SOCIAL HOUSING RENTS

CONSULTATION RESPONSE

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INTRODUCTION

Thank you for the opportunity to respond to this consultation exercise.

The social housing sector provides a secure and affordable home to millions of people in the UK, with at least a million more who need to access to the sector.

It is therefore important that any consideration of capping rents takes account of not just the impact on existing residents, but also protects the long-term health of the sector to attract investment and thus deliver safe homes that are energy efficient, thus cutting residents' bills for years to come. Investment also supports the sector to expand to improve access for those who need a home.

Our perspectives on the consultation issues have been shaped by members of our Affordable Housing Committee. Their views come in two parts:

This brief cover sheet provides responses to the questions asked.

There is then an accompanying paper in the annex, which we hope is helpful, in explaining the wider context of investment in the sector, and how that might be affected by the Government's decisions on rents. We have also sought to explain the consequences and likely approach that shared ownership providers will take to supporting their residents.

We reach six main conclusions:

1. We cannot support a cap, but that does not mean we want to see unbridled rent rises. We simply think there are better ways of protecting tenants, whilst ensuring that the most damaging effects of capping rents, that have been seen before, do not occur. There are already regulatory obligations on providers' boards to take account of affordability. Many will not apply the full CPI+1 increase. Providers already support residents with affordability difficulties via mechanisms such as hardship funds and provide a range of other support from energy efficiency improvements to employment support. The Government should trust the sector to support its residents.

2. Our White Paper issued earlier this year, set out the sector's substantial capital requirements to meet new housing need, retrofit existing stock, and provide building safety remediation. This is estimated at £32bn over ten years. A cap would also impact on the operations of the sector. Illustrative modelling suggests that HAs alone would likely need to make savings in the region of £1.2billion if rents are capped at 5%. Providers may have more options than simply making revenue cost savings, but this £1.2billion does represent c4-5% of management, maintenance, and major repairs expenditure. It is worth stressing generally also that conditions in the sector are a lot more challenging than when rents were previously capped, with inflation, interest rates, wage inflation, construction costs, and operational costs all growing at rates far higher than in recent history.

3. For the sake of national growth also, the Government should not be setting a rent cap. The sector provides a vital counter-cyclical role in delivering new homes and supporting wider construction activity when other parts of the housing and construction sectors are contracting.

4. Any proposed cap could also setback future investment in the sector. Stability and predictability in rent policy are essential to provide a foundation for housing providers, investors, and lenders to have the confidence to invest in affordable housing at scale, and to do so at low cost of funds. The need for stability and predictability is particularly important at times of rapidly changing market conditions, with inflation and interest rates increasing and gilts fluctuating.

5. Providers of shared ownership property already have the tools to support shared owners that need it. Actions, voluntary or otherwise, that reduce the attractiveness of shared ownership to funders, especially those relatively new entrants with an appetite for shared ownership, will further reduce development capacity, compounding the loss of capacity that will arise from caps to rental income.

6. Regardless of whether a cap is set or not, mitigation measures are required if the sector is to deliver on its important purposes and priorities – building safety, energy efficiency, repairs, and maintenance, and increasing the number of affordable homes, which are needed more than ever. This is because, even with no cap, the sector will need to support its residents and will face other increased pressures on operations, development, and its cost of capital.

   There are several forms of mitigation that could be considered. These might include increased spending on the Affordable Homes Programme and revisions to the Benefit Cap.

   Looking beyond 2023-4, a commitment to index linking of rent increases from 2025 will assist recovery from recent economic pressure, sustain and grow capacity for future investment in new and existing homes, and support continued investor confidence to participate in the affordable housing sector.

A fuller list of consequences of a rent cap is listed in the last two pages of this document.

CONSULTATION QUESTIONS

Question 1: Do you agree that the maximum social housing rent increase from 1 April 2023 to 31 March 2024 should be subject to a specific ceiling in addition to the existing CPI+1% limit? To what extent would Registered Providers be likely to increase rents in that year if the government did not impose a specific ceiling?

We do not support a ceiling being imposed. We do not think it is a sufficiently targeted measure. For numerous reasons set out in this paper we think the short and long-term consequences of a cap on the finances of the sector are damaging and will prevent a lot of activity that benefits residents taking place on maintenance, energy efficiency and delivering more affordable homes. It will also impact on economic activity, which contributes to growth.

Housing association boards will be best placed to understand what their residents need by way of support and balancing that with investment in homes and services. That will often not mean CPI+1, but providers also face significant cost inflation and boards will need to balance the two. The Government should trust the sector to support its residents and make the best all-round decisions for them.

Question 2: Do you agree with imposing a ceiling of 5%, or are there alternative percentages that would be preferable, such as a 3% or 7% ceiling? Do you have any comments or evidence about the potential impact of different options, including of the 3%, 5% and 7% options as assessed in our Impact Assessment (Annex D)?

We do not agree with imposing a ceiling on rent increases, below the CPI+1% limit.

We have rehearsed several damaging consequences elsewhere in this paper, which mainly also impact residents.

The relatively unique perspective we can bring is the impact on private sector investment in affordable housing:

- A reduction in 'green appeal' and desire to provide ESG funding (as zero carbon works are not pursued)
- Loss of confidence in the stability of affordable housing as a generator of index-linked income that increases smoothly over time (as rent increases will have been below inflation for 5-6 years out of the 10-year period 2015-25)
- Loss of confidence in the stability of the affordable housing to generate steady growth in asset values (as cost increases cannot be fully offset)
- Need to price in the risks arising from uncertainty, impacting credit scores and therefore increase costs of debt

- Loss of capital allocations to other countries / sectors / investment classes
- Reduction in the pool of providers that can deploy capital, and thus reduction in demand for funds
- Reduction in the value of rental assets held in charge or owned, as property condition reduces and rental potential for a mortgagee in possession falls
- Reduction in the value of shared ownership assets, as the income profile changes
- Increased impetus to reconsider covenant structures.

Question 3: Do you agree that the ceiling should only apply to social housing rent increases from 1 April 2023 to 31 March 2024, or do you think it should apply for two years (i.e. up to 31 March 2025)?

We disagree with a ceiling being applied. Given the volatility in both inflation, interest rates, and energy prices at present, it is quite difficult to make any judgements on caps for one year, let alone two.

It is why we promote the alternative of allowing providers' boards the flexibility to make their own decisions, as they will be better placed and nimbler to economic, local, and individual conditions.

Question 4: Do you agree that the proposed ceiling should not apply to the maximum initial rent that may be charged when Social Rent and Affordable Rent properties are first let and subsequently re-let?

We agree, but there will be a growing gap between actual rents and formula rents for most social rent properties for decades and the Government should consider some sort of 'catch-up' mechanism.

Question 5: We are not proposing to make exceptions for particular categories of rented social housing. Do you think any such exceptions should apply and what are your arguments/evidence for this?

If a ceiling is applied, we believe there should be an exemption for supported housing provision.
It is difficult to reduce operating costs due to the nature of services and customers they support, and where margins are already extremely low.

Any savings will also not end up predominantly in the pockets of tenants as the vast majority of tenants in the sector will receive housing benefit or universal credit to pay their rent.

If a rent ceiling is applied to supported housing, there will be a significant risk to the viability of some organisations, and future provision, as many of the organisations involved in this type of housing are under financial strain, with rising costs of energy, staff, repairs, etc.

ANNEX

Rent Policy & The Foundations of Private Capital in Affordable Housing

Contents

Note: With particular thanks to Savills for their input and evidence into this paper.

Executive Summary

The availability, cost, and deployment of private capital is central to delivery of new and existing affordable homes by housing associations and for-profit registered providers. The largest 250 of these registered providers (RPs) use around £86bn of debt to deliver their growing stock of 2.2 million homes: with for profit providers attracting £7-10bn in the last 10 years.

Appetite for additional investment is strong. Over the next 10 years, HAs need to raise at least £32bn in new finance to deliver building safety works including sprinklers, decarbonisation and 46,000 new homes per year at the Future Homes Standard. And over the next 5 years, FPRPs have the potential to deliver £27bn of new private capital to help deliver more than 140,000 much needed new affordable homes.

RPs make an important contribution to economic growth through their development and investment activities, as well as supporting households' financial strength and employers' access to labour by providing affordable homes. Their development and acquisition activities are important to housebuilders, supporting volume and speed of delivery and (as seen in 2008) with some ability to act counter-cyclically at times of downturn.

Investors deploy funds into affordable housing because it is a safe, long-term, low-risk asset that delivers a steady risk adjusted return. It matches the liabilities that pension funds and other 'patient capital' require over the long term; and accordingly, the interest rates paid by RPs are (historically) low.

Central to the investment proposition of RPs and private funders are the rent policies that apply to affordable rented and shared ownership homes. These are set by government and are implemented through regulatory standards and leases which are binding on registered providers. Both specify above inflation annual increases and allow providers discretion to set lower increases if desired. RPs are required by the regulator to take account of the local market context and affordability to customers when setting and increasing their rents.

In response to the sustained high rate of CPI and the consequent cost of living crisis that particularly affects lower income households, RPs have considered what flexibility they have around the 2023 annual increase for renters and shared owners. Latterly, government has proposed using its power to direct the regulator to cap increases for renters.

Illustrative modelling suggests that HAs alone would likely need to make savings in the region of £1.2billion if rents are capped at 5%. RPs have more options than simply making revenue cost savings, but this does represent c4-5% of management, maintenance and major repairs expenditure. In practice RPs' responses will be a balancing act between operating expenditure, capital expenditure and use of debt.

The external imposition of a cap on rent increases reduces the ability of established businesses to respond to the economic headwinds that they and their customers are facing, and thus their capacity to sustain their business plan priorities for investment in new and existing homes, service standards, and social wellbeing. It is essential that they can align revenue stream growth with the cost of capital. Removing capacity to do this undermines delivery.

RPs have recent experience of dealing with government-imposed reductions in rental income. Efficiencies were made, asset investment re-profiled, and planned development output reduced. Considering a further intervention, it is important to note that the efficiencies made to offset the rent cut have already been taken, and the context in which they managed that income reduction is significantly different from the current time when need for investment in existing homes is high, inflationary pressures on operations are high, and cost of debt is increasing. Notably the cost of funding increased by 3-4% in the 12 months to October 2022.

Coming on the heels of the government-imposed 2016-20 rent cut, a mandatory cap risks driving changes in the pricing and terms set by established funders to RPs. It could also undermine confidence of investors that are new to the sector - known as the "wall of capital" – who bring new money that is beginning to increase availability of funding to deliver new homes and improvement programmes for existing homes. RPs are well regulated, as they are closely overseen by the Regulator of Social Housing, whose steady and stable approach backed up by a clear framework gives confidence in robust financial governance. A high level of political intervention in a sector is not good regulation, and indeed undermines the benefits derived from it. Of particular concern is the effect on risk adjusted returns in the sector, and the potential medium to long term impacts of this.

In terms of the overall objective to protect tenants from exposure to high cost of living pressures, RPs already have a range of tools available to provide targeted support to renters and shared owners facing affordability constraints, and good insight into which customers most need assistance. The blunt tool of a mandatory cap on rent increases is too restrictive in a context where the most vulnerable to financial pressure can already be protected by other targeted means that RPs can deploy.

The government's impact assessment estimates that a 5% cap on rent increases could save government £4.7bn in welfare spending over a five-year period. This is a small saving in comparison to the potential negative effects on the £27bn of new private capital that FPRPs could bring into the sector over five years, and the tens of billions of private finance that HAs could raise to deploy in improving property conditions and providing new homes.

Fundamentally, the disbenefits of a mandatory cap on rent increases will outweigh the gains.

1. Introduction

This report sets out the role of rent policy in creating the conditions for sustainable private investment in affordable housing, for both new supply and improvement of existing homes. In describing the role, it aims to bolster understanding of the operation and contribution of private investment in the affordable housing arena and considers the risks to new supply and investment in existing homes posed by the current policy and economic environment.

It considers rent policy set by government for affordable rented housing and shared ownership, which is implemented through regulatory standards and leases which are binding on registered providers. It also considers service charges, which whilst not subject to control under government policy are a subject of debate in the current climate.

Within this report, the experiences, perspective, and operating models of not-for-profit housing associations (HAs), for-profit registered providers (FPRPs), and the established and new entrant investors backing these businesses are reflected; alongside existing research and data that set out the historical context and current trends/issues facing providers of affordable housing.

Whilst HAs and FPRPs both deliver affordable homes for rent and sale and operate as Registered Providers (RPs) within the same regulatory framework, they have differing interests and operating models. HAs currently deliver most new affordable homes and are directing substantial investment into existing social homes. As such their capacity is under pressure but continued access to private finance is central to delivery of their core business objectives. FPRPs make a growing contribution to the supply of new homes and have potential to attract more investment and so continue to increase the pool of private capital in the affordable housing sector.

Fundamentally, this report shows that stability and predictability in rent policy are essential to provide a foundation for housing providers, investors, and lenders to have the confidence to invest in affordable housing at scale, and to do so at low cost of funds. The need for stability and predictability is particularly important at times of rapidly changing times of market conditions, with inflation and interest rates increasing and gilts fluctuating.

The external imposition of a prescribed rent increase cap on all RPs should be avoided. Such a cap would reduce the ability of established businesses to respond to the economic headwinds that they and their customers are facing; and it risks driving changes in the pricing and terms set by established funders to RPs, as well as reducing the availability of resources from new entrant funders. RPs already have an ability (and regulatory expectation) to exercise restraint in setting rent increases and have the tools to deliver targeted support to households that need it. Ultimately the disbenefits of a government-determined rent cap will outweigh the gains.

2. History of private investment in affordable housing

All social housing was delivered with public or charitable funding until the mid-1980s. Almost all delivery was through local authority direct provision of council housing. Many small HAs had also been created and these were funded with grant from 1974, in most cases to fill gaps unable to be met by council housing such as area-based regeneration.

Housing associations: debt finance from banks and bonds

Changes to housing policy in the 1980s encouraged local authorities to transfer ownership of affordable homes to HAs. This led to rapid growth in the number and scale of HAs. From the late 1980's to date, HAs have been the main providers of new affordable housing taking on £86.3bn of private debt alongside £39bn of government grant[1], bringing total RP stock to 2.8 million affordable homes.

HAs borrow private finance to deploy alongside rental income from tenants and capital grant provided by central government. Banks and building societies historically lent at favourable rates (reflecting the security of rental income underpinned by government rent policy and funding support for affordable housing) over long terms, building up almost £55bn of investment in the period up to the Global Financial Crisis in 2008-09. This funding model was complementary to HAs' operating model, with net rental income covering debt costs over the long-term, driven by indexed rent increases of at least RPI (now CPI).

The recapitalisation of high street banks following the GFC restricted access to cheap long-term debt. In some cases, banks were underwater on much of their lending and wished to renegotiate loan portfolios with HAs.

HAs have tapped the capital markets for sources of long-term funding since the early 90's and increasingly since the Global Financial Crisis. This has delivered over £30billion of funding to date, starting with the large players (Places for People, L&Q) but now extending right across the sector to relatively small HAs. Bond aggregators for the smaller RPs are also a feature. The bond issuances are well-suited to the high-demand, long-term inflation-linked and stable nature of affordable housing. There has been a full range of offers ranging from 10 years to 40+ years with sizes starting as little as £50m up to £350m and larger. The market has matured significantly, and spreads have been extremely competitive with the strong ESG credentials of the sector combined with income stability attracting a huge weight of capital interest.

Bonds introduced new types of investors to RPs, including many UK and overseas institutions and pension funds. Many have become familiar and comfortable with the features, risks, and rewards of the sector.

For profit registered providers: direct institutional investment

Until the late-2000s, only charitable RP or government organisations could operate affordable housing. The Housing and Regeneration Act 2008 permitted profit-distributing organisations to operate affordable housing. Fourteen years on, there are 67 of these for-profit RPs (FPRPs) operating alongside 1,330 not-for-

[1] RSH Global Accounts 2021

profit HAs. HAs and FPRPs are subject to the same regulatory framework. The primary difference is the ability of FPRPs to distribute profits in the form of shareholder dividends, whereas HAs profits are non-distributable and are returned to the business to support future investment in stock and building new homes.

FPRPs own just under 20,000 affordable homes according to Savills' latest analysis[2]. That means investors have grown the number of affordable homes they own by 47% since the end of March 2021; and this built on an increase of 50% between 2020 and 2021. The number of FPRPs has grown too, more than doubling from 31 in 2017 to 67 in 2022. A strong pipeline of applications means this has the potential to grow further.

Many have backing from institutional investors looking to build large, long-term portfolios. Private investors have long funded HAs by offering debt and buying bonds. Some of these investors, having become familiar with the sector, have now registered FPRPs. They have looked through the bond structures and seen the potential to deliver enhanced investor returns through direct asset ownership. Others are developers who want to retain control of the Section 106 homes they deliver, so they can sell larger, stabilised portfolios at a premium.

The level of interest in the affordable housing sector from new money and new equity investors has never been higher. The combination of net initial yields of stable 3-4.5% available on new build mixed tenure affordable housing and low costs of borrowing, makes English affordable housing a very attractive asset class. We are at the dawn of a new era of FPRP provision and, as with the Build to Rent market, the weight of capital seeking access far outweighs the availability of product. The availability of private investment via FPRPs is beginning to make a very significant contribution with an estimated £6-7billion in total now deployed over the last 10 years. Crucially, to date just 5 FPRPs are responsible for over 90% of new supply – all backed by large-scale well-established UK and US backed institutional capital.

Over the next 5 years, FPRPs have the potential to deliver £27bn of new private capital to help deliver more than 140,000 much needed new affordable homes.

Appeal to investors

The regulated status as well as the steady income stream of general needs affordable housing rents have generated a huge amount of interest from investors, which continues to build momentum. Particularly during periods of economic uncertainty and volatility, capital has flowed consistently into RPs as investors seek quality and safety. There are plenty of examples in recent years that highlight this strength in demand, including Clarion's £50m 2048 bond tap in early 2021 which priced at 0.88% over gilts and LiveWest's benchmark primary issue of £250m 2056s, which priced at 0.90% over gilts and attracted over 2.5x over-subscription.

As noted in L&G/BPFs recent paper, the aims and objectives of institutional investors are closely aligned with the societal benefits of providing new affordable housing[3] with investors benefitting from a long-term cashflow and households benefitting from security of tenure and high-quality affordable accommodation.

[2] Equity investment in affordable housing; May 2022

[3] Delivering a Step Change in Affordable Housing; March 2022

Investor interest in the affordable housing market reflects a natural progression by the investment community seeking returns from the relative stability of real residential assets, starting with the student market and latterly the build to rent market.

The sector continues to attract interest from increasing pools of capital across the full range of fund mandates, operating over a variety of risk profiles and over a range of hold periods. Core pension fund and insurance fund capital continues to provide the basis for stabilised exits for long-term hold. Core plus funds operating a mix of development, s106 and stabilised stock over a medium-term hold period, are an increasing source of capital. Value-add funds provide the ability for investors to take development risk over shorter hold periods. The sector also continues to attract investment from Family Offices and High Net Worth individuals where there is more opportunity for bespoke investment terms. There are also significant opportunities for lenders to leverage investments at fund, JV, FPRP level – with the potential to attract relatively lower cost funding drawing upon the delivery of investment at scale.

Whereas 10 years' ago, the focus was very much on long-term stable capital, the future is likely to draw upon the full range of investment mandates for equity and debt.

3. Operations of HAs and FPRPs

The overall financial capacity of RPs is predicated on strength and stability of the core rental income stream overlaid with levels of indebtedness, underlying asset value, and the ability of the business to maintain loan covenant compliance whilst meeting cost obligations.

HAs face high costs associated with making their existing homes comply with building safety and energy efficiency standards and this is impacting capacity and appetite to invest in new homes. The figures involved – particularly for decarbonising the stock - are potentially very large compared to the scale of development programmes. At 2020 prices, Savills estimated that £20.0bn of investment would be required over the next ten-years to pay for building safety works from 2021-2026, and the initial phasing in of decarbonisation from 2026-2030. The cost of these works has been subject to significant inflationary pressure over the last year.

Savills' detailed study of capacity for the NHF in 2020 showed that HAs would need to raise £32bn in new finance by 2030 to deliver building safety works including sprinklers, decarbonisation and 46,000 new homes per year at the Future Homes Standard.

Development activity is concentrated in a relatively small number of providers - the largest 50 developing HAs deliver around 73% of new affordable homes. A third of respondents to a 2021 Savills survey said they are scaling back existing development aspirations to prioritise investing in existing stock. Some are also experiencing further pressures from increased costs and lost revenue due to the Coronavirus pandemic, and this was cited by interviewees as potentially leading to a lack of appetite to push for higher delivery figures in the next programme.

The larger developing HAs do not have significant untapped financial capacity, with lower interest cover and higher gearing than the sector-wide average and increasing liabilities. Use of debt funding for expenditure on existing stock diminishes interest cover because, unlike development, such expenditure is considered as capital improvements and is deducted from surplus. In isolation, long-term funding for development is credit positive and would slightly increase financial capacity, but this excess would be exhausted quickly if it was used to fund more development, particularly for sites that are larger, more complex, or carry additional planning risk.

FPRPs don't (yet) have legacy stock issues and with modern, more energy efficient homes, they have lower repairs and maintenance costs, and huge capacity to take on more new supply. However, they are subject to the same economic headwinds as HAs which affect their funding costs and, in some cases, their operating costs.

Inflation has been well below 4% per annum for most of the previous 25 years; however, it has risen sharply since February 2022, driven by a rise in energy prices and a mismatch of resurgent demand with ability to supply goods. As a result, CPI inflation reached 10.1% in July 2022 and has far exceeded the 2% target for the past year.

RPs have felt effects of inflationary pressures. Energy costs affect office space; fuel costs directly affect customer services such as repairs; increased materials costs directly affect repairs, planned maintenance and development; and the indirect effects of these materialise as upward pressure on wage bills, and collapse of suppliers and renegotiation of fixed price service contracts.

This position leaves HAs seeking to make choices around revenue, capital expenditure and debt that balance their core objectives of achieving long term stability to support housing delivery into the future and protecting current tenants' social and wellbeing needs. FPRPs, often with rapid growth plans and outsourced management arrangements, have more significant exposure to changing cost of debt, which is considered in more detail below.

4. RP business plans and the proposed rent cap

RPs get the bulk of their revenue from social housing lettings – effectively regulated rents and shared ownership. 84% of HA and FPRP stock is low-cost rental, which is a mix of general needs and supported housing. 88% of general needs homes and almost all supported housing is let at a Social Rent, where initial rent is determined by a formula that considers national rent levels, local wages, and property values. 12% of general needs homes are let at Affordable Rent, where initial rents are capped at 80% of local market rents. Rent increases on these properties is subject to a multi-year rent settlement set by government. The current rent settlement runs from 2020 to 2025, allowing rents to rise by up to CPI + 1% per year. The September CPI figure is used to determine rent increases that in most cases take effect the following April. Global rental income from social housing lettings for the year 2020-21 was £14bn, with a further £1.5bn from service charges[4].

HA and FPRP business plans therefore contain future rent increases linked to CPI+1% to 2025 and to CPI or CPI+1% annually thereafter. Despite the high rate of inflation in recent months, RPs have not built this into business planning, preferring to model rental growth on previous lower OBR projections, and therefore rental income in business plans has not been predicated on 10% increase in 2023-24.

The recently issued consultation on a direction to the RSH regarding the Rent Standard for 2023-24 primarily considers ways to mitigate of the impact of a potential CPI+1% rent increase on tenants. It seeks to understand the effects of a one- or two-year rent settlement, with increases capped at 3%, 5%, or 7%. It would affect annual rent increases but not rent setting for re-lets or new homes.

RP's have recent experience of an unexpected deviation from stated rent policy, as rents were subject to a mandatory 1% reduction in each year from 2016-20. Although there is some learning from the effects of this policy, the current economic context and changes in provider types and priorities means that consequences will be different for the current proposed amendment to the Rent Standard.

The likely level of CPI at September 2022 which would otherwise have been utilised as the basis to set rent increases for April 2023 is around 10% - a significant level above business plan projections. However, there are also significant cost inflationary drivers affecting contractor, supplier and construction costs, some service areas (especially utility costs), and in some cases pressure for increased pay awards – these combine to drive costs at a rate that it typically higher than CPI for many providers.

Therefore, whilst a commitment to CPI+1% rent increases might have delivered increased resources over and above business plans, the interplay between income and costs is more complex. Our research and analyses with providers suggest that the sector needs rent increases in the region of 7-9% to "break even" in revenue terms for 2023-24. At the same time, there is little appetite from provider boards for rent increases that add further pressure on the finances of low-income households (those that pay all or make a contribution to their rent).

Whilst revenue income and cost pressures are broadly being felt across all parts of the sector, there are significant differentials between HAs and FPRPs in the context of investment into development. HAs are expected to be required to reallocate large elements of capital investment to their existing stocks to address challenges of building and fire safety, damp, mould, and energy efficiency. For FPRPs however, the focus on delivering new homes is likely to be critical – making stability in rent policy even more important in providing the conditions for continued low-cost investment.

If the proposed cap on rent increases goes ahead, 2023-24 will be the fifth year out of the last eight in which a confirmed rent-setting framework has been disregarded. The optics of this will necessarily have an impact on approaches to business planning and perceived risk, both for long-established HAs and the fastest growing new providers who entered the sector during this period.

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[4] This figure includes rent and shared ownership combined

Housing Associations

The principal impact of capping rent increases at a rate lower than the aggregate of cost inflation across the full range of expenditure areas will be to reduce operating margins. The way HAs approach business planning in this context matters for their good financial governance, and management of debt and expenditure.

For some providers, this will drive revenue savings and efficiencies to maintain operating margins and to secure continued flexibility for future investment by maintaining (for example) interest cover headroom. Those savings will be made at a time when there is arguably more support needed for households in social and affordable housing – increased staff time ensuring rent is paid and preventing hardship, management of increased damp and mould risk as households turn heating off, and so on.

Given that rent increases need to be in the region of 7-9% to break even across the sector, our illustrative modelling suggests that HAs would likely need to make savings in the region of £1.2billion if rents are capped at 5%.

This represents c5-7% of day-to-day management and maintenance expenditure, or c4-5% if major repairs are included in the cost base.

It is important to be clear that RPs have more options than simply making revenue cost savings. Realistically RPs' responses will be a balancing act between operating expenditure, capital expenditure, and use of debt i.e., proposed borrowing is scaled back. Careful consideration will be given to understanding trade-offs and consequences of options and decisions. Where providers are prepared to accept a dip in operating margins and cut back on investment, the impact on investment programmes could be significant.

For-profit providers

Whilst FPRPs are not affected by the legacy issues and pressures relating to existing stock, and CPI+1% at 11% is likely to be well above the estimate of rent increases in their business plans, FPRP plans are still affected by inflationary pressures on costs of materials, services, and wages.

5. Shared ownership rents

Shared ownership rents are not regulated by rent policy but are a contractual matter between landlord and tenant set out in the lease. The standard form of lease used by most providers states that rents will increase by up to RPI+0.5% annually. It is understood that RPs can reduce rent, not apply an increase, or apply a lower increase without varying the lease.

RPI runs higher than CPI, and some providers have expressed concern about the effect of permitted rent increases on shared owners who are by their definition lower income households and are exposed to various cost of living pressures as well as, possibly, increasing service charges and mortgage costs.

For HAs, shared ownership properties are rarely in charge and so fluctuations in value do not affect loan security. However, where providers have large, shared ownership portfolios a voluntary reduction in shared ownership rental income would impact on cashflow, covenant compliance, and revenue to invest in rental stock.

Many FPRPs hold more shared ownership homes than rental property. Funders backed these assets because of the inflation plus link, the relatively low operational risk, and the low risk of exposure to policy intervention compared to rented housing. The RPI+ link is fundamental to the business case, and if providers voluntarily break the link, it will undermine funder confidence in the asset class. Similarly for providers, they need to be able to align their revenue stream growth with their cost of capital – downward pressure on revenue combined with upward pressure operating costs (for some) and debt costs (which increases the cost of holding the residual capital) hinders ability to deliver the required returns.
From an investors point of view, the value of shared ownership assets changes if the income profile associated with it changes. Revenue stability is therefore essential.

We have only recently started to see a strong market emerging in trading shared ownership stock, as the funders active in the sector have diversified. This is beneficial for liquidity and should be allowed to grow further. It allows property that is capital intensive for HAs to be sold to FPRPs that desire the long-term income; thus, releasing capital for HAs to re-invest in new development.

Actions, voluntary or otherwise, that reduce the attractiveness of shared ownership to funders, especially those relatively new entrants with an appetite for shared ownership, will further reduce development capacity, compounding the loss of capacity that will arise from caps to rental income.

Providers already have the tools to shield shared owners who are at risk due to increasing housing costs. They can, and do, exercise forbearance on the rent if a shared owner is in financial difficulty, without altering the terms of the lease or significantly reducing their revenue stream in a way that impacts required financial performance. Similarly, they can buy back equity from shared owners who are unable to sustain their proportion of ownership or participation in the tenure at all. They have good insight into their customers' circumstances and strong channels to publicise the assistance they make available. The cost of increasing discretionary funds to support households that need assistance is significantly lower than the cost of providing blanket reductions to all shared owners; and capacity to fund programmes to provide revenue support or equity buy-back is reduced if shared ownership income is reduced across the whole portfolio.

6. Service charges

Service charges are not regulated by rent policy, although the Rent Standard indicates a preference for service charges not to increase by more than rents do. Where costs run above rental inflation, RPs would have to subsidise services if they restricted service charge increases.

For Social Rent properties, service charges are payable in addition to the rent and therefore there is scope to recover the actual costs of communal services from tenants. In fact, best practice would suggest full cost recovery of service costs through an "estimated/actual" approach.

However, given that a significant proportion of these charges relate to communal energy, heating and lighting, which have been subject to very high inflationary pressures, RPs are considering whether a simple "pass on" to tenants who are already disproportionately affected by the cost of living crisis would be appropriate for 2023-24. The 6-month Energy Bill Relief Scheme may assist with reducing actual costs that would otherwise need to be recovered in 2023-24; but it gives no protection against estimated costs that inform in-year service charges, and these will likely be high.

Service charges are therefore an area of additional concern for RPs as not being able or willing to pass on charges weakens the link between service costs and charges and reintroduces what used to be called rent pooling (where tenants not receiving services contribute to costs through rent or service charge income). For FPRPs providing social rent properties, this might be a "first time impact".

Loan security valuations assume full cost recovery of service charges, and so any RP deciding to protect tenants from service charge increases would expect to see financial consequences beyond change in cashflow and margin.

For Affordable Rent properties any service costs are included within the rent and so it is the landlord, rather than the tenant, who is exposed to cost increases that outstrip rental inflation. Increased service costs for Affordable Rent reduce the amount of net rental income received to support business activities. The Energy Bill Relief Scheme will help 2022-23 finances, but the impact of high service costs in 2023-24 remains a concern.

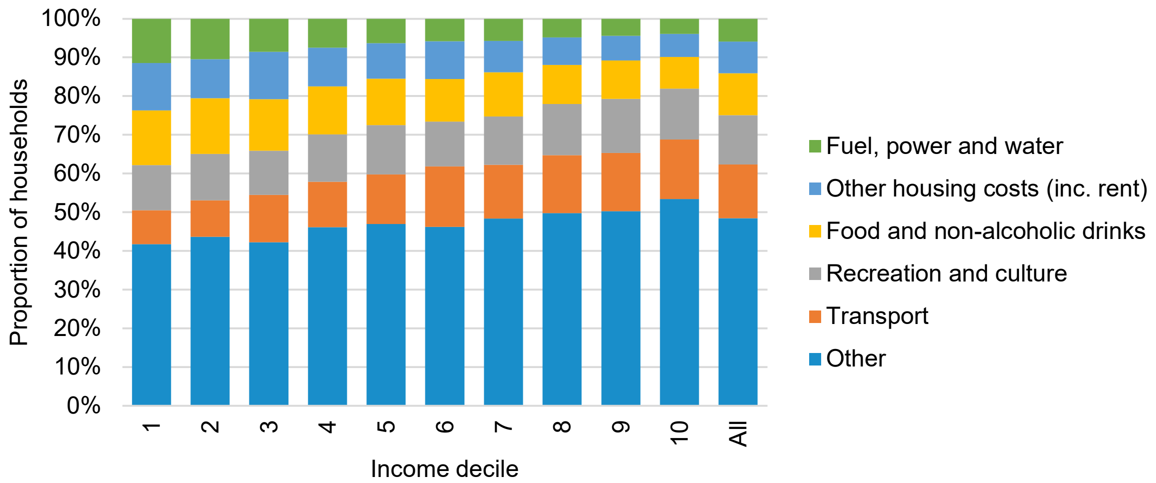
For shared ownership, the principle of full cost recovery also applies to shared owners living in multi-family accommodation i.e. flats with communal spaces/services. Any discretionary waiver or even deferral of service charge costs to protect household income means the cost falls onto RPs. Necessarily this then reduces income available to invest in rental properties and meet funder' covenants or service debt.
RPs are well placed to use hardship funds to assist tenants and shared owners who are struggling financially. Through these they can provide help that most meets the needs of the household, for example provision of white goods and furniture, debt write-off, or match funding charitable funding applications. If budgets are used to subsidise service charges for all, capacity to allocate funding for targeted support is reduced.

7. Customer experience

As providers of accommodation to lower income households, some of whom are particularly vulnerable due to age, health, or disability, HAs and FPRPs take the customer experience into account when determining their financial priorities. As well as having an interest in tenants' wellbeing, RPs will be mindful of increased arrears and property turnover that can arise from pressure on household incomes.

Inflation

The sharpest increases in costs have been seen in food, fuel, and energy, with the resultant pressure on non-discretionary household finances referred to colloquially as the “Cost-of-Living Crisis”. Whilst the government has announced a package of support with energy costs for residential households; the high cost of energy remains a concern for affordable housing residents because households with lower incomes spend a greater proportion of their incomes on power and fuel. The poorest 10% of households spent 12% of their income on fuel, power, and water in 2020, double the 6% average across all households. Similarly, the Russian-Ukraine conflict is likely to keep food and oil prices elevated for some time.



Welfare benefits

Where a tenant renting from an RP has a low income, they may be able to claim help with housing costs through the benefits system. The Benefit Cap limits the total benefits that a working age tenant/household can claim when they are not in employment; and the limit is implemented by reducing help with housing costs payable. Because rents are lower in affordable housing than in private renting, there is a little more headroom for RP tenants before they are affected by the Cap i.e. the cap primarily affects private rented tenants. However, with the Cap fixed since 2016, and affordable rents increasing since 2020, there is a prospect that more RP tenants will find their benefit entitlement restricted over time.

	Outside London	London
Couple/family rate	£20,000 per year	£23,000 per year
Single person rate	£13,400 per year	£15,410 per year

In 2020 Savills projected that smaller families renting general needs affordable family homes would begin to be affected by the Benefit Cap by 2025, with pressure spreading across the South-East and affecting the rest of the country by 2030 if rents continued to increase at around 3% per year[5].

[5] i.e. assuming CPI at 2% and the permitted +1% being applied

This would increase the number of households who were unable to cover rent from benefits, with the effect that those who continue to cover their rent will their income to cover non-housing living costs fall below the minimum level provided by the welfare system. The consequences could include an increase in arrears, voluntary or required end of tenancies, homelessness, 'voluntary' overcrowding via households combining. Alongside the cost-of-living crisis the future effects are likely to be greater than those experienced to date by Benefit Capped households. RPs seeking to prevent such outcomes may choose to increase resources to help these households to progress into work; but in the context of a tightening economy and forecast recession, where availability of jobs reduces and competition for vacancies increases.

Increased expenditure to offset the effects of the benefit cap on households and/or higher voids or arrears resulting from pressures on tenants both impact on RPs capacity to raise and service finance.

Shared owners – a foot in both camps

Shared owners may be simultaneously exposed to rent inflation and current pressures in the mortgage market. Some of those living in flats may face a triple whammy with service charge increases coming alongside high rent and mortgage costs increases.

However, not all shared owners will come under such pressure. Not all properties are subject to service charges. Longer standing owners will have higher equity (from a combination of house price inflation and staircasing), giving both lower rents and a firmer cushion if forbearance is required. Not all owners will be due to remortgage soon.

RPs will want to focus their support on the shared owners who are under stress and will use understanding of their customer base to do this.

8. The future of private capital in affordable housing

We already know there is huge investor appetite for environmentally friendly, regulated assets that provide tangible social benefit. Investor interest in the affordable housing market reflects a natural progression by the investment community seeking returns from the relative stability of real residential assets, starting with the student market and latterly the build to rent market. Investors deploy funds into affordable housing because it is a safe, long term, low risk asset that delivers a steady risk adjusted return. It matches the liabilities that pension funds and other 'patient capital' require over the long term; and accordingly, the interest rates paid by RPs are historically low. This position gives existing and future RPs a deep well of capital to draw on as they grow and invest in existing homes.

Investor confidence and support for the affordable housing sector depends on the availability of a stable policy environment. The sector has been subject to a range of government fiscal and policy interventions in recent years, and the current economic climate is especially challenging with rising cost of debt (which has seen a 3-4% increase in the 12 months to October), cost inflation, and so on.

Investors have considered the political and economic backdrop to affordable housing, assessing the creditworthiness of the sector and the risk profile compared to other residential asset classes and indeed other property sectors.

Early mover new entrants such as L&G Affordable Homes, Heylo, Sage Housing and ReSi, established their FPRP entities in 2017 and 2018 – this was shortly after the Government imposed a 4-year rent cut policy (2016-2020) that was announced just two years after announcing a 10-year rent settlement for annual increases of CPI+1. Other recent policy changes include the introduction in 2020 of Energy Performance Certificate and Decarbonisation targets for residential property, and in 2021 of a new model lease for shared ownership. So far, new entrant FPRP investors have adapted to the changing policy environment and maintain their commitment to invest in the sector.

Patient capital can withstand some bumps over a long term but fundamentally it cannot be exposed to much risk, political or otherwise. Investors value the robust regulation to which RPs are already subjected by the Regulator of Social Housing, which takes a steady and stable approach with an explicit intention to give confidence in robust financial governance. However, a high level of political intervention in a sector is not good regulation, and indeed undermines the benefits derived from it.

If credit committees and credit rating agencies begin to lose confidence in the credit worthiness of the sector, e.g., due to financial performance or concern about policy directions, the capital allocation required by lenders / investors will increase. This leads directly to an increase in the cost of debt for associations. On average the sector is rated at a low single A. If average ratings reduced to BBB+, the increase in debt costs would be in the region of 20-40 basis points.

The foundations for maintaining investor confidence include long term stability on rent policy, ongoing provision of capital grant to support new supply along with continued availability of planning led affordable housing.

9. Summary of consequences and policy options

In undertaking robust business planning RPs always need to consider their short- and long-term plans for operating expenditure, capital investment, and borrowing to balance expenditure and liabilities appropriately with income.

Particular financial priorities in the current economic context include:

- Maintaining strong financial governance, including adherence internal treasury golden rules
- Protecting compliance with lending covenants, in particular interest cover ratios.

Consequently, a rent increase cap, coming at a time of rapidly increasing cost of debt, high inflation, and instability in financial markets, could have the following consequences:

- Significant reduction of investment in existing stock, including progress towards zero carbon, with providers resorting to a minimum investment standard of statutory compliance plus maintaining components at Decent Homes level
- Increased incidences of damp and mould resulting from reduced investment, which ultimately cost more to rectify than the initial preventative investment would
- Reduction in liquidity arising from reduction in availability of capital from HAs and FPRPs to acquire tenanted stock from other RPs
- Reduction in liquidity arising from loss of FPRP buyers for HA stabilised shared ownership portfolios – an emerging source of capital for HA decarbonisation/growth plans
- Loss of capacity to improve financial performance of portfolios through active asset management e.g. remodelling of underperforming properties to better meet local housing need, despite higher need to use such tools
- Reduction in development and acquisition of new affordable homes, despite already high levels of need for such homes and increasing affordability pressures in the owner-occupier and private rented sectors
- Depression in prices offered for s106 properties, with knock on consequences for the viability of SME builders and delivery delays due to renegotiation of planning obligations
- Reduced net income from Affordable Rent properties as service charges increase as a proportion of the gross rent
- Loss of financial viability in supported housing portfolios and dedicated supported housing providers, where it is difficult to reduce operating costs due to the nature of services and customers they support, and where margins are already extremely low
- Reduction in the security value of supported housing stock
- Reduction in the ability to provide and financial support for customers and target this at households that most need it
- Increased need for lenders to grant waivers on loan covenant calculations, in order to carve out financial capacity to deliver fire safety, net zero and other building safety works

And as a direct result of these consequences, providers of private capital to RPs may experience:

- Reduction in 'green appeal' and desire to provide ESG funding (as zero carbon works are not pursued)
- Loss of confidence in the stability of affordable housing as a generator of index-linked income that increases smoothly over time (as rent increases will have been below inflation for 5-6 years out of the 10 year period 2015-25)
- Loss of confidence in the stability of the affordable housing to generate steady growth in asset values (as cost increases cannot be fully offset)
- Loss of confidence in the stability of the sector if there are mortgagees in default
- Need to price in the risks arising from uncertainty, impacting credit scores and therefore increase costs of debt
- Loss of capital allocations to other countries / sectors / investment classes

- Reduction in the pool of providers that can deploy capital, and thus reduction in demand for funds
- Reduction in the value of rental assets held in charge or owned, as property condition reduces and rental potential for a mortgagee in possession falls
- Reduction in the value of shared ownership assets, as the income profile changes
- Increased impetus to reconsider covenant structures.

It is possible to suggest mitigations to accompany a below inflation cap on rent increases that aim to protect affordable housing outcomes and safeguard appetite for, and volume of, private investment into the sector. However, the optimum approach is not to deviate from current rent policy. This approach enables RPs to target assistance at households that most need it; maximises flexibility afforded to RPs to manage their business plans in the face of strong economic headwinds; and maintains confidence of investors in the sector from whom tens of billions of pounds need to be raised over the next ten years.

Alongside any rent increase the Benefit Cap requires revision. This would reduce the financial pressure experienced by households and reduce the likelihood of lost revenue to RPs (placing further pressure on margins) arising from its implementation.

Looking beyond 2023-4, as we approach the end of the ten-year rent settlement given to RPs in 2013, of particular importance is a commitment to index linking of rent increases from 2025 to assist recovery from recent economic pressure, sustain and grow capacity for future investment in new and existing homes, and support continued investor confidence to participate in the affordable housing sector.