.

As of 2019, about 1.16 million households in England were wait-listed, standing by to move into a home from an existing affordable housing stock of 4.15 million units. Besides suitability issues, the long waiting list is a result of significant house price increases in recent years, exceeding income growth (**Figure 3**), as well as scarce new developments.

Figure 3. House prices and average income index



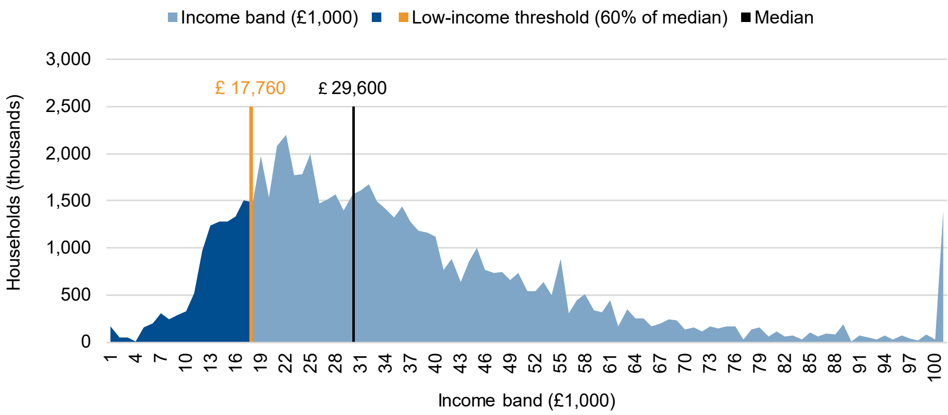
Source: Office for National Statistics, Halifax

Families can wait more than five years before securing an affordable home. It is expected that an additional 100,000 to 145,000 affordable units per year will be needed to close the gap[4]. London and South East England require the largest increase.

96.5% of UK households meet the income criteria for affordable housing

If we apply eligibility criteria (see **Figure 11** for summary) based on income alone: 17.5% of UK households potentially qualify for social housing if we use low income as the measure for eligibility (**Figure 4**). As much as 79.0% could qualify for affordable rent (excluding share eligible for social rent) and 95.9% for shared ownership. If we add social rent and affordable rent together, 96.5% of UK households meet the income criteria. Please note, these numbers do not reflect other key eligibility criteria, such as average local earnings, how long a household has been resident in an area (preferably five or more years), as well as local market rents and housing prices that local authorities take into account when determining eligibility.

Figure 4. UK income distribution: "low-income" threshold in 2019 was £17,760



Source: Office for National Statistics, Scope calculations

Private capital sources will be required to support a reduction in the supply-demand gap.

Private capital sources will be required to support a reduction in the supply-demand gap, as government funds are insufficient. Otherwise, the affordable housing supply-demand gap will remain. The government's renewed Affordable Homes Programme is expected to fall more than 80% short to the budget required to build the 145,000 units needed per year. As announced this year in the 2020 Spring budget, the government will dedicate GBP 12.2bn of public funding out to 2026, which compares to the required GBP 12.8bn per year that the National Housing Federation estimated. [5]

Stable performance

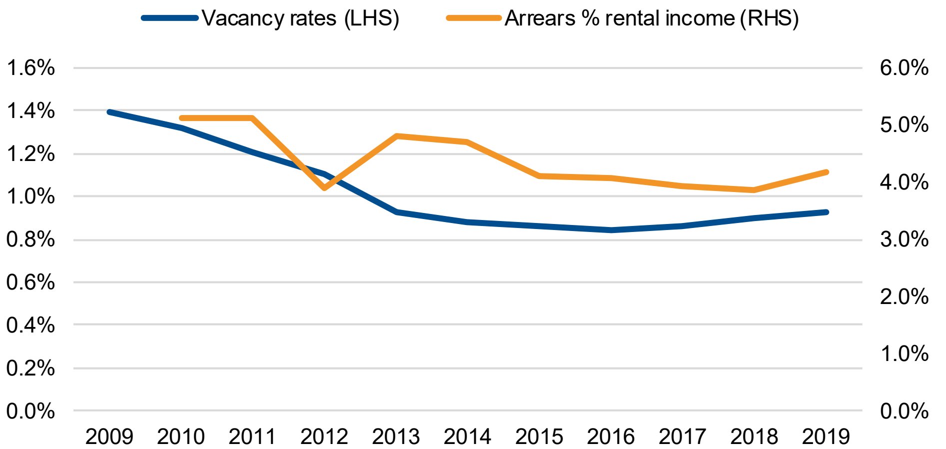
Collateral quality in the affordable rent space is strong due to stable rent level.

Collateral quality in the affordable rent space is quite strong due to stable rent levels compared to the private rental market. However, rent increases for affordable housing tenants are regulated and are either linked to the consumer price index or reflect a cap of 80% of comparable market rents. Despite the limited upside, these rents are attractive to investors as they are less correlated with the overall rental market and therefore provide a hedging element in a down-cycle.

Vacancy rates in the sector have been low due to strong demand (**Figure 5**) from renters in need of housing options that fit within their tight budgets. Discounts of up to 25% to more than 50% to the private market rent provide huge benefits to this demographic (**Figure 6**), which on average saves 6% of income through affordable options, subsidising their cost of living. These savings are not trivial and provide a reliable anchor to low vacancy rates.

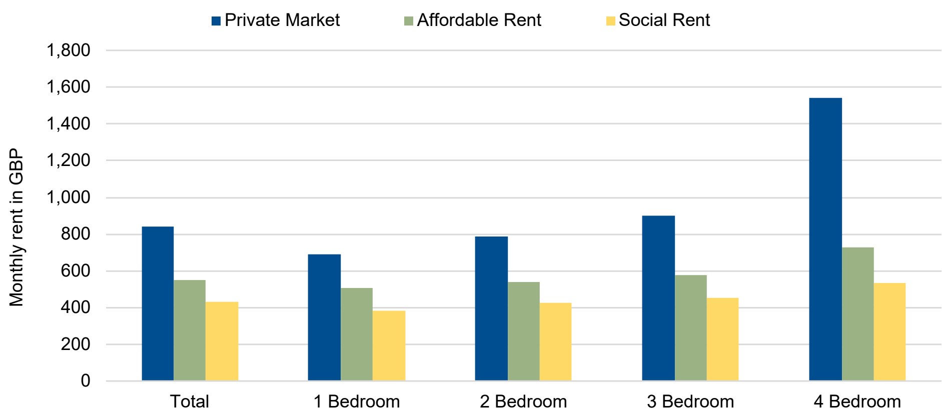
[4] https://thinkhouse.org.uk/site/assets/files/1471/savills0419.pdf
[5] National housing federation - https://www.housing.org.uk/globalassets/files/resource-files/grant_modelling_report_june_2019.pdf.

Figure 5. **Affordable housing – performance indicators**



Source: Ministry of Housing, Communities & Local Government, Regulator of Social Housing

Figure 6. **Monthly rental cost (2019)**



Sources: Regulator of Social Housing; Office for National Statistics; Scope calculations

The sector is exposed to riskier tenants with less flexibility to evict delinquent tenants

Of course, the sector is by nature exposed to a riskier tenant profile and there is less flexibility to evict delinquent tenants. More than 4% of rental income across all housing providers has been in arrears over the past 10 years. However, about 70% of all tenants that fall behind on rental payments return to performing status, which limits the risk of potential short-term liquidity impairments for investors.

Opening up to capital markets and reshaping the industry

We believe that regulation will provide more flexibility on affordable rent and shared ownership projects, the most profitable project types in the lower-income housing sector. At the same time, the lowest-income housing (i.e. social rent that relies heavily on government grants and funding) will continue to represent a decreasing percentage of below-market home stocks.

Brexit and Covid-19 may cause a government budget reallocation

Considering its budget reprioritisation following the GFC, the UK government may further reduce the share of budget dedicated to affordable homes to address more immediate economic developments and uncertainties from Brexit and Covid-19.

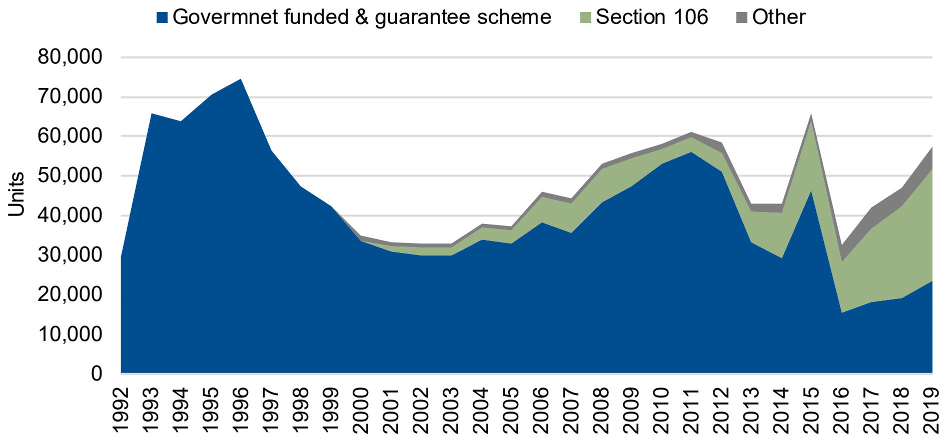
To offset the public spending shortfall, we expect that the government will introduce measures that encourage more private capital to enter the market. For-profit providers will likely seek return-enhancing regulatory changes, such as more flexibility in the form and terms of funding, a loosening of rental caps and easier access to foreclosed property to sell in the open market, along with more efficient and flexible approval processes for new projects.

Today, registered providers (RP) focus on building market-linked properties via partnerships with developers. The share of affordable units set aside in these development projects are geared towards higher margin products – namely affordable rent and shared ownership schemes, as opposed to social housing rentals[6]. There are no requirements on the types of affordable homes to be provided. Section 106 only stipulates that developers must set aside a minimum proportion[7] of affordable housing units when building out a new development, and then sell the freehold or lease to an RP.

Section 106 affordable housing developments have lighter regulations

Private creditors are mainly interested in affordable housing stemming from Section 106 developments, given the lighter regulatory touch, increased freedom to operate and better tenant profile.

Figure 7. Sources of affordable homes



Source: Ministry of Housing, Communities & Local Government

Regulatory actions and public policy pose uncertainty

The affordable homes sector carries a certain amount of public policy uncertainty.

The affordable homes sector inherently carries a certain amount of public policy uncertainty. This was recently demonstrated by the UK government announcing a proposal for substantial sector reforms on 6 August 2020. The overhaul is intended to be in place by late 2023 or early 2024. In the past, banks experienced their own regulatory shock, crystallising in changing capital charges, which made the asset class unattractive for them. Careful consideration must be also be given to environmental and social factors to avoid regulatory actions that might impair a project's profitability.

Regulation evolution

Affordable housing regulation in the UK has been slowly easing over time.

Affordable housing regulation in the UK has been slowly easing since the Thatcher era. The GFC accelerated the need for non-government sources of funding (**Figure 1**) to deliver housing units and service existing stock, as government resources were spread thin. A few years after the crisis, large banks, which had been key sources of long-term funding for housing associations, withdrew funding largely because they were forced to start repricing their long-term loans every five years. The new financing structure was incompatible for housing associations' assets and liabilities maturity profile.

[6] The tenant applicable for social rented houses also subject to the strictest income and qualifications.
[7] Affordable housing units are set at a minimum of 30% of total units subject to a developer's profit margin guidance of around 20%.

Figure 8. Key legislation since 2008

Legislation	Impact
The Housing and Regeneration Act 2008	Permitted for-profit entities to enter the market.
	Registered providers no longer subject to strict re-investment rules.
	Introduced enhanced funding structures.
2011 Affordable Rent Act & Localism Act	Housing credits were provided to tenants, which resulted in cash flows more aligned with the private market. This effectively enabled registered providers to tap the debt capital markets given the improved asset/liability match.
	Registered providers could charge rents of up to 80% of market value. Not to be applied to existing tenants.
	Flexible tenancies were introduced. Fixed terms of no less than two years.
	Reduced reliance on government grants.
Housing & Planning Act 2016	Incentivised private investor involvement by allowing more flexibility in sources of available funding.
	Extended 'right-to-buy' programme that began in 1980. Qualified tenants have the option to buy their home at a discount that can reach 70%. Proceeds are intended to finance affordable rental housing. However, tenants of private registered providers typically cannot use the right-to-buy programme.
	Allows authorities to take more aggressive action against questionable private sector landlords.
	Registered providers can dispose of properties without regulatory consent.
Planning for the Future 2020 ***Proposal stage until 29 October 2020***	**Section 106 replaced with a new Infrastructure Levy. Affordable home deliveries can be used to offset the development levy. The levy will be a nationally-set rate(s) applied against the share of increased land value following a development approval.** **Target proportion of affordable housing tenures: 25% owned and 75% rented.**
	Shared ownership, among other types of affordable ownership schemes, is intended to be phased out and replaced with an affordability scheme that applies a 30% discount to the market price.
	Zoning restructured: three main types: i) Growth ii) Renewal iii) Protection. Once a zone is designated there will essentially be no controls by local or regional governments. Officials state this will speed up planning.
	Smaller developments may not have to contribute any affordable housing.

Looking ahead – headline risk and reforms

United Nations question the benefits of private equity and institutional real estate investors in the affordable housing sector

The influx of private capital to the affordable housing sector is not without its detractors. One of the more prominent critics has been the United Nations (UN), which for years has questioned the benefits of private equity and institutional real estate investor activities in the affordable housing sector. A particularly scathing comment came last year when UN human rights experts "condemned the 'egregious' business practices of giant private equity and investment firms which are scooping up low income and affordable homes around the world."[8]

It's not just the UN that has been vocal: a local campaign by housing activists in London thwarted a GBP 4bn joint venture between Haringey Council and a developer in 2018. Part of the planned redevelopment included the demolition and rebuilding of two council estates (social housing). This is not the only case where proposed development has been rejected in England.

These opinions are also not trivial when it comes to ESG factors. Institutional investors wanting to invest in affordable housing must carefully consider the social elements of projects; the partner selection; and the interaction with local authorities. The sensitive nature of the topic can lead to significant costs if the right balance is not struck across stakeholders – as demonstrated by the failed venture with Haringey Council. Stakeholder empathy, transparency and a consensus-oriented objective are equally important to project planning and execution in this sector.

Parliament proposals aim to simplify and expedite the planning process

Recently, parliament announced sweeping proposals to overhaul the current development planning system, with the aim of simplifying and expediting the planning process through new types of zoning; restructuring how affordable housing should be quantified and delivered; restructuring the tenure mix; and centralising planning a little more. Feedback from stakeholders is due by 29 October 2020; with further rounds of expected engagement followed by the legislative process. Expectations are that a clear picture of these reforms will not be ready until the back end of the current term of parliament – late 2023 or early 2024.

The reforms have good intentions and will be quite beneficial if properly developed, but the implications will not be known until the practical details are fleshed out. Until these reforms become law, Section 106 remains.

Scope's credit considerations

CRE Security and CMBS Rating Methodology lays out Scope's analytical framework

Scope's analytical approach when considering credit risk for development projects without building permission risks and existing properties is laid out in our General Structured Finance Rating Methodology and our CRE Security and CMBS Rating Methodology when appropriate. Enforcement is of particular significance in this sector for Scope and investors alike given the regulation and necessary interaction with government authorities, which spurs additional uncertainty. Additional elements critical to our credit analysis are instrument seniority and refinancing risk, while term-default risk is generally low.

[8] United Nations Human Rights Office of the High Commissioner: https://www.ohchr.org/EN/NewsEvents/Pages/DisplayNews.aspx?NewsID=24404&LangID=E

Enforceability is improving

Enforceability has improved since 2016

On balance, enforceability has improved since 2016. However, there are limitations that are still costly and/or prolong the timing of the process. Improvements include the First, Housing and Planning Act 2016, which allows RPs to dispose of assets without regulatory consent[9], while the standard Mortgagee Protection Clause (MPC) has eased the mortgage liquidation process in the event of an RP's bankruptcy.

However, such a disposal process in the event of an RP's bankruptcy still has its legal challenges. For example, the properties to be disposed must be exclusively offered to other RPs or a local council for the first three months they are marketed, which would not reflect actual market values.

Potentially dynamic order of seniority

The seniority rank-order in an enforcement process is not always straightforward.

The rank-order of seniority, particularly in an enforcement process, is not always straightforward in market-linked collateral. Certain provisions may introduce a demotion of an otherwise senior claim, which could lead to reduced recoveries.

In the case of shared ownership collateral, the most complex affordable home product, tenants can purchase a portion of the property (10% minimum) based on market prices and make up the difference by paying below-market rent to the RP. The tenant can purchase further shares up to 100%, known as staircasing, with mortgages offered by building societies and a few banks.

In the event of tenant defaults, RPs have senior secured claims on the shared ownership property as long as the property was not 100% acquired by the borrower. But their claims are subject to the mortgage lenders' decision. Before foreclosing on shared ownership properties, RPs firstly need to seek the mortgage lender's intention to staircase upon the tenant's arrears notice. If mortgage lenders decline to staircase, RPs can market the property but must repay the lender the minimum amount due along with any sales proceeds. In such a case, there may be a shortfall in collections and thus a depressed recovery amount for the RP.

Refinancing risks

Refinancing risks are generally limited.

Refinancing risks are generally limited, in Scope's opinion, as the sector generally shows low loan-to-value ratios (LTV) and sound debt yields due to stable rental cash flows. Nevertheless, while refinancing risk may at present be limited, the importance of properly evaluating this risk is no less critical. The LTV we refer to considers the actual property market value, as opposed to the industry-specific valuation method[10]. The standard affordable homes-backed loan has an LTV that is on the lower end of the commercial real estate universe. In some private transactions Scope has observed development project funding with LTVs as low as 50%.

Sound debt yield may attract investors

Debt yields are strong and stable at about 5%-6% (**Figure 9**), which reflects well in a refinancing case and should also attract investors with medium-term investment horizons. If a transaction has a mix of under-development and finished properties, debt yields can reach 8% when considering income from unit sales along with rents.

Stability of debt yields reflects the generally cheap cost of credit, which in turn results from the sound debt-service capabilities of the asset class but also the strong track record of the industry, with no default in the sector that resulted in a loss to lenders and only one insolvency since 1996.

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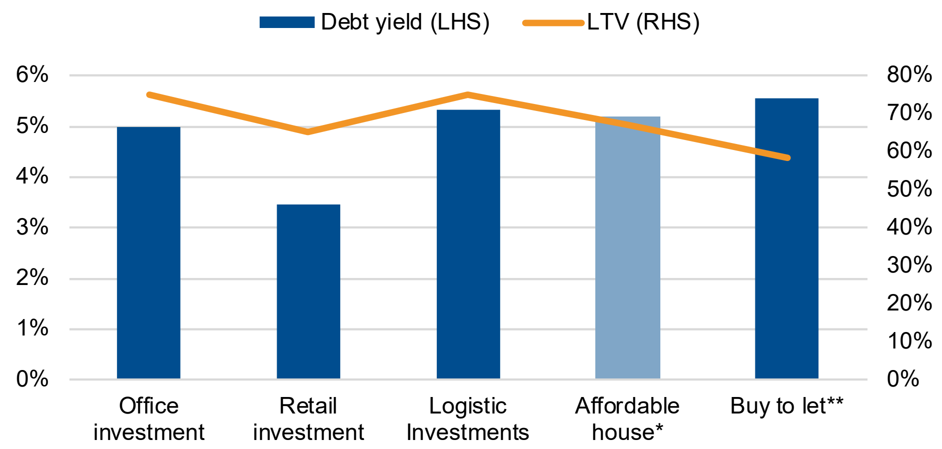
[9] However, charitable RPs remains required to have regulatory consent upon disposals of land according to Charities Act 2011.
[10] The sector adopts Existing Use Value for Social Housing (EUV-SH) valuation and Market Value Subject To Tenancies ("MV-STT") in reporting and borrowing terms. The EUV-SH and MV-STT are around 40% and 20% lower than the market value from Scope's database.

Figure 9. Debt yield and LTV across sectors



Source: CBRE, Bank of England, The Housing Finance Corporation, Scope calculations

*Scope calculation by using data from investor report as of September 2019 by bLEND Funding Plc, a funding vehicle set up by The Housing Finance Corporation to finance participated UK housing associations.

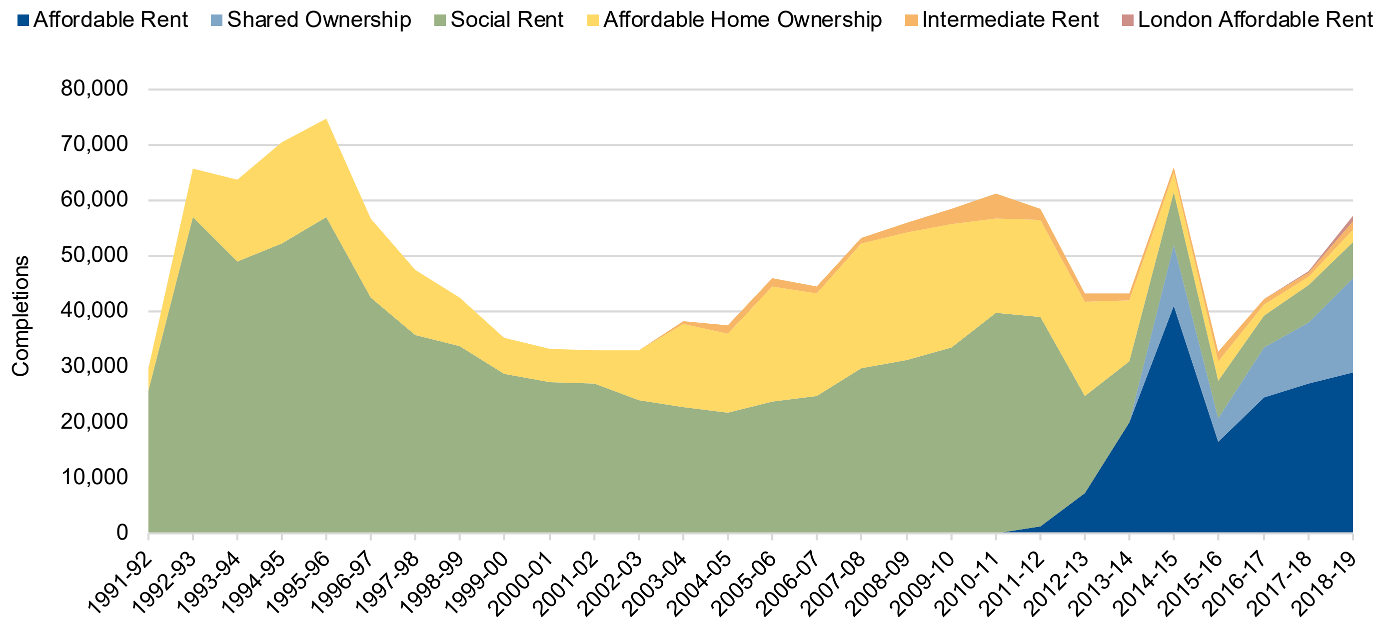
**Assume 1.5% costs and taxes

Appendix I Affordable housing: Bridging the private sector and social housing divide

Discounted housing in England is mainly composed of three segments: i) social rent, ii) affordable rent and iii) shared ownership, with the latter two segments comprising the affordable housing space. Additional segments exist, but the bulk of housing inventory can be found in one of these three buckets.

Employed social renters are on lowest end of the income spectrum, where affordable renters fall somewhere between low-income earners and middle-income earners. Additionally, social renters are more often unemployed, disabled, or retired, in comparison to affordable renters. Shared ownership is available to those who are employed and earn up to a certain maximum amount, depending on the jurisdiction.

Figure 10. Annual new home completions



Source: Ministry of Housing, Communities and Local Government, Scope calculations

Figure 11. Discounted housing segments

	Household income	Tenant	Key features
Affordable Rent **(*Affordable housing*)**	- Maximum £71,000 household income (1-2 bedroom).[1] - Maximum £85,000 household income (3+ bedrooms).[1] - Note: income thresholds are decided by local authorities.	- "Qualifying" households: Either: i) households wait-listed for social housing, or ii) households falling within parameters defined by local authorities. - Can't afford local market rent. - Typically have a job, but earnings fall somewhere between low-income (60% of median household income) and a level able to reasonably service market rents.	- 20% minimum haircut to market rent. - Tenancy qualification thresholds vary by jurisdiction. - 12-month trial period usually followed by a 5yr fixed rental term. - Typically funded/provided via Section 106 agreements. Government grants can also be used, but this is rare. - 70% of market rent on average.[2] - If a unit is eligible for re-letting, it usually must remain an affordable rental unit.
Social Rent	- Typically, £17,760 or less with limited savings. - £12,376 was the median household income in 2019.[2] - Note: income thresholds are decided by local authorities.	- "Qualifying" household with low income - defined as 60% of the median. - Can't afford local market rent. - Namely: Low-income earners, unemployed, elderly, disabled, homeless.	- Rent: formulaic and set by local authorities. - Formula is based on: i) property value, ii) local income levels, and iii) size of property. - 12-month trial period usually followed by a 5yr fixed rental term. - Mainly funded by government grants. - 51% of market rent on average.[2]
Shared Ownership **(*Affordable housing*)**	- Up to £80,000. - Up to £90,000 (London).	- Typically employed and assessed as being able to sustain shared ownership. - Can't afford local market prices.	- 25-75% of the home's value can be owned, with rent payments making up the difference.[3] - Owners have the option to increase their ownership share over time. - Home can be sold at any time, but it must be sold to another shared ownership applicant.

Sources[1,2,3]: London & Quadrant Housing Trust; Ministry of Housing, Communities & Local Government; GOV.UK

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