



Because good homes make everything possible

Why aren't housing associations building more social rented homes?

Strategy, Research & Communications

January 2019

Introduction

Housing associations have been criticised for not building enough social rented housing while making higher surpluses than ever before.

The argument runs that associations have become too commercial, building too many homes for sale, making excessive surpluses, paying their executives too much, and failing to focus on their original social purpose of providing homes for people who cannot afford the market.

This view is damaging the reputation of housing associations and feeding into a wider narrative, partly brought to the fore through the Grenfell Tower tragedy, which suggests residents and stakeholders are beginning to lose trust in social landlords.

This paper briefly examines the development finance model for housing associations and seeks to explain why the argument above presents too simplistic a picture. It shows why housing associations cannot just turn on the social rent taps in the current policy and economic environment without putting themselves at very considerable financial risk. We use real examples from Network Homes' past and present development programmes to illustrate the reality of housing association development today.

Summary

Network Homes has analysed the relative costs of building homes during our 2008-11 grant-funded programme and our 2015-18/2016-21 grant-funded programme. The results show:

- our average cost to build each home has increased 42% or by £85,000 to £285,000 per home in less than ten years
- adjusting for RPI inflation between 2010 and 2018, our average build cost per home would be £247,210 today. Actual costs per home are 15.3% higher
- we are receiving on average a third of the grant per home today (taken across all projects and affordable tenures) that we received in 2008-2011: £33,600 per home compared to £102,641 per home
- In percentage terms we received over 51% of the cost of each home in government grant in 2008-11 compared to less than 12% today
- Based on our sample, each subsidised affordable home today costs Network Homes on average over £250,000 from loans, reserves and income from sales compared to less than £100,000 just seven years ago
- to convert all homes to social rent in just the seven schemes analysed from our current programme would cost Network an additional £81.4m, or a weighted average of £162,820 per home, on top of internal subsidies already provided



- scaled up across our whole secured development pipeline programme, the additional subsidy required to convert all homes to social rent would be nearly £500m.
- New higher grant rates of £60,000-£80,000 per social rented home will still require investment of more than £200,000 per home from Network Homes, money that has to come from borrowing, reserves or cross-subsidy from sales, and will mean Network is still providing c.75% of the overall costs of each home compared to c.50% just ten years ago.

Within this research Network has also considered the frequently made charge that housing associations are not using their large financial reserves to build more. We re-examined how Network Homes is using reserves to fund new affordable homes development:

- In the last 3 years Network Homes made combined surpluses of £251m and has already reinvested £232m back into new homes development. The remainder is being invested in services for residents, including significant IT systems improvements, maintenance of existing homes, or will be invested in new homes in future years.
- Our private borrowing from banks and other investors has increased from £665m in 2014 to £859m in 2018 – a 29% increase in just four years. This rate of increase is not sustainable long-term.
- The more money we use to subsidise each individual home, the less we have available to subsidise other homes. Effectively, we have a choice between providing a lot of subsidy per home for fewer homes or less subsidy per home but to more homes – ie. there is a clear trade off between helping more people in housing need at slightly higher rents or helping fewer people but keeping their rents lower
- For 2017/18, 38% of our completed homes were for ‘genuinely affordable’ rents and 79% of our 3,000 home overall pipeline is for affordable tenures (‘genuinely affordable’ rents plus Affordable Rent and shared ownership).

The government’s goal to deliver 300,000 new homes a year by 2025 is unlikely to solve the housing affordability crisis in any reasonable period of time:

- If the input costs of new housing – the price of land, the cost of construction labour and materials, loan interest charges, consultants fees – keep rising, it is extremely hard to get the out-turn costs – rents and sale prices – down
- the planned ramping up of supply could serve in itself to increase competition for land and construction labour and materials, pushing up the input prices further and so preventing the lower out-turn prices and rents needed to improve affordability
- private housebuilders will continue to do what they always do, only releasing into the market the amount of new stock they feel can be absorbed while maintaining



their prices and profit margins, thus defeating the government's purpose (a concern which the Letwin Review¹ seeks to address)

- 'Brexit effects' could mitigate against the government's aims by reducing immigrant construction labour (leading to skills shortages pushing up the labour price) or stalling the sales market (leading housebuilders to hold back new building)

Now that government has changed policy and is beginning to invest more in social rented homes, the biggest challenge of housing policy is to arrest the unrelenting climb in residential development input costs. Until this is achieved, without enormous government grants neither housing associations nor local authorities will be able to provide the volume of subsidy needed to get the numbers of social rented homes required built at a cost lower income households will reasonably be able to afford.

As our Future Shape of the Sector² report said earlier this year: ensuring a good majority of new homes are affordable will require a potent mix of housing associations' own resources and borrowing power, more partnerships and joint working, better access to more affordable land, and continuing strong levels of direct government subsidy.

How government policy changed how housing associations build homes

In understanding why associations cannot simply go back to the days of making almost no surplus and building only social rented housing, the government policy framework provides an essential backdrop.

Very briefly, as is well-known, the Coalition government decision in 2010 to introduce Affordable Rents (at a maximum of 80% of market rent) instead of social rent (at closer to 50% of market rents) came alongside a cut of over 60%³ in government capital housing grants to subsidise building costs. Overall, from operating with a grant rate of around 50% of the cost of each home for the 2008-2011 Affordable Housing Programme, housing associations were now trying to make do with a grant rate of around 15% for the 2011-2015 programme⁴. The overall size of the programme was also severely restricted as the government imposed austerity cuts. In addition, it was intended that associations would claim the grant at the end of each project rather than the beginning.

The cut in grant levels and change in payment terms had a major impact in increasing the money housing associations had to find at the beginning of a project to fund the construction of homes.

¹ <https://www.gov.uk/government/publications/independent-review-of-build-out-draft-analysis>

² <https://www.networkhomes.org.uk/news/future-shape-of-the-sector-commission/>

³ <https://www.nao.org.uk/wp-content/uploads/2012/07/1213465.pdf>

⁴ http://d3n8a8pro7vhmx.cloudfront.net/themes/5417d73201925b2f58000001/attachments/original/1434463838/Building_New_Social_Rent_Homes.pdf?1434463838



The government logic was that housing associations would recoup the extra cash laid out at the start over time through the higher rent payments residents would make. The conditions imposed for receiving grant included that associations should seek to lift their rents to at or near 80% of market level. The conditions initially imposed for the 2015-18 government housing grants programme were even more stringent.

In practice, what this new regime meant was that housing associations needed considerable extra financial strength in reserve to convince the banks and financial markets to lend them more money upfront to get development projects off the ground. And with a smaller national grant programme, associations who wanted to maintain their size of programme to help more people required further extra money.

Of course, housing associations could have refused to play ball, decided the cuts were too severe, the conditions for grant too onerous, and simply stopped building. But that way no new social rented homes would have been produced.

Most developing associations took the pragmatic view that it was better to try to build some rented housing at below market levels rather than none, ie. they wanted to continue to fulfil their social purpose rather than abandon it in unfavourable government policy conditions.

Many housing associations, particularly in London where the market cost of renting is so high, also did everything possible to get rents for new homes well below the 80% of market level the government was advocating. The average housing association Affordable Rent in London since 2011 has been around 60-65% of market rent. But seeking to deliver on social purpose in this way has simply cost associations more money in the early days of tenancies.

There were essentially three main ways housing associations could find the extra money required to keep building affordable rented homes – borrow more from the banks and financial markets; increase income, mainly by building more homes for shared ownership and outright sale and using the profits generated to help subsidise the cost of affordable rented homes; and become more efficient in running their organisations by cutting operating costs. Government further encouraged associations to convert some existing social rented homes to Affordable Rent as they became empty to increase capacity.

The economic backdrop

The economic backdrop of this decade is even more well-known and does not need dwelling on here. The key factors as far as the affordability of housing and housing association development are concerned have been that:



- Real income growth has been extremely poor by historic standards, meaning people have been unable to afford to pay more for their housing costs or are badly financially squeezed in doing so
- The cost of building homes has continued to increase. Land value and construction cost rises averaging well above inflation have made the economics of building new homes with out-turn rents or prices below the market level much more difficult.

This has exacerbated the effects of government policy change on the provision of genuinely affordable new rented housing. If people's wages are stagnating, but the cost of building is going up and the government is providing far lower grant subsidies, there is bound to be a problem with providing subsidised rented housing at a cost lower income families – those generally worst hit by austerity – can afford.

The reality of financing social rented homes

The Network Homes team has:

- analysed the relative costs of building homes during our 2008-11 grant-funded programme and our 2015-18/2016-21 grant-funded programmes
- examined relative grant rates per home
- assessed the financial requirements of converting all homes built for Affordable Rent, shared ownership and outright sale back to social rent and the impact this would have on Network Homes' overall financial position

To do the work, we have looked in detail at the finances of a sample of seven development schemes built through the 2008-11 programme and seven schemes built during, or in progress under, the current 2015-18/2016-21 programme.

All of the developments were in London and Hertfordshire, Network's main operating areas and we have sought to make the mix of schemes as equivalent as possible:

- Five schemes in each programme were in broadly similar London boroughs with two schemes in Hertfordshire
- The size mix of homes is almost identical
- The mix between land led and s.106 sites was very similar
- Almost all homes analysed in both programmes were for affordable tenures (2008-11: 26 homes for private sale; 2015-18/16-21: 56 homes for private sale)

The table below gives a headline view of our findings.



	Number of homes (7 schemes)	1 beds	2 beds	3 beds	Total scheme costs	Average build cost per home	Average grant per affordable home	Average grant per affordable home - % of cost
2008-2011	404	40%	38%	21%	£81m	£200,495	£102,641	51.2%
2015-18/ 2016-21	500	37%	40%	21%	£142.5m	£285,000	£33,600	11.8%

A few points are immediately obvious:

- our average cost to build each home has increased 42% or by £85,000 in less than ten years
- we are receiving on average a third of the grant per home today (taken across all types of project and affordable tenures) that we received in 2008-2011
- each subsidised affordable home today requires Network Homes to find on average over £250,000 from loans, reserves and income from sales, compared to less than £100,000 just seven years ago

In total, to build 404 homes in seven sample schemes in 2011-15 Network received £40.5m in capital grant. By contrast, in building 500 homes in seven sample schemes in our current programme we will receive £8.15m in capital grant. So in this programme, across the same number of schemes, we are providing 100 homes more while receiving over £32m less in government grant.

Adjusting for RPI inflation between 2010 and 2018, our average build cost per home should be £247,210 today. But our actual costs per home are 15.3% higher than this, which indicates how much faster than general inflation land prices and construction costs have grown.

We further examined how much additional finance would be needed to convert all of the homes in the seven schemes assessed from today's development programme to social rent (or London Affordable Rent, its closest equivalent).



Total extra subsidy needed AR - SR	Total extra subsidy needed SO - SR	Total extra subsidy needed Private sale -SR	Average extra subsidy needed per home AR - SR	Average extra subsidy needed per home SO - SR	Average extra subsidy needed per home Private sale -SR	Total extra subsidy needed for full conversion – all homes to SR	Weighted average extra subsidy needed per home for full conversion
£8.41m	£57.5m	£15.5m	£38,478	£233,383	£288,990	£81.41m	£162,820

AR = Affordable Rent; SO = shared ownership

For just seven development schemes, Network Homes would need to find an additional £81.4m in funding from borrowing, reserves or other sources to manage to build all of the homes at a social rent level. However, note that costs per home on some schemes are considerably greater than others (generally, land-led schemes cost more to build per home than s.106 sites), so the amount of extra subsidy per home required varies markedly between schemes.

In providing these developments, we are already supplying £4.6m in subsidy from our internal reserves (plus direct profit from our scheme sales) to make them viable to build in today's market. The £81.4m - an extra £11.6m per scheme on average - would be on top of this.

And this is for just seven schemes providing only 500 homes. Assuming a similar average across the entire 3,000 homes in our current secured development pipeline, Network Homes would need to provide additional subsidy across the programme of nearly £500m to build all of the homes for social rent.

With no cross-subsidy from sales, the vast majority of this sum would need to come from swiftly increased borrowing. The risk for housing associations of very high additional borrowing over a very short period is of breaking financial covenants with lenders. Ramping up very large amounts of extra borrowing very quickly would also ring alarm bells with the Regulator of Social Housing and any breaking of covenant would certainly bring regulatory action. Financial risk management is a crucial skill for developing housing associations in today's climate.

Possible ways to improve the position would be to reduce the development programme substantially (which would rather defeat the object), reduce the volume of social rented homes and retain a broader tenure mix (again leaving us to face charges of 'not doing enough' to make homes affordable), do much more via joint ventures or in partnerships to partially de-risk development, or acquire far more land at discounted or zero value and receive much, much higher grant levels.



The myth of ‘unused’ housing association financial reserves

An argument frequently thrown at housing associations as part of this debate is that we should use our reserves and surpluses to fund more affordable home building; that we are not doing enough to ‘sweat our assets’.

In 2017/18 Network Homes made a net surplus after all costs of £44.3m; the previous year it was £51.8m. Our Financial Statements for 2017/18 show Network Homes has reserves of £372m.

However, those financial reserves do not represent money sitting in our accounts waiting to be used – they are a quirk of how housing associations are required to account by law. In the jargon, they are not ‘cash-backed’. The reserves figure is simply a statement of the accumulated surpluses Network has made over time. As the next section shows, in reality, year in and year out, our surpluses are being consistently fully used to invest in new homes and services.

Our Financial Statements also show that Network Homes has £69.5m ‘at cash and bank’. This is the real money we have in reserve, which is theoretically available for us to use. So why aren’t we using it?

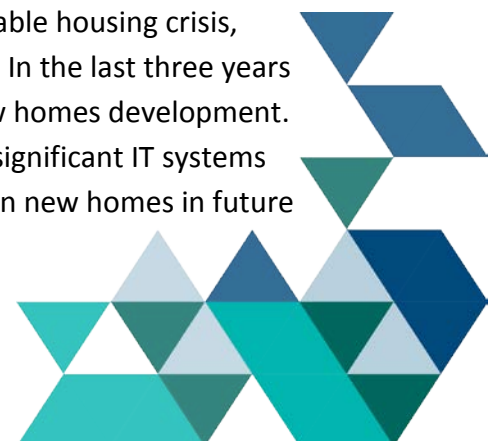
Firstly, we have an internal policy which requires us to keep a minimum of £25m available at all times in cash. This is what we might call our emergency ‘rainy day’ money. This has to be kept at a sufficient level to fund our organisational cash flow for three months.

The remaining deposits we hold largely as part of our requirements to demonstrate to our lenders and to the industry Regulator that we are a financially sound and stable business. This is part of the quid pro quo of housing associations needing to borrow very large sums of money in the current policy and housing economic environment to finance new affordable housing. Our lenders and the Regulator use a range of measures to regularly check that their money and the social housing assets we hold are safe. A level of cash reserves is one of those requirements and provides some of that comfort.

When housing associations took much less risk, lenders and the Regulator required much less comfort in the form of available cash and other measures. This allowed associations to operate at much lower levels of surplus and reserves.

How we make investment in affordable housing work

In our efforts to ensure we are doing all we can to tackle the affordable housing crisis, Network Homes invests huge amounts of money in building homes. In the last three years we have made total surpluses of £251m and invested £232m in new homes development. The remainder is being invested in services for residents, including significant IT systems improvements, maintenance of existing homes, or will be invested in new homes in future years.



Our private borrowing from banks and other investors has increased from £665m in 2014 to £859m in 2018 and we are in the process of seeking substantial additional loans to allow us to build more homes.

However, there is a limit to how long this can continue. We are stretching ourselves precisely in order to keep delivering on our original social purpose and mission. But if the cost of building continues to rise and government subsidies remain relatively low, then at some point we will reach our borrowing limits and can only rely on other sources of income or reducing our risks on each scheme by, for example, doing more joint ventures or using other, more innovative (some would say risky) financial mechanisms.

Building a higher proportion of social rented homes brings that moment much closer because of the very substantial subsidies we need to put in for each home. We are, however, doing all we can to make the homes we build more affordable.

All of our profits from shared ownership sales are reinvested directly into new homes development. With outright market sales we also reinvest the profits but in two stages, initially making a level of allowance for 'risk cover' during the sales period. In 2017 the Network Homes Board agreed to invest £45m of internal subsidy towards the social and affordable homes we plan to build in our current programme and our development pipeline.

This will allow a higher level of internal subsidy per affordable rented home in an attempt to keep rent costs down for new tenants. But, clearly, the more money we use to subsidise each individual home, the less we have available to subsidise other homes. Effectively, we have a choice between providing a lot of subsidy per home for fewer homes or providing less subsidy per home but to more homes.

This year, as part of the revision of our Five Year Strategy, we set some clear annual targets around our approach to growth and new development. These included that we would build a minimum of 25% of our programme for 'genuinely affordable' rent (social rent, London Affordable Rent, London Living Rent, or local authority restricted rents) and that a minimum of 60% of our pipeline programme would be for affordable tenures.

For 2017/18, 38% of our completed homes were for 'genuinely affordable' rents and 79% of our 3,000 home overall pipeline is for affordable tenures ('genuinely affordable' rents plus Affordable Rent and shared ownership).

Nationally, in 2017/18, according to the National Housing Federation⁵, housing associations completed 41,556 new homes, with 35,794 of these (86%) for affordable tenures, including 4,500 social rented homes mostly developed with no government grant at all.

⁵ http://s3-eu-west-1.amazonaws.com/doc.housing.org.uk/Supply_statistics_briefing_2017-18.pdf



Is the tide turning?

Since the change in Conservative administration in 2016, we have seen a return to a more productive relationship between government and housing associations. Not only has the government recognised that the housing market is broken, it has understood that social rented housing forms an important part of the social fabric of this country; the more so since Grenfell. We have seen:

- an additional £3.4 billion invested by government in affordable homes, including more flexibility in how grant funding is spent and £2 billion specifically for social rented housing – the first funding for social rent since 2011
- the return to a CPI +1% annual rent settlement from 2020 (the current 1% annual real terms rent cut has also cut into the income associations can reinvest in building)
- Higher grant levels available for each new home
- The creation of strategic partnerships between grant investors (Homes England and the Greater London Authority) and housing associations, recognising the complex nature of development and the flexibilities needed to produce the most effective results
- Much greater investment in the basic infrastructure needed to support new homes
- The creation of a more activist Homes England, able to tackle some of the tough obstructions in the way the housing and land markets work
- The announcement of longer-term programme certainty in government investment from 2022
- A level of planning reform

Government has also set a target of 300,000 new homes a year in England by 2025, though it has not indicated how many of these should be affordable.

So will affordability now improve?

The difficulty for the government and housing associations is this: while the input costs of new housing – the price of land, the cost of construction labour and materials, loan interest charges, consultants fees – keep rising, it is extremely hard to get the out-turn costs – rents and sale prices – down.

The government's prescription so far is based on the idea that more supply will satisfy demand and once equilibrium has been reached or an over-supply created the price (or rent) will begin to fall.

But potential issues with this include:

- the planned ramping up of supply could serve in itself to increase competition for land and construction labour and materials, pushing up the input prices further and so preventing the lower out-turn prices and rents needed to improve affordability



- private housebuilders could continue to do what they always do, only releasing into the market the amount of new stock they feel can be absorbed while maintaining their prices and profit margins, thus defeating the government's purpose (an issue highlighted again in the Letwin Review⁶ and which the government has said it will seek to change as a result of Letwin's recommendations)
- 'Brexit effects' could mitigate against the government's aims by reducing immigrant construction labour (leading to skills shortages pushing up the labour price) or stalling the sales market (leading housebuilders to hold back new building)

Even if a persistent 300,000 new homes a year were achieved, the improvement in housing affordability would take many years to come through because of pent up and new demand sustaining prices/rents and the likelihood of continued high input costs of building.

- The cost of residential land with planning permission in London rose from £29.1m per hectare in 2015⁷ to £36.8m per hectare in 2017⁸, according to government figures
- A Civitas⁹ report in 2017 estimated that 74% of the increase in UK house prices between 1950 and 2012 was due to land price inflation.
- Research from the New Economics Foundation¹⁰ in 2018 showed that the top 10% of local authorities in terms of land prices accounted for 73% of households in temporary accommodation and had experienced a 70% drop in new affordable/ social rented homes between 2011/12 and 2014/15, compared to a drop of 20% in the rest of England
- Research from the Centre of Progressive Policy and the National Housing Federation¹¹ shows that gaining planning permission on land created nearly £11 billion profit in 2016/17 for landowners, with housing associations looking to build more affordable homes consistently outbid for land

High input costs will continue to force housing associations to commit very large amounts of resource to each new affordable home. A grant rate of £60,000-£80,000 a home still means investment of more than £200,000 per home from Network Homes for each affordable home developed, money that has to come from borrowing, 'reserves' or cross-subsidy from sales. In relative terms, Network Homes will still be required to resource around three quarters of the cost of each new home, compared to around 50% ten years ago.

So if this is the reality of housing affordability today, what else can be done to improve it? This will be the subject of a second research paper in the winter.

⁶ <https://www.gov.uk/government/publications/independent-review-of-build-out-draft-analysis>

⁷ <https://www.gov.uk/government/publications/land-value-estimates-for-policy-appraisal-2015>

⁸ <https://www.gov.uk/government/publications/land-value-estimates-for-policy-appraisal-2017>

⁹ <http://www.civitas.org.uk/content/files/thelandquestion.pdf>

¹⁰ <https://neweconomics.org/uploads/files/what-lies-beneath.pdf>

¹¹ <https://progressive-policy.net/wp-content/uploads/2018/09/LVC-Report-Sep-2018.pdf>



Conclusions

This paper shows that it is too simplistic to blame the fall in the number of social rented homes being built on housing associations. A combination of government policy, increases in the input costs of developing homes, and historically poor real income growth over the last decade, have made it impossible for associations to continue provision of social rented homes during the 2010s in the same way they did in decades past and made housing less affordable for our new residents.

In pursuit of their social purpose, housing associations have sought to keep building subsidised rented housing as best they could despite unfavourable conditions. This has included ramping up loans, investing surpluses and other income, and developing skills in market sales to help cross-subsidise affordable home development.

These actions have made housing associations substantially more risky businesses, requiring complex and different management skills. At the same time, associations have been managing new risks to the certainty of their basic income as a result of welfare benefit reforms affecting resident incomes and the imposition of a four year real terms rent cut on affordable homes. This has also made it harder to invest extra in subsidising new housing supply.

Now that government has changed policy and is investing more in social rented homes, the greatest challenge of housing policy is to arrest the unrelenting climb in residential development input costs. Until this is achieved, without enormous government grants neither housing associations nor local authorities will be able to provide the volume of subsidy needed to get the numbers of social rented homes required built at a cost lower income households will reasonably be able to afford.

As our Future Shape of the Sector¹² report said earlier this year: ensuring a good majority of new homes are affordable will require a potent mix of housing associations' own resources and borrowing power, more partnerships and joint working, better access to more affordable land, and continuing strong levels of direct government subsidy.

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¹² <https://www.networkhomes.org.uk/news/future-shape-of-the-sector-commission/>

