BUILDING THE HOMES BRITAIN NEEDS

THE AFFORDABLE HOMES FUND

OCTOBER 2019
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Creating more places for people to thrive and be recognised as a sector leading landlord
ABOUT YOUR HOUSING GROUP (YHG)

WE ARE A NEW GENERATION OF HOUSING PROVIDER, WORKING TO BUILD AS MANY QUALITY HOUSES AS IS POSSIBLE IN ORDER TO PLAY OUR PART IN SOLVING THE NATIONAL HOUSING CRISIS.

We’re proud to provide 28,000 homes already and are always looking for new and innovative ways to provide more. We offer affordable and social housing and our ambition is to lead the way in a new, improved rental offer. We’ve recently introduced three-year tenancies across some of our portfolio – the first step towards our ultimate ambition of providing our tenants with life-long tenancies that will enable them to make long-term decisions around the type of home they want, the lifestyle they prefer and the community they want to live in.

We commissioned this report in order to help address the real need behind the housing crisis: finding innovative ways of getting more funding into the housing sector, particularly at the affordable and rented side of the market where demand is so acute.

ABOUT THE AUTHOR

Chris Walker is a former government economist who spent over 12 years as a civil servant in the Treasury, the Department for Work and Pensions, and the Department for Communities and Local Government, where he was a senior economic adviser. Chris’s experience covers all aspects of housing and he now works as a research and economic consultant on housing, planning and local economic growth.
EXECUTIVE SUMMARY

THIS COUNTRY IS IN URGENT NEED OF AN ANSWER TO THE CHALLENGE OF DELIVERING MORE HOUSING IN THE ALL-IMPORTANT ‘AFFORDABLE’ RANGE.

The private developers who dominate the market have simply failed to address this, and if incentives stay the same, they will never be particularly motivated to do so. This report suggests a different approach: a radical new expansion of housing delivery by the housing association sector, underpinned by a government-backed, but investor-funded, ‘Affordable Homes Fund’.

The new fund would aim to attract private investment from trusted sources, particularly pension funds, offering reliable returns from large-scale, affordable rented housing developments. It would comprise genuinely additional housing funding that debt-constrained housing associations could access to build homes.

Link-ups between pension funds and new rental developments are not a new idea, and the partnership has mutual benefits. Giving housing providers comparatively low-cost finance, in addition to the rental yields on new developments would give funds a return over a long period that matches their liabilities very well. The big issue is that such partnerships are few and far between and so small in scale that they cannot hope to make a dent in current levels of demand.

Policymakers are, however, becoming increasingly interested in expanding this model as a means to providing a solution to the present crisis in affordable rented housing in the UK. We need hundreds of thousands of new units in every region over the next decade, just to meet the present level of demand.

The issue, as ever, is funding. There is a potential market for investment into affordable housing, but it needs government to step in to accelerate its development. This is where we have created the concept of a new national fund designed to kick-start affordable development on a mass scale.

This would be designed to create an appealing investment proposition for pension fund investors and an opportunity for all local authorities in England to generate revenue from their land holdings, reducing their reliance on central government money. It would also provide direct encouragement of ‘modern methods of construction’ in order to mass-manufacture new homes at speed.

TO ACHIEVE THIS, GOVERNMENT SHOULD:

• Establish a fund comprising additional money for house-building that debt-constrained housing associations can access to build homes. This should be facilitated and regulated by central government, but funded by external investors.
• Seed the fund with an equity loan of up to £2bn to get development started and the fund working quickly.
• Guarantee social rents rising at CPI or CPI+1 per cent just for affordable homes within the fund to provide reliable returns.
• Amend the pensions regulations to enable Defined Contribution (DC) pension funds to increase their investment in affordable housing.
• In the longer term, enable individuals to be allowed to invest directly into the fund – perhaps creating an option in which people can invest in new housing in their local areas.

The fund would directly finance areas in need of affordable housing delivery and would also encourage advanced offsite manufacturing capability, so that new homes could be delivered at much greater speed. The result would be a radical addition to the affordable housing output of this country.

Our projections suggest that the fund would be capable of financing the delivery of 30,000 affordable homes each year, once it becomes operational within 24 months. This would eliminate the annual deficit in affordable house building, stopping the housing crisis getting worse each year due to the annual under-delivery of this stock.

The case for government intervention to help create this new driver of housing output is now extremely compelling, especially in light of the inability of existing market players to fill the gap in affordable delivery. The time for policy action is now.

Brian Cronin
Group Chief Executive, Your Housing Group
INTRODUCTION: TACKLING THE CRISIS IN AFFORDABLE HOUSING

The government has set out clearly that England needs an additional 300,000 homes a year, including 225,000 new build completions, just to keep pace with the growing demand for homes. The latest figures show that English homebuilding is currently at its highest level since 1990,1 but this is dependent on private investment and productivity growth. We cannot simply rearrange the deckchairs of the traditional volume builder. Given that we are currently nearing the top of the economic cycle, this is a productivity challenge facing the UK economy as a whole, it is far more acute in the housebuilding industry. With current conditions, commercial housebuilders cannot build many more than 150,000 homes a year in England. Indeed, private enterprise completions numbered only around 131,480 in 2017/18. This is insufficient, particularly when we are possibly near the top of the economic cycle.

The fact that the present housebuilding gap exists, even after several years of strong cyclical growth, shows that it is caused by structural issues that dog the housebuilding industry. These issues are particularly apparent for the main private sector ‘volume builders’, who are responsible for delivering the bulk of UK housing. Their capacity is currently stretched and, even with sufficient land and funding, housebuilders cannot build the homes people need quickly enough. The housebuilding industry lacks the capacity and skills necessary for further substantial growth.

However, ultimately, housing associations are constrained by capacity issues similar to those which limit commercial housebuilders. Indeed, many housing associations commission commercial housebuilders to build their affordable homes for them. This lack of skills and available workers points to a clear need for modern methods of construction (MMC) to unlock housebuilding capacity and productivity growth. We cannot simply rearrange the deckchairs of existing capacity between commercial builders and housing associations, or market and affordable, and hope that output increases significantly. We will turn to the issues that must be addressed in order to widen the application of MMC to the mainstream marketplace later.

Underlying structural barriers aside, another blockage stymieing affordable homebuilding is the way in which housebuilding is funded. The housing market is highly cyclical and dominated by commercial volume builders delivering homes for market sale. This means the bulk of housing output in this country is dependent on private investment in good market conditions. Whilst homebuilding is currently at its highest levels since 2007/08, when completions peaked at 170,610, another recession would very likely knock housebuilding off course. Housebuilding fell by 40% in the recessions in the 1980s and 1990s and halved after the financial crash of 2008 on an annualised basis. History tells us that subsequent recovery could take the best part of a decade – i.e. yet another lost decade of housebuilding.

Given that the present housebuilding gap is running at 160,5702 and new build completions at 160,5703, so at present, we are well below these government targets. Uncertainty caused by Brexit may make that gap increasingly difficult to close too.

The fact that the present housebuilding gap exists, even after several years of strong cyclical growth, shows that it is caused by structural issues that dog the housebuilding industry. These issues are particularly apparent for the main private sector ‘volume builders’, who are responsible for delivering the bulk of UK housing. Their capacity is currently stretched and, even with sufficient land and funding, housebuilders cannot build the homes people need quickly enough. The housebuilding industry lacks the capacity and skills necessary for further substantial growth.

The housing association sector could do much more to respond to this insufficiency issue and step up the number of homes it delivers in the all-important ‘affordable’ housing range. On the assumption that 30% of new build homes across the country need to be affordable to meet current demand, we need 75,000 affordable new build completions a year. Some suggest higher: Savills, for example, has recently suggested that 100,0004 new affordable homes are built a year, though their figure includes all forms of new supply. Affordable housebuilding levels, however, even though they are not cyclical, currently appear stuck at around the 45,000 to 50,000 a year mark.5

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Creating more places for people to thrive and be recognised as a sector leading landlord

1 Ministry of Housing, Communities and Local Government, Live table 120
2 Ministry of Housing, Communities and Local Government, Live table 123
3 Ibid
4 Savills, The Savills Housing Sector Survey 2018
5 Ministry of Housing, Communities and Local Government, Live table 1000
Increasing the number of affordable rent homes built would be the real target market in expanding the role of housing associations. However, many housing associations are debt-constrained, which limits their ability to invest to build. It has been argued that equity investment in this sector, alongside debt-funding, would ease these constraints. The oft-cited source of pension fund money has never quite materialised, however. While things are starting to happen in the build to rent sector in earnest – though not without substantial government policy support – a ‘build to affordable rent’ version is sadly missing.

In short, the market has a missing middle. This possible market or regulatory failure is a justifiable target for policymakers to fix. The real task is enabling and encouraging pension funds to flow into the affordable building sector. Pension fund money in the de-accumulation phase, in particular, needs safe investment so tends to be heavily invested in government gilts, currently bearing a low return of around 1.75%. In contrast, pension funds in the accumulation phases typically require rates of return beyond what an affordable rent product can offer (cue build to rent) and are often heavily invested in equities.

Finally, it is worth noting that we may be on the brink of a local authority funding crisis. The Local Government Association estimates a £3.1bn shortfall in local authority budgets next year alone. While many cash-strapped local authorities have land, many are reluctant to sell off their assets. A more appealing prospect would be to generate a steady income from their land whilst retaining ownership of it, or receiving property assets of equal value in exchange.

The picture that emerges here argues for a radical new expansion of affordable housing delivery, driven by three mutually beneficial actors: pension funds providing investment in return for a reliable long-term yield; local authorities providing land, which they would retain a stake in; and housing associations managing and taking care of the housing stock. The key question is, how can we make this happen?

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6 Local Government Association, ‘One in three councils fear funding for legal duties will run out within three years’
Imagine affordable homes being built at scale and speed; churned out by factories in the Northern Powerhouse and Midlands Engine; with cheaper labour; funded by pension fund money; on land leased by local authorities; generating affordable rent income to pay for pensions and local government services; with professional and trusted housing associations managing the stock and taking care of tenants.

This vision has been discussed as the solution to tackling a large part of the UK’s affordable housing crisis. However, nobody has yet explored how to take this vision and concretely implement it, in fact, we are currently nowhere near delivering it. What we do have is some semblance of the key building blocks: an emerging and rapidly growing build to rent sector, invested in by small pockets of pension fund money; a nascent though arguably basic offsite manufacturing capability; and a long-standing regulated social rent product that could offer a lower risk – albeit for slightly though lower return – investment proposition than ‘standard’ build to (market) rent.

This paper therefore seeks to build a model for bringing the four ingredients together and helping bring the vision closer to reality. It proposes a government-backed and seed-funded affordable housing fund, which is private sector-led and managed, offering affordable housebuilding equity. This would bring about:

- An established build to affordable rent (BTAR) model with genuinely additional private money that debt-constrained house associations could access to build homes through modern methods of construction (MBTAR).
- An appealing investment proposition – mix of risk and reward – for pension fund investors.
- An opportunity for all local authorities in England – including those who are cash-strapped – to generate cash from their land holdings, reducing their reliance on central government money and the antiquated grant formula mechanisms dishing it out.
- Encouragement for the rapid innovation of modern methods of construction to grow both our capability and capacity, ultimately to mass-manufacture homes at a low cost.

It would evolve the build to rent model accordingly, creating an affordable rent product for a wide spectrum of those looking for this tenure, including social housing tenants and those in housing need unable to access the market, such as those on local authority waiting lists.

Furthermore, because the housing crisis has affected those further and further up the income scale, including those on average incomes wanting to access homeownership, adding a shared ownership offer could bring significant benefits to a build to affordable rent model, by potentially reducing voids and maintenance and repairs costs, so boosting net rental yields to support model viability and returns to pension investors.

As a result of yield considerations, there is unlikely to be a substantial social rent offer.

A key challenge to market build to rent is the affordable housing requirements, which can pose a challenge to the viability of these schemes. The build to affordable rent model presented in this paper would, ideally, not be mono-tenure, but instead a genuinely tenure-blind mix of market and affordable tenures – without ‘poor doors’ – for both rent and ownership. We recognise this may be difficult to achieve at first. One avenue is the possibility of mixed build to rent and build to affordable rent (including shared ownership) schemes acting symbiotically – build to affordable rent acting as a de facto affordable housing offer on build to rent schemes. In other words, the fund envisaged in this paper could help fund the affordable housing requirements on build to rent schemes.

The simplicity and flexibility of this model is that it requires no changes to legislation or legislative space, as it is built around contractual relationships between government and the private sector. This includes the proposed social rent guarantee only on the affordable homes built through the fund. This would ensure, through contractual means, that social rent income would either rise by CPI or CPI+1 for these homes for 25 years. The fund would be compensated for in some way if the government wanted to change its social rent policy in the future – i.e. if social rents did not rise by CPI or CPI+1.
UNDERSTANDING THE OPPORTUNITY

THE ATTRACTIONS OF THE BUILD TO RENT SECTOR

Build to rent homes are designed and built specifically for renting. Schemes usually take the form of a large block of apartments with a shared 24-hour concierge and other facilities, such as a gym, with fully integrated services and one person managing the whole building. Generally located near good transport links and local amenities, they are typically targeted at middle to high-income professionals.

The set-up offers scale economies in terms of operational costs over the traditional buy to let model, where net yields are lower. The attraction for large pension and insurance funds is that they have the upfront capital to invest in large blocks of flats, which are let out and managed by a single company at lower average cost, helping to boost net rents to generate the sufficient return.

There are currently nearly 30,000 completed build to rent homes in the UK as at the end of 2018. It remains a very small but rapidly growing sector, with around 6,500 built in 2018.

The fundamental demand for build to rent is very strong: population growth and lack of housing supply combined with a young professional population who are facing an underwhelming buy to let landlord offer and are less able to access homeownership in the way they once could. A lack of affordability is compounded by stagnant wage growth amongst the young, and tougher mortgage regulation since the credit crunch. A million more 20-34 year olds are living at home with their parents than there were 20 years ago, despite no rise in their population. Homeownership rates amongst this age group have subsequently plummeted.

Build to rent is also a distinct asset class within the private rented sector and has been defined as such in the National Planning Policy Framework. This potentially makes it more investible.

Savills recently estimated that an average 4.3% net yield is achievable on UK build to rent, with average net yields in the North of England and Scotland higher still at 4.9%. The latter appears roughly at the ‘strike rate’ that makes it an attractive proposition for pension funds, said to be around a 5% net yield (according to investors at a round table held for this research - more on this later). It also compares favourably to the 2.75% net yield available of mature and buy to let portfolios.

Historically, nominal market rental growth has tracked wages growth very strongly averaging around 3% per annum, also close to CPI+1%, though both earnings and market rental growth have been lower during the last decade as a result of the financial crash. Rents are not volatile like house prices and rarely go down. For long-term investors like pension funds, including pension annuities, seeking stable income with at least CPI growth, this has obvious appeal.

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1 British Property Federation, ‘Building boom for UK build-to-rent’
2 Ibid.
3 The Guardian, ‘Nearly a million more young adults now live with parents – study’
4 Institute for Fiscal Studies, ‘Barriers to homeownership for young people’
5 Savills, ‘Investing in Private Rent’
6 Ibid.
7 Office for National Statistics, ‘Index of Private Housing Rental Prices, UK: monthly estimates’
Savills observes that given build to rent is a relatively immature asset class that hasn’t been around for long, and given certain regulatory risks (e.g., increased affordable housing obligations), the risk premium over gilts remains high at over 3% (circa 5% net demanded by investors versus 1.75% for 15-year gilts). This constricts the growth of an investment product that can only offer an average 4.3%, with 4.9% net or more only attainable in certain localities and regions.

Savills also notes the uncertainty over how much the built-to-rent market can absorb large volumes of new rental stock. These so-called ‘market absorption rates’ were the subject of Sir Oliver Letwin’s recent ‘Independent review of build out’, which looked at build out rates in the traditional build-for-market-sale sector.

A ‘build to affordable rent model’ could potentially overcome these obstacles, by reducing the risk premium required. The risk premium is largely the result of political, regulatory and market risks. But these risks are very different for affordable rent housing and largely more benign. A build to affordable rent model could also provide ‘en-masse demand’ given all the households on the local authority waiting lists that need housing, removing the market absorption constraints of ‘market’ build to rent or build for market sale.
DELIVERING BUILD TO AFFORDABLE RENT AT SCALE AND SPEED

Modern methods of construction, or 'offsite manufacture', is a broad catch-all term used to describe varying degrees of buildings (or elements of buildings) that are produced in a factory and then transported to a building site for assembly. The method of producing housing is therefore fundamentally different to the traditional method: it uses machine-built operatives where traditionally, tradespeople such as bricklayers, plasterers and carpenters would have been used.16

There are relatively few established offsite manufacturers and only a modest, though not insignificant, number of buildings that have been constructed using these methods in England. Application has largely been limited to student housing and budget hotels, with some penetration at the lower end of the market where speed of delivery is particularly important. But there has been next to no penetration in the middle and upper residential and wider commercial markets.17

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16 RICS, ‘Modern Methods of Construction: A forward thinking solution to the housing crisis?’
17 Building.co.uk, ‘Construction methods: modular’

OCCUPANCY

In construction project management, the ‘golden triangle’ of desirables, namely budget, quality and speed, all trade off against one another. The technology exists for fully automated offsite manufacturing plants to produce buildings that are cheaper, higher quality and quicker to deliver – i.e. an improved golden triangle – but such technology requires substantial upfront capital investment and therefore a risk to investors in the offsite manufacturing sector.

Offsite manufacture of homes can be cheaper largely due to scale-economy cost savings that accrue from the replication of production, exactly as in the mass-manufacture of goods such as cars and televisions; the scales of economy drive down the cost of each unit produced. Quality and speed are both higher, ultimately because the computers and robotic machines used in repetitive advanced manufacturing processes are more precise and quicker than people making things by hand. Factory conditions also make quality-control much easier.

The greatest potential is with a large client with a strong and steady pipeline that can be standardised, with a long-term manufacturer to client relationship. As schools, hospitals, and affordable housing are non-cyclical, with large housing association and local authority clients, they appear perfect candidates for offsite manufacture.
GROWTH OBSTACLES

However, offsite manufacturing capital investment is risky. It requires high ‘sunk’ capital costs before a single home can be produced.18

More fundamentally, offsite manufacturing requires high utilisation rates to drive scale economies to deliver cost-savings and turn a profit. It is estimated a minimum order of 2,000 units (homes) or more is necessary for a single plant to achieve this to any discernible extent.19 For example, Apple might need to manufacture around 1,000,000 iPhones to bring down their average production cost sufficiently to price at a competitive level and make a profit.

But unlike an iPhone factory, high utilisation rates of offsite manufacturing can be difficult to achieve because the customer or client base is not well-established and demand is more variable. Furthermore, the highly cyclical nature of the housing market, with its volatile demand, does not lend itself to factory production that ultimately relies on high volume sales with reasonable consistency.20 That is why offsite manufacturing has an even greater risk. But with a reliable and sufficiently large client or customer base that puts in orders on a regular basis, the risk starts to diminish.

Currently the risk pervades, and to manage that risk many UK offsite manufacturers have limited their investment exposure so that they are, in reality, limited to simpler manufacturing techniques and are not fully automated. As such, offsite manufacturing can be described as an ‘infant industry’ – nascent, with limited capability and capacity insufficient to be game-changing. This is a classic catch-22 situation.

A build to affordable rent model with a pioneering, national, ‘Affordable Homes Fund’ would provide the non-cyclical affordable housing demand over a prolonged period, marshaling build supply into a set of standardised housing products, replicated in the hundreds of thousands, and funnelled through a single (but very large) customer – i.e. the fund. This could be a way to break the catch-22, providing large scale orders to selected offsite manufacturers established through a competitive tender, enabling, and perhaps even obligating them, to put the additional capital investment required in to create the state of the art production facilities we need.

18 This also means that entry costs are high, which in turn means reduced competition. Less competition can mean cost efficiencies not being passed on to customers and this has sometimes been observed.
19 According to an industry expert attending a roundtable for this report.
20 RICS, ‘Modern Methods of Construction: A forward thinking solution to the housing crisis?’
FUNDING BUILD TO AFFORDABLE RENT

Increased investment in new build affordable housing and a safe return for pension funds is the fabled ‘virtuous circle’ we know should be available. There is demand for housing – and a need for affordable housing in particular – and there is supply of funding. But the fact it is not happening suggests a market failure or a regulatory one, possibly even both.

Pensions in the UK today are mostly defined benefit (DB), final or average salary schemes, as opposed to defined contribution (DC), dependent on contributions and investment returns), though there is a longer-term shift to DC. There is around £2 trillion in traditional DB pension schemes and nearly £400bn in DC schemes (2018). A fraction of such sums could be game-changing if they were used to fund affordable housing. Indeed, to give a sense of perspective, the housing association sector’s entire debt – the mainstay of its funding for affordable homes – is around £72.5bn.

OPPORTUNITY

It is important to distinguish between short-duration (three to five years) high return operations driven by private equity and long-duration (40 years) low return operations underpinning pension annuities. The opportunity for funding affordable housing lies with the latter.

Around 8% of DB schemes, around £150bn to £200bn, have been bought out via bulk purchase annuities. These liabilities require ‘matching’ with long term assets and will invest in real, illiquid assets, including infrastructure and housing.

DC funds are expected to grow to around £1 trillion by the mid-2020s. The DC annuity fund seems to present the perfect demand for a safer, but lower return asset class, using affordable housing as the investment. Some also see an opportunity for affordable housing to emulate student housing as a tradeable institutional asset class, one that also draws in international investors.

As an indication of its commercial potential, L&G have already set up a social housing provider ‘L&G Affordable Homes’ as a subsidiary of L&G Capital. The predictability of social rent, which is regulated and will rise by CPI plus 1% from April 2019 for five years, is a key attraction.

2 Regulator of Social Housing, ‘2018 Global Accounts of private registered providers’
3 They must meet the ‘Solvency II’ matching criteria.
4 Legal and General, ‘Modular homes: Making the housing market fairer for all’
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Currently DC funds have only limited investment potential in real, illiquid, assets like housing. To get them more into these assets requires some rule changes, or a relaxation of the rules, that the government is currently consulting on – including the ‘permitted links’ rules concerning how much fund money can be invested in property.

Nonetheless, some pension funds may still view investment in the institutional rented sector as too risky. Trustees of traditional DB funds are reluctant to invest in illiquid, assets like housing because of innate conservatism and fiduciary duties, the need for liquidity, and because many are too small to allocate assets much beyond gilts, traded fixed income and index equity.

Further, The Pensions Regulator (TPR) naturally conveys to the industry “don’t go bust”, so implicitly pension funds are encouraged to invest in safe options, like government gilts. In other words, reinforcing a penchant for conservatism in an already inherently conservative pension fund sector.

The required yield, namely a high risk-premium, is also an obstacle. According to participants at a roundtable held for this report, including experts from the pensions industry, investors demand a 5% net return on build to rent investments. This is a significant risk premium over gilts at 1.5 to 1.75%. This partly reflects the fact that build to rent is not fully ‘tried and tested’, as well as the political, regulatory and market risks mentioned previously. Some at the roundtable also cited ‘mistrust of government and regulatory risk’ as a reason for the risk premium’s existence.

This is perhaps unsurprising, given what happened with the 1% social rent reduction policy announced in the 2015 Budget. This back-tracked directly on a social rent policy reform just two years earlier, with the annual uprating of social rents changed from RPI+1% to CPI+1%, with the government promising ‘long-term certainty’ (of CPI+1) in social rent setting. Other explanations for the risk premium’s existence were conspicuous by their absence. In short, the government just saying it will do CPI or CPI+1 is unlikely to be good enough.

So there are potential regulatory blockages to greater pension fund investment in market rent and affordable rent housing, perhaps because it is viewed as too risky by TPR. But potentially ‘safer’ affordable housing might offer better prospects than market housing in this regard, particularly if TPR is to be persuaded of the need for any further regulatory changes beyond those being consulted on.

25 Department for Work and Pensions, ‘Investment Innovation and Future Consolidation’
**MAKING AFFORDABLE BUILD TO RENT A REALITY**

There is currently only a semblance of what is needed to bring about the vision of a pension-funded, build to affordable rent sector, that uses modern methods of construction.

To recap, we have:

- A non-cyclical yield-bearing product i.e. affordable homes paying social or affordable rents that have historically been tied to inflation.
- A product that has less regulatory risk in certain regards – for example, a higher future affordable housing requirement is a regulatory risk for build to market rent affecting its viability, but this is obviously not a risk for affordable housing itself.
- Regulated social rents and no market volatility risk that is associated with private market rents, though again there is clearly a political risk around social rent setting.
- An ‘infant’ modern methods of construction industry – which is better than none at all.
- Cash-strapped local authorities with land that need an income.
- An apparent ‘wall of pension fund money’ that requires OIRO 5% net return on equity when it comes to build for market rent. Here it is observed there is no shortage of funds to invest in built to rent, but there is a shortage of schemes.

What we do not have is:

- A social rent sufficiently de-risked from government policy – ‘political risk’. In other words, government can do what it likes when it comes to future social rent setting.
- A fully automated offsite, advanced, manufacturing capability, at least not with sufficient capacity, that can offer significant cost savings on traditional build methods.
- A single large customer that could provide the large-scale orders over a long period of time that is needed for offsite manufacturers bidding for the work to drive their investment in fully automated high-tech offsite manufacture.
- Pension regulation that supports, or at least does not deter, pension fund investment in affordable housing.
- Proof of concept that build to affordable rent could work as an investment proposition.

The rationale for government intervention in these spaces is to increase the number of affordable homes being built, and in so doing to bring forward the establishment of a large and advanced offsite manufacturing capability so that the nation can deliver the homes it needs sooner rather than later. This would also resuscitate dormant productivity growth in the construction sector.

In terms of high-level public policy objectives, both increased housing delivery and offsite manufacture have productivity imperatives. A step-change increase in affordable housing delivery also has the curtailment of housing benefit expenditure as an imperative. These are the potential wins for the government.

But they come at a price: we identify some key asks of government to bring about pension fund investment in affordable housebuilding, using offsite manufacture. This would be through the establishment of a new national ‘Affordable Homes Fund’:

- The government to brigade the establishment of the single fund (see next chapter), a fund sufficiently large that it can diversify and pool risk across different locations, producers and products, and act as a ‘single customer’ for mass orders of offsite manufactured homes channelled through four or five producers.
- The government to ‘seed fund’ the ‘Affordable Homes Fund’ with an equity loan of up to £2bn, depending on the private pension money attracted in, with 20 pence matching for every 80 pence of private pension and housing association money.
- The government to guarantee social rents rising at CPI or CPI+1% just for affordable homes within the fund, through contractual means, for a period of 25 years, and to compensate the fund when social rents do not rise by at least CPI or CPI+1% either:
  - monetarily; or
  - through write down of its equity-loan; or
- by allowing dispensation for the fund to convert a sufficient number of void homes in the portfolio from affordable rent to market rent, to mitigate the loss of yield.
- Amend the pensions regulations to enable DC pension funds to increase their investment in affordable housing, as currently being consulted upon.

The fund needs to be a single fund in order to get the scale of demand for offsite manufacturers, to maximise risk-pooling, and because it is providing proof of concept — pioneering to reduce wider investor uncertainty and hence risk. Government seed funding at a low or zero fee is needed to make the fund viable in order to deliver the necessary return on equity to investors. Indexation is needed to enable pension fund liability matching of the pensions they pay out, which will often be indexed to CPI. ‘Plus 1’ could also support an earlier repayment of the government’s equity loan — noting around 42% of social rent increases are not paid for out of housing benefit. In other words, it draws in further private contribution.

The Ministry of Housing, Communities and Local Government, ‘Rents for social housing from 2020-21’

In the UK’s long term market rental and earnings growth, so stabilises affordability.
AN ‘AFFORDABLE HOMES FUND’

KEY FEATURES
- A pooled fund invested in affordable housing in multiple locations nationwide to de-risk location-specific markets.
- Run by a nominated equity aggregator body – the fund manager. This is a similar approach to the affordable homes guarantee model, where the nominated debt aggregator body was the Housing Finance Corporation.
- Ensuring that there is zero contingent liability for government.
- It could be part of a social housing REIT to be tax efficient.
- Investable by private and public investors, namely private and public pension funds.
- The fund is accessible by housing associations and local authorities offering housing scheme propositions for the fund to invest in.
- Seeded by a fully repayable government equity loan funding accounting for up to 20% of the fund (up to £2bn), not subordinate to private equity.
- The government equity loan funding could potentially classify as government debt (until repaid) and this would therefore be a key consideration in the next government Spending Review.

A ‘fund-enveloped’ government social rent guarantee* that rents on affordable homes within the fund can rise by CPI or CPI+1% each year, for 25 years, with government compensating the fund for any shortfall if social rents do not rise by at least CPI or CPI+1%. This would be a legally-binding contractual arrangement with the fund only. It would not be determined by government say so or, at the other extreme, through legislation.

The guarantee is likely to score on the government book as zero, much as the affordable homes guarantee does and so would not require government money unless called in (i.e. unless social rent did not rise by at least CPI or CPI+1).

The fund should aim to deliver around 4% net yield to private pension, housing association and local authority investors, ideally index-linked rising by CPI or CPI+1, with the social rent government guarantee*. These investors would hold shares (units) in the fund commensurate with the amounts they invest.

HOW THE FUND MIGHT WORK IN PRACTICE

CAPITALISATION – AN ILLUSTRATION

- £10bn of capital raised for the fund (to build circa 50,000 homes at £200,000 each) -
  - £6bn of private equity from pension funds, equivalent to around 1% of potential pension fund money.27
  - It could also include public or local authority pension fund money.
  - £2bn (zero interest, zero fee – paid for out of HB savings) equity loan from central government, possibly within their affordable homes programme following the next Spending Review. An option to exit after 25 years.
  - An equity loan not subordinate to private equity.
  - £2bn from housing associations and local authorities partaking in the scheme. Local authority equity investment could also take the form of land – local authorities receiving an asset, namely shares in the fund, commensurate with the full market value of the land put in.

INVESTMENT IN NEW AFFORDABLE HOUSING

- Housing associations and local authorities would bid to the fund for investment in housing schemes they put forward. Those that are successful contribute their share of equity, either through their surplus money or borrowing, but instead of having to borrow £1 for each £1 capital funding requirement for a scheme they would only have to borrow 20 pence with the fund providing the other 80 pence in equity.
- Housing associations would not own the housing – the fund would own it – but they are perfectly positioned to manage and look after the stock.
- There would be a criterion for:
  - The share of housing built by offsite manufacture for any given scheme put forward, say at 10 to 25%.
  - Tenure mix, including with market sale and rent and no mono-tenure social housing schemes.

27 Including £150bn to £200bn ‘bought out’ DB and nearly £400bn DC, up to £600bn in total.
**GENERATING A SUFFICIENT RETURN - AN ILLUSTRATION**

- To keep things simple, an assumed affordable rent offering at 80% of market rent.
- An affordable rental yield of 4.8% gross assuming market rental yields are 6.0% gross.
- Fully up and running, a £10bn portfolio will generate £480m rental income p.a., with:
  - £240m p.a. going in dividends to private equity investors (4% net RoE on their £6bn).
  - £80m p.a. going in dividends to housing associations (4% net RoE on their £2bn).
- Increased by CPI each year guaranteed.
- Fund manager fees of 0.5% of fund value p.a. (i.e. £50m on a £10bn fund).
- £80m p.a. going in dividends to housing associations (4% net RoE on their £2bn).
- Property management, maintenance and major repairs costs similar to housing association costs reported in the annual global accounts of housing providers.
- Property major repairs costs only beyond five years when the homes are no longer ‘new build’.
- Underpinned by social rent policy ‘guarantee’ for the fund of CPI or CPI plus 1% for 25 years:

**Illustrative fund income, distributions and costs (nominal £ million)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Affordable rent income @ 4.8% yield gross*</th>
<th>of which:</th>
<th>Dividends to private investors @ 4% RoE**</th>
<th>Dividends to housing association @ 4% RoE**</th>
<th>Property management costs @ GA**</th>
<th>Property maintenance costs @ GA**</th>
<th>Property major repairs costs @ GA, from year 6**</th>
<th>Fund management fee costs @ 0.5% of fund cap**</th>
<th>Surplus, in year</th>
<th>Surplus, cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year1</td>
<td>480.0</td>
<td>(240.0)</td>
<td>(50.0)</td>
<td><em>(50.0)</em></td>
<td>10.0</td>
<td>10.0</td>
<td>10.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year2</td>
<td>494.4</td>
<td>(244.8)</td>
<td>(51.0)</td>
<td><em>(51.0)</em></td>
<td>15.0</td>
<td>25.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year3</td>
<td>509.2</td>
<td>(249.7)</td>
<td>(52.0)</td>
<td><em>(52.0)</em></td>
<td>20.2</td>
<td>45.2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year4</td>
<td>524.5</td>
<td>(254.7)</td>
<td>(53.1)</td>
<td><em>(53.1)</em></td>
<td>25.7</td>
<td>71.0</td>
<td>71.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year5</td>
<td>540.2</td>
<td>(259.8)</td>
<td>(54.1)</td>
<td><em>(54.1)</em></td>
<td>31.5</td>
<td>102.5</td>
<td>102.5</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year10</td>
<td>626.3</td>
<td>(286.8)</td>
<td><em>(59.8)</em></td>
<td><em>(59.8)</em></td>
<td>4.8</td>
<td>69.0</td>
<td>69.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year25</td>
<td>975.7</td>
<td>(386.0)</td>
<td><em>(80.4)</em></td>
<td><em>(80.4)</em></td>
<td>139.4</td>
<td>1,105</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* rises CPI+1 per annum, assumes 2% CPI ** rises CPI per annum

**THE PRIZE**

For government, the main prize is macroeconomic, a potentially increased housing delivery through productivity gains. However, it is uncertain whether increased investment in offsite manufacture would deliver genuine reductions in unit costs and productivity gains.

Productivity improvement goes way beyond improving the viability of the fund (more on this later). If the productivity growth in the housebuilding sector were to be improved by just 1% per annum through greater use and development of the offsite manufacturing industry, it would mean supply-side growth of 2,000 homes per annum. That’s 20,000 ‘additional’ homes per annum by the tenth year and 40,000 per annum by the twentieth, compared to the counterfactual. Whilst clearly not much to change things over night, the latter is game-changing territory with homebuilding (net additions) currently at around 220,000 and the government’s target 300,000.

The main cost to the government is the £2bn equity loan provided at zero interest or a nominally low fee. This would not be subordinated to the pension fund equity and the government would be able to recover this in full after 25 years – the fund would be given dispensation to sell sufficient homes in the portfolio at open market value from year 25 to raise the capital to do this, if necessary. If the government were to borrow the £2bn, the interest cost would be around £35m a year (at around 1.75%, the current government 15-year gilt rate). However, the cost of a CPI or CPI + 1 social rent guarantee policy would currently score on the government books as zero, given that is what the social rent policy is currently. Again, the guarantee would only apply to the homes in the fund, not to social rent policy more widely.

However, the housing benefit savings of housing 50,000 households in affordable rented housing instead of market rented housing would be around £70m per annum assuming average market rents of £1,000 per month and 58% of the affordable rents paid by housing benefit.28 Even accounting for higher possible household formation – for example, housing 5,000 (10%) additional households that would not otherwise have been housed, the housing benefit savings would be just sufficient to cover the £35m interest cost to the government borrowing £2bn for its equity loan to the fund.

This would be a cost-effective way of housing households most in need, but also a very efficient way of encouraging innovation augmenting offsite manufacturing industry at the same time, purely through a large-scale demand underpinning and without direct government subsidy and the state aid implications this may have.29

If build to affordable rent could be used alongside build to rent it could be a way to de-risk the build to rent model from the regulatory uncertainty over future affordable housing requirements, thus increasing investment in build to rent as a further contribution to increasing the nation’s housing supply.

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28 Assumes average market rent £1,000 per month, affordable rent £800 per month, housing benefit covering 58% of rents i.e. £580 per month in market rent vs £464 per month in affordable rent. Annual Housing Benefit savings without additional household formation = 50,000 homes x £580 x 12 months = £35,600,000.

29 Depending on the nature of our long term relationship with the European Union.
A key risk to the government is that it is unable to recover the £2bn equity loan or recover it in full, or that the value of the equity loan is decreased by a fall in the market value of the homes ultimately securing it. This risk is reduced if the equity loan is unsubordinated, as proposed, and there is no reason why it should not be if the required rate of return to private equity investors can be achieved, including through the Social Rent Guarantee policy. It seems improbable that the value of the security – the housing stock in the fund portfolio at open market value from year 25 – would be less after 25 years (i.e. the first government ‘exit point’) than it was initially.

A further risk for the fund (and, as an investor, the government) is bad investment decisions made by the fund manager – acquiring the homes in locations where there is insufficient demand or need and hence insufficient rental yields. This risk would be reduced through good institutional set up that is divorced from political interference and thus ensures decision-making is entirely commercially based, as would be the case for any other private equity fund. It is easy to identify the markets where demand and need are most acute, so allocation of fund money would be where yields are sufficient and with undertaken with thorough due diligence. This already happens in the public sector too, with the allocation of social housing grant funding and happened with the £1bn build to rent fund, though we propose that the aggregator body would have no role in the allocation of fund money – the fund manager would be private sector, independent and autonomous.

Another risk for the government is that they decide at some point in the future that the social rent policy will rise not by CPI or CPI + 1%, but by something less. While there would be nothing to prevent the government changing its social rent policy, there would be flexibilities for the government to compensate the fund with the difference in the portfolio’s social rental income between the new social rent policy and CPI or CPI+1. It could either:

- Offer direct ‘cash compensation’ to the fund; or:
- Write down its equity loan to the fund by a commensurate amount; or
- Give the fund dispensation to convert some homes from affordable rent to market rent to mitigate any fall in rental yield versus CPI or CPI+1.

There is no housing development risk – the bidding housing association as housebuilder, or a commissioned commercial housebuilder, as well as the offsite manufacturer would bear all the development or production risk, just as happens with grant funding. They would be commissioned by the housing association to build the homes, as happens now, and the fund would pay for the homes upon completion. There would, however, be an upfront contractual undertaking by the fund to buy the homes when completed, if completed to the agreed specification and provided with a quality assurance guarantee by the NHBC or a similar organisation.

The key challenges in London and South East markets will be land and here local authorities and London boroughs may have a role to play in providing land as an equity offering that delivers them the same return on equity as private equity investors. Land is less of an issue in the Midlands and the North, but this should not necessarily preclude local authority involvement through a land contribution in these locations.

A further risk is that the capital investment by offsite manufacturers does not happen, with a ‘race to the bottom’ in the pricing of bids. But with sufficient scale, the most cost-effective production is likely to be one where there is significant investment in fuller automation that will drive the average cost of producing each unit down. Competition between offsite manufacturers should drive this process.

That is why there should not be one or even two preferred manufacturers used by the fund, but perhaps four or five at any one time, subject to periodic review, possibly through a charter or franchise arrangement.

The production risk with the offsite manufactured homes should lie with the manufacturer. If during production it transpired they were unable to produce the homes to the agreed specification or quality for the agreed cost, they would bear that risk. Payment for the homes by the fund would be on delivery, but again with an undertaking by the fund to buy the homes if produced to the quality and specification agreed. This is fundamentally no different to any other manufacturing process and the use of product warranties.

The biggest uncertainty in the whole model is the required rate of return for equity investors for a build to affordable rent product. This could be anything from close to the risk free rate of return of 1.75% net (unlikely) to the required rate of return on the standard build to rent model of 5% net (also unlikely). This is a wide range – a simplistic half-way point is around 3.25 to 3.5% net. We have modelled 4%. With the social rent guarantee, the risks overall would hopefully be less than ‘market’ build to rent - there is no housing market risk as such and there are fewer planning and regulatory risks due to uncertainty over future affordable housing requirements. The modelling presented here suggests a fund could be viable under various policy permutations with an ROE to investors of 4% (net). The key uncertainty is whether this would be sufficient i.e. is the build to affordable rent proposition set out sufficiently less risky than build to market rent one to reduce the required return on equity price from circa 5% to 4% net? We present some of the evidence in the next section.
WHAT WOULD THE FUND ACHIEVE?

This brief chapter sets out how the fund could finance the delivery of 30,000 affordable homes each year, once it becomes operational within 24 months. This would eliminate the annual deficit in affordable house building, stopping the housing crisis getting worse each year due to the annual under-delivery of this stock.

HOW THE PLAN WOULD WORK:

- In year one, government would set up the fund with an equity loan of £2bn, meaning financing for around 10,000 new homes would be available immediately. At the same time, the fund would seek investment from pension funds and housing associations.

- Following consultations with pensions industry experts, our conservative estimate is that it would take around 24 months for the fund to reach a level where it provides enough financing for the delivery of 30,000 affordable homes each year. This means around £6bn a year, with the likely balance being £3.6bn a year coming from pension funds and £2.4bn a year from housing associations.

- 30,000 homes is the figure that housing analysts estimate to be the annual deficit of affordable housebuilding – a flow of unmet demand which means the crisis of people waiting for housing worsens every year. The aim would be to end this deficit: stopping the ‘flow’ and allowing government to focus on the ‘stock’ of un-housed people, e.g. people waiting in emergency accommodation for housing.

- If the fund delivered more financing than is needed to fund 30,000 homes a year, this extra could of course be put to use with that stock problem. The fund would seek as much additional investment as possible.

- Housing associations would manage the stock, but the fund would own it, with government guaranteeing that rents on properties within the fund would be allowed to rise at CPI or CPI+1 – the rises under current social rent policy – for 25 years. This would generate predictable long-term returns at lower risk, attracting investors in.

- While this fund would be available for institutional investors at first, in time there could be a ‘retail offer’ allowing individuals to invest part of their own pensions or even ISAs in residential property schemes covered by the fund.
EVIDENCE BASE

There was broad consensus at the roundtable held for this report that pension funds require build to rent yields of around 6 to 7% gross and 5% net.16

Current build to rent schemes appear to yield slightly less than 5% net. Again, Savills recently observed that “net initial yields on BTR deals averaged 4.3% between 2015 and 2017.”17 This ranged from 3.8% in London to 4.9% across Scotland and the north of England.

Yields in central London are lower, Knight Frank’s reporting shows that net initial yields of 4% on central London schemes is not uncommon.12

All in all, the ‘biting point’ for build to rent appears to be between 4% and 5% net. This appears achievable in many parts of the country but not all.

This rule of thumb may change, of course, as the cost of borrowing changes – namely, changes in the Bank of England base rate and government gilt rates.

It is further observed that: “Build to rent works best in locations where open market sales values range between £300 and £700 per square foot. Any lower and it is difficult to build the scheme cheap enough, any higher and the rents don’t go high enough to offer required yields.”13

This would approximate, for example, to a £250,000 to £575,000 for a two-bed flat.

As wider context, CBRE research shows net yields on all residential rentals, ranging from 3.15% in London Zone 2 prime markets and 5.25% in outer London and South East secondary markets.14

Table: average gross and net rental yields in a selection of location types, to September 2018

<table>
<thead>
<tr>
<th>Location type</th>
<th>Gross yield, %</th>
<th>Net yield, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prime, London Zone 2</td>
<td>4.25</td>
<td>3.15</td>
</tr>
<tr>
<td>Secondary, London Zone 2</td>
<td>5.25</td>
<td>4.00</td>
</tr>
<tr>
<td>Prime, outer London and SE</td>
<td>5.00</td>
<td>3.75</td>
</tr>
<tr>
<td>Secondary, outer London and SE</td>
<td>7.00</td>
<td>5.25</td>
</tr>
<tr>
<td>Prime, prime regional centres</td>
<td>5.75</td>
<td>4.25</td>
</tr>
<tr>
<td>Secondary, prime regional centres</td>
<td>6.50</td>
<td>4.75</td>
</tr>
</tbody>
</table>

30 Net is after the deduction of costs.
31 Savills, ‘Investing in Private Rent’
32 Knight Frank, ‘Residential Yield Guide, January 2019’
33 Allsop, ‘Built to rent – juggling the challenges of investment and development’
34 CBRE, ‘United Kingdom Monthly Index – July 2019’

MODELLING

THIS SECTION SETS OUT THE EVIDENCE BASE, ASSUMPTIONS AND RESULTS OF MODELLING POLICY OPTIONS FOR THE SOCIAL RENT GUARANTEE AND SUPPORT (OR NOT) FOR OFFSITE MANUFACTURE, UNDER A STANDARD SET OF ASSUMPTIONS, WITH SOME STRESS-TESTING OF THESE.
Turning to achievable affordable rent yields, a very simple approximation is to take 80% of gross market rent yields – if gross market rental yields of 4.25 to 7% are achievable, as appears to be the case, then this would translate loosely to gross affordable rental yields of 3.5 to 5.5%.

Looking at a typical difference between gross and net yields of 1.25 to 1.75%, this also suggests net affordable rent yields of 1.75 to 2.25% depending on the market. 1.75% clearly would not be sufficient to attract investment, as this is broadly the risk-free rate of return as approximated by 15-year government gilts and yet build to affordable rent is not a risk-free proposition. 4.25%, however, should be sufficient.

Housing associations would be expected to take a leading role in a build to rent model, providing the management and operating services for the properties in the fund portfolio.

In the housing association social rented sector specifically, unit operating costs across the largest housing associations are reported annually in the Social Housing Regulator’s Global Accounts of housing providers. These were reported in 2018 as:

<table>
<thead>
<tr>
<th>Mean average operating cost</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management</td>
<td>£1,016</td>
</tr>
<tr>
<td>Service charge</td>
<td>£599</td>
</tr>
<tr>
<td>Maintenance</td>
<td>£1,028</td>
</tr>
<tr>
<td>Major repairs</td>
<td>£179</td>
</tr>
<tr>
<td>Depreciation</td>
<td>£803</td>
</tr>
<tr>
<td>Total 1</td>
<td>£3,528</td>
</tr>
<tr>
<td>Total 2(^{16})</td>
<td>£3,025</td>
</tr>
</tbody>
</table>

Total 2, which excludes services charges approximates to a net to gross differential of 2.2 percentage point with an average open market value of a social home of £140,000 and 1.5 percentage point with an average open market value of a social home of £200,000. Whilst £140,000 is closer to the average open market value of a home in the social housing stock currently, £200,000 is the average assumed capital cost in the build to affordable rent model presented in this paper and sits at the middle of the 1.25 to 1.75% range for market residential rentals suggested in the CBRE data, as a high-level indication of operating costs in the residential rental market overall.

\(^{15}\) Regulator of Social Housing, ‘2018 Global Accounts of private registered providers’

\(^{16}\) Excluding service charges

These assumptions are based broadly on the evidence base of the previous section.

- Achievable market rent yield, 6.0% gross
- Implied achievable affordable rent yield, 4.8% gross (80% of market)
- Unit cost nationally (construction and land) £200,000
- Implied market rent, £12,000 p.a.
- Implied affordable rent, £9,600 p.a.
- Unit management cost £1,000 p.a., unit maintenance cost £1,000 p.a., and unit major repairs and depreciation cost £1,000 p.a. – after five years on new build
- Fund management costs 0.5% of capital investment
- CPI 2%
- Cost and dividend uprating CPI
- Social Rent Policy Guarantee CPI + 1% for 25 years
RESULTS

Broadly, achieving a market rent yield of 6% gross (implied affordable rent yield of 4.8% gross) with a social rent guarantee of CPI plus 1% could sustain a return on equity of 4.0% net without any in year losses for the fund.

Alternatively, with a social rent guarantee of CPI only, a market rent yield of 6% (or an affordable rent yield of 4.8% gross) could only sustain a return on equity (ROE) of only 3.5% net without an in-year loss.

If a reduction in costs was achieved from £200,000 per unit to £182,000 per unit – from innovation in offsite manufacture induced by demand from the fund – it would boost gross affordable rental yields from 4.8% to 5.3% and could enable a social rent guarantee of CPI only to deliver a ROE of 4%; this would make a significant improvement to the viability arithmetic (second column versus third in table below). Achieving a cost-reduction is uncertain, however, and 9% is probably optimistic for the early years.

Table: Fund viability of different policies and assumptions

<table>
<thead>
<tr>
<th></th>
<th>Standard assumptions</th>
<th>Stress-tested</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Policy 1</td>
<td>Policy 2</td>
</tr>
<tr>
<td>Social Rent Guarantee:</td>
<td>CPI+1</td>
<td>CPI</td>
</tr>
<tr>
<td>Market rent yield (gross)</td>
<td>6%</td>
<td>6.6%</td>
</tr>
<tr>
<td>Implied affordable rent yield (gross)</td>
<td>4.8%</td>
<td>5.3%</td>
</tr>
<tr>
<td>Reduced construction cost?</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>ROE - rate of return achievable for investors (net)</td>
<td>4.0%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Fund viability</td>
<td>Excellent</td>
<td>Fair to good</td>
</tr>
</tbody>
</table>

POLICY 1

4.8% gross affordable rent yield, 4% ROE, CPI + 1% social rent guarantee, £200k cost per unit [excellent viability]

The £10bn fund would make a very small surplus of £10m in year one rising to £139m in year 25 (and £1.1bn cumulatively if not reinvested), after all dividend distributions and costs. The fund would therefore be comfortably sustainable and over time could build a strong contingency position which could potentially be used to pay down the government’s equity loan.

POLICY 2

5% gross affordable rent yield, 4% ROE, CPI social rent guarantee, £182k cost per unit [fair to good viability]

This might be a realistic proposition if the assumed rental yields can be achieved (4.8% gross as assumed on standard build, boosted to 5.3% through cheaper offsite manufacture). The £10bn fund would make a surplus of £47.5m in year one, but an in-year loss of £12m in year 25 with a cumulative surplus of only £50m. The figures are tight and contingency virtually non-existent. This is useful illustratively as it demonstrates the difference a small reduction in unit costs can make to fund viability, and the potential value of developing offsite manufacture in an attempt to reduce costs to deliver the required returns to investors, at potentially risk (e.g. CPI guarantee versus CPI+1 guarantee) to the government.

STRESS-TESTING

Identifying schemes with strong yields is paramount to the success of the fund. If a market rent yield of only 5% gross were achieved instead of 6% - or an affordable rent yield of only 4% gross instead of 4.8% – then even with a social rent guarantee of CPI plus 1%, the fund could sustain a return on equity (ROE) of only 3.0 to 3.25% net. This ROE is probably below what the market would require.

With an achievable market rent yield of only 5% – affordable rent of 4% gross - and a social rent guarantee of CPI only, the fund could sustain a return on equity of only 2.5% net at best, broadly only 0.75% above the risk-free rate of return currently. This ROE is almost certainly below what the market would require.
CONCLUSION

It is well documented that the housing market in the UK is in crisis. The persistent under supply of housebuilding has priced more and more people out of home ownership, increasing dependency on a suboptimal private rental market where rents are rising but standards are falling. This has led to an urgent demand for hundreds of thousands of more affordable housing units to be built.

Housing associations can provide the country with a credible solution to meeting these needs. Yet, in order to build more affordable housing, the housing association sector requires considerable external investment.

This is where the concept of an ‘Affordable Homes Fund’ comes in. Such a fund would empower pension funds to invest in the housing association sector, providing them with a stable return while enabling them to hit their ethical obligations. The fund could yield a return on equity of up to 4 or 4.5% per annum, without any losses for the fund.

Meanwhile, the fund would be an attractive opportunity for the government too, who has determined that England needs an additional 300,000 homes a year to keep pace with current housing needs. On top of this, there is a clear and growing demand for affordable rent.

In summary, we are calling on the government to:

- Establish a fund comprising additional money for house-building that debt-constrained housing associations can access to build homes. This should be facilitated and regulated by central government, but funded by external investors.
- Guarantee social rents rising at CPI or CPI+1 per cent just for affordable homes within the fund to provide reliable returns.
- Amend the pensions regulations to enable DC pension funds to increase their investment in affordable housing.
- In the longer term, to enable people to invest directly into the fund themselves – perhaps creating an option where people can invest in new housing in their own local regions.

The fund would direct finance to areas in need of affordable housing delivery and would also encourage advanced offsite manufacturing capability, so that new homes can be delivered at greater speed.

The result would be a radical addition to the affordable housing output of this country: the financing for the delivery of 30,000 affordable homes each year, once the fund is operational after two years. If achieved, this would eliminate the annual affordable homes deficit and stop the housing crisis from getting worse.

The case for government intervention is compelling, especially in light of the inability of existing market players to fill the huge gap in affordable homes delivery. We call on policymakers of all parties to bring this positive change about.