Development and Change: Private finance for social housing in the UK

A Background Paper for the LSE London Private Finance Seminar, March 4th, 2009

Christine Whitehead and Peter Williams

Introduction

The creation and development of the private finance market for housing associations and stock transfers has been central to the development of social housing over the last twenty years. This paper explores both why private finance was introduced and how the market for social housing has changed and evolved. It also seeks to explore the impacts of the current financial crisis and how this may impact on the ways this market might develop over the next 5 to10 years.

The principles

Housing finance and policy in the UK has been highly tenure specific. Historically almost all social housing was provided with government direct subsidy to suppliers and government sponsored debt. Yet the sector consisted of large and growing capital assets unencumbered by debt together with secure streams of rental income providing the potential for low risk borrowing.

The last Conservative government recognised very early in their policy development that three interrelated changes were required:

(i) to reduce public sector borrowing;
(ii) to improve incentives to increase efficiency; and
(iii) to expand the role of private finance, both equity and debt, in the provision of housing of all types but notably into new and existing social housing.

The approach involved:

- integrating housing finance within the deregulated general finance market, which enabled households to obtain mortgages more readily and at the same time increase their equity stake. It also ensured that suppliers had an appetite for housing debt;
- the Right to Buy which supported homeownership among lower income households; and
- the introduction of private finance into social housing within a carefully regulated environment supported by demand side subsidies (Whitehead, Gibb & Stephens, 2005).

Underlying the approach was the understanding that housing and in particular social housing had many of the attributes of a utility in providing a buoyant near certain rental stream and therefore a low risk product valuable in balancing portfolios.

The development occurred within the broader context of changing governance structures throughout the public sector. In particular central government had little belief in the competence of local authorities and wanted direct control over their own commitment through the use of upfront rather than revenue subsidies. This could be best achieved through Housing Associations. Equally privatisation was seen as one means of achieving value for public money and focussing objectives.

Before 1988

Prior to the Housing Act 1988, which introduced the mixed funds regime, the system for financing the building or acquisition of new homes by housing associations had evolved in an appropriately piecemeal fashion. The Housing and Planning Act 1974 introduced a new regime switched the basis of funding from annual subsidies to up front capital grants with a loan from the Housing Corporation (HC) (much reduced by the grant and repayable if the property was sold). A formal accounting system was introduced putting HAs on a more businesslike basis (Bromwich *et al*, 1991). Local authority subsidy moved to a system of gap finance based on deemed rents and costs.

The increasing pressures to reduce public expenditure added to the momentum to find alternative funding sources. Recognising that associations could over time begin to create assets and produce surpluses, in 1980, a grant redemption fund (GRF) was put in place in the Housing Act 1980 thus reinforcing the reality that 'loans' were being made which could be redeemed even though all of the funding was defined as public expenditure. The GRF came into effect in late 1982 and although it had a limited impact it did prompt thinking around future funding structures (Hills, 1990).

Even so, the history of private finance for housing associations is somewhat 'chaotic' in that it 'evolved' rather than being the outcome of a specific policy decision. . There was no clear start date and it was initiated as much through the efforts of a small group of individuals and organisations as it was by any substantial engagement by government. However, as Murie (2008) notes, by 1976/77 the government had gone as far as offering guarantees to the HC if it could raise £50 million of private money and the HC began to offer its own guarantees to help associations raise overdraft finance. In 1977 it set up its own Housing Corporation Finance Company as a wholly owned subsidiary which bought loans from the Housing Corporation, using money raised by Morgan Grenfell thus releasing new cash for development finance.

Throughout, the big stimulus was the squeeze on public funds alongside a growing recognition that associations were accumulating properties and assets. But the process was far from simple and it took several years to work through the terms and conditions necessary for a well functioning market. These included the ranking of loans and existing grant, fixed and floating charges, LIBOR linked lending, syndication rules, whether guarantees were needed, whether there should be restrictions on the borrowing in terms of LTV and what was the appropriate capital weighting to be applied.

By 1980/81 the HAs had a stock of over 400,000 rental homes. In 1981 the NFHA published a discussion paper on private finance in housing associations which contained proposals for investors to take equity stakes in property (initially shared ownership homes). A small pilot scheme was undertaken with a pension fund taking the equity interest with HAG being provided but on a reduced basis to make the books balance. Sutton Hastoe HA also began to fund shared ownership

with low start deferred interest funding from Nationwide BS and by late 1983, the society moved to offer index linked borrowing on a much bigger scale.

By the mid 1980s, prompted in part by continued government cutbacks in housing association investment and the introduction of the Right to Buy for tenants of non charitable associations, a small number of associations and advisers (notably Rachel Terry at CIPFA Services and James Capel) were exploring alternative funding models. A number of the deals that came to fruition were with associations working with local authorities that provided loan guarantees. Alternatively local authorities, having raised finance at Public Works Loans Board rates, leased the homes built back to the associations. Some associations also developed without HAG using Urban Development Grant or their own resources. In 1984/85, and reflecting the developing agenda, the HC and Nationwide BS launched the joint Open Door shared ownership scheme using index linked mortgages (later Alliance and Leicester BS also provided mortgages under this scheme).

A separate but not unrelated development was the setting up of the National Home Loans Corporation in 1985. It was formed to invest in mortgage loans secured directly on UK properties and it began life by buying loan portfolios from local authorities and other lenders. Local authorities had been required to provide mortgages to tenants buying their homes under the Right to Buy. By 1984 these books totalled around £4bn. NHLC was important in that it showed that there was an investor appetite to buy property related assets and cashflows. The creation of the NHLC was followed by that of the Mortgage Funding Corporation, the Household Mortgage Corporation and the Mortgage Corporation all of which raised their funds entirely from the wholesale market.

Within government the HC had begun working with the Department of the Environment (DoE) on a private finance regime. The first serious breakthrough came in late 1985 when a group of associations agreed that North Housing Association (NHA) would test the market. A project team was formed and by April 1986 a basic model was developed. North had been founded by the father of the then Secretary of State for Environment Nicholas Ridley as the North Eastern Housing Association and had a significant stock of homes, some of which had been built without government grant. The association was asset rich but it had two problems to confront. First, lenders and investors had little recent experience of lending on rented housing and second, the north was not seen as the ideal base for such an investment. Further the government had to clarify their involvement. In this context and after considerable debate inside government and beyond, Housing Association Grant (HAG) was made available but subordinated and viewed in some senses as quasi equity.

To address the issues of lack of market knowledge and concern about development concentrated in the north, NHA agreed to develop in the south of England, to contribute from its own reserves and to let the homes on assured tenancies with rents 25% above fair rents. Fourteen local authority partners were to provide land at nil cost in exchange for 50% nomination rights and collectively to guarantee the loan. In May 1987 North Housing Association raised £65 million in the City of London via loan stock at around 9% for 40 years to build 3,500 assured tenancies. Peabody Trust followed shortly after with a £10 million fixed interest loan from Nationwide BS after abandoning a 35 year fixed rate stock issue in the City. In March 1989 Network HA announced £10 million syndicated loan via the British and Commonwealth Merchant Bank.

The momentum was building. Ridley had been a Treasury minister and was reasonably placed to overcome both Treasury and DoE doubts (Murie (2008) characterises both as ‘sceptics and delayers’). The deregulation of building societies in the Building Societies Act 1986, access to index linked funding and the creation of the shared ownership lease provided important elements.

The creation of the Housing Finance Corporation (THFC) was piece in the jigsaw. It was set up in November 1987 (by the Housing Corporation and the NHF with DoE and Treasury involvement – see Pryke and Whitehead 1991 for a useful discussion of this new venture). Crucially, the Government agreed that THFC and other lenders could take a first charge security based on association assets and ahead of grant. Its first bond issue was in 1987 for £30.75 million for 6 housing associations. The properties to be built were to be leased to local authorities and managed by housing associations. THFC moved rapidly to support this new market and by 31 March 1991 it had committed £157 million, the largest amount from any lender. However there were enormous difficulties in addressing issues of scale and the lack of an asset base at THFC. These almost guaranteed major timing and transaction cost problems.

In 1987/88 the Housing Corporation which had been tracking these developments closely launched its own private finance initiative with a Challenge Funding scheme offering only 30% HAG (compared to the 75/80% normal at the time). The first scheme to be funded was that by the Wales and West Housing Association and SHAW (the Secondary Housing Association for Wales) which developed a 'mixed funded' scheme in St Mellons near Cardiff. The Cardiff scheme had focussed upon getting Urban Development Grant but this was not possible given it was a greenfield site. Adam Peat the former Head of Housing at the Welsh Office and then Chief Executive of Tai Cymru exploited the government's interest in private finance to get St Mellons through as a one off scheme. Treasury approval, free land from the city and a loan from the Halifax Building Society which also raised £15 million of index linked funding for housing associations and the Milton Keynes Development Corporation (Kleinman, 1988).

This was also the era of central government's major assault on local government. With increasing controls on their borrowing capacity, the Right to Buy in place and the loss of stock now becoming an issue, many authorities began to explore ways they might secure the future of the social rented stock in their ownership. Despite some misgivings it was recognised that a transfer to a new housing association set up under charitable rules funded by private finance and with a receipt coming back to the authority did have many attractions. The 1985 Act put in place the principles by which large scale voluntary transfers (LSVTs) could occur. Chilterns was the first full scale transfer in December 1988 in advance of the implementation of the more detailed 1988 legislation (there had been estate transfers before, eg Cantril Farm in Knowsley in 1983).

In 1988/89 Nat West was the first of the clearers to enter the market. But by early 1989, in the light of the 1988 Act, the Housing Corporation was able to report that it had made contact with some 80 lenders in the nine months to March 1989. At the end of the financial year building societies had lent £148 million (45% of market), clearing banks £26m (8%), other banks, £45m (23%), THFC £38.5m (11%), insurance companies £36m (11%) and others £1.25m. In total some £325 million had been raised and the Corporation anticipated a private finance requirement of at least £500 million of HAG funded schemes in 1991/92 and up to £800 million by 1993/94. The English stock transfer funding market was also set to grow apace from around £130 million in 1988/89 to £700 million in 1991/92 and with substantial annual fluctuations reaching nearly £2 billion in 2000/01. Scotland and Wales subsequently came on stream.

Perhaps the final evidence of a developing market was the creation of a specialist housing finance journal. *Social Housing* was set up by Tim Roberts and Sebastian Taylor in 1988. The magazine was independent and funded by subscription income and advertising. The first issue was in November 1988 with a handful of subscribers mainly among the HAs and banks. It is one proof of the market's maturation that the readership has steadily grown to nearly 2,000 subscribers and a

readership of around 6,000, reflecting the broadening of the whole social housing activity. Readers are drawn typically from RSLs, ALMOs, LAs, banks, building societies, house builders, regeneration specialists, accountants, surveyors, central government, consultants, academics, the regulator, trade bodies – in other words the full range of stakeholders.

Thus before the 1988 Act, which set out the formal framework for introducing large scale private finance both into new social housing provision and to fund the existing stock, there had been many strands of development. These included in particular funding LCHO schemes; bond issues based on rental streams both individual and syndicated across HAs; one-off demonstrations of mixed funded projects including agreement with the HC and the Treasury; and the start of LSVTs based on the 1985 Act. The scene was set for a more transparent and coherent approach which could clarify and reduce risks and therefore make private finance cost effective.

The Housing Act 1988

The Housing Act 1988 formalised the mixed funding regime for HAs with a scheme which involved six main attributes:

(i) cash limited capital grants (HAG) at an initial average of 75% of projected costs, but expected to decline to around 50%. Allocation was to be based on local housing needs indicators but with competition between associations;
(ii) development risks were to be borne by HAs;
(iii) the difference between grant and total cost was to be funded from the private finance market;
(iv) lenders were to have a first charge on HA assets, with HAG treated as a subordinated loan;
(v) rents were to be set by the HA in order to ensure that the association could at least break even; and
(vi) Housing Benefit would continue to be available to cover the rent up to market rent for low income households.

HAs thus faced real risks for the first time. They also had direct incentives towards efficiency and the more effective use of their own assets. The private finance institutions however gained comfort from the HAs' freedom to increase rents, the existence of Housing Benefit and the security of HA assets.

At the same time the 1988 Act improved the process by which existing LA stock could be transferred usually to newly-formed HAs made up of existing Housing Departments. The incentives to transfer were considerable in that there would then be freedom to invest and manage the stock and the transfer price allowed for appropriate improvement investment. On the other hand they depended in tenant agreement and usually entailed rent guarantees for some years. The transfer price was formally a simple net present value calculation but there were many complexities – not least with respect to Right to Buy receipts.

Other relevant changes in the 1988 Act related to LCHO – with much greater emphasis on developing shared ownership as an effective way of meeting aspirations and levering both debt and equity; and various initiatives mainly concentrated on new building which later used the PFI model – which were much less successful.

The new system was introduced in April 1989. For a variety of reasons the initial outcome was less positive than expected because the call on grant was more immediate than the Corporation had

anticipated leading to a shortfall and a variety of emergency measures. The associations' exposure to the risk of cost overruns – with any scheme deficit or major repairs requirement falling squarely on them – was of particular importance, especially given the volatility of the economy at that time. This drove a move towards fixed cost new build schemes on greenfield sites and away from the rehabilitation of existing urban areas. The Housing Corporation bidding and allocation process which focussed on lowest cost provision enhanced these pressures.

Lender reaction to the new private finance regime was muted and very cautious. While a number of banks and building societies dipped their toes into the water (offering mortgage like instruments for borrowing on a range of terms) most remained reluctant, partly because interest rates were rising and this was a novel funding sector (Randolph, 1993). Of course part of this the economic climate. Bank base rate moved from 9% in 1988 up to 15% in 1989 before falling away to 10% in 1991. It was hardly the best environment in which to launch a new market for private finance.

The initial pool of lenders and investors was quite small. In the first three years banks provided about half the funding. Building societies – still the major providers of mortgages – were more cautious, in part because of the lack of a proven resale market. Bond issues generated around one sixth of the funding but from a narrow range of investors. Terms and conditions were tough – the margin over LIBOR was well over 200 basis points and the deferred interest rate model suggested by government proved inappropriate.

Even so, by March 1991 in excess of £2 billion had been raised by housing associations across Great Britain. Alongside this was roughly a further £1 billion for stock transfer. The November 1992 Housing Market Package, through which the Housing Corporation was given £577 million to spend by the end of March 1993, was seen as giving a significant boost to the market, levering in an additional £328 million of private finance.

Throughout the 1990s the Housing Corporation made efforts to expand this market. It set up a Private Finance Unit in 1988 with Barbara Ainger in charge, plus Lawrence Greenberg, Janis Morton and Marion Turner. Barbara Ainger than left in 1988 to set up THFC with Lawrence Greenberg taking over as manager. Nick Waloff joined it in January 1989 and stayed with it until May 1997. Ian Blelloch was manager from April 1993 until March 1996. Mike Dudman from LTSB took over the Unit as its sole person, working under Clare Miller, in June 1997 when he was replaced by Gill Rowley.

The Unit had a mixed history struggling at times to find its purpose. However for a period it produced an annual review of private finance (first published in 1988) and held regular meetings and seminars with lenders. They expanded the number of lenders to the sector though it must be said many entrants were short term (this was especially true of a number of Japanese and German banks; see appendix 1 for a list of lenders who entered the market in England over the period 1989 to 1997). Through the 1990s the number of lenders did expand alongside the volume of lending. The market fairly quickly became dominated by key players, Nationwide BS, HBOS, Abbey, RBS, Barclays, Banque Paribas and Bradford and Bingley. There were then a number of other players, Britannia, Northern Rock, Cheshire and a number of smaller regional players eg Principality in Wales, Dunfermline in Scotland and Derbyshire in England. The Council of Mortgage Lenders set up its social housing panel in the mid 1990s to provide collective representation of this group. By 1990/91 some 37 funders had lent directly to housing associations and a further 30 were involved in syndicates.

During the 1990s there were a range of product initiatives with respect to the market including the use of credit enhancement techniques, the creation of borrowing clubs, syndication and various adjustments to key ratios and valuation techniques. It also saw the further development of the bond market with RBS, Hambros and the Royal Bank of Canada entering the market alongside THFC. As this suggests debt lenders like RBS began to take a more strategic view of lending to this sector originating debt (thus capturing the up front arrangement fees) and then selling it out to the market. With competition increasing lenders were slowly forced to reduce the margins on loans (these steadily fell from around 200 basis points when market began) and to loosen terms and conditions. Whitehead (1999) provides a summary of the market in the early to mid 1990s. This competitive drive by the debt lenders meant that bond finance by contrast was often seen as expensive and less flexible. It also increased dependence on a small number of large lenders which were particularly interested in the scale achievable through LSVTs.

Five years on in 1996, the market looked very different with over £10 billion raised for a full range of lenders with an average grant rate of 47%. Average rates were around 70 basis points above LIBOR with the strongest associations achieving around 50 basis points. AAA insurance ratings were in place and the first large-scale unsecured loans were put in place in 1997. The market was definitely maturing.

As the minutes of the annual seminar at LSE make clear, the range of concerns about the market for private finance for social housing had changed dramatically since 1989. Then there was almost complete lack of understanding of the market and a desire for more explicit government guarantees. By the mid 1990s the concerns were those arising from an effectively developing market in a mixed economy. These included:

(i) the market appeared to be treating associations as more homogenous than they actually were – this was particularly true for BME associations;
(ii) associations were becoming more complex and diversified organisations; and particularly that
(iii) the development of the market had occurred during a period of declining interest rates when government had enabled above inflation rent increases and growing surpluses. This flexibility was unlikely to be maintained as the Housing Benefit costs to government of rent rises were taking up most of the revenue from the rent rises themselves. Moreover rents in some lower demand areas were beginning to be close to market levels, raising issues with respect to the value of subsidy.

1996 and after: the relationship between finance institutions and the government

By 1996 the market was seen as mature but, in part because of that belief, it was subject to a number of pressures, most of which were generated by government. Their priorities were further to reduce public expenditure; to bring the Housing Benefit bill under control; to expand the LSVT process into lower valued areas; and to decrease per unit subsidy. Additional complexities arose from incorporating other agendas through HAs notably the mixed communities approach which increasingly used s106 to support more complex mixed tenure developments and initiatives to support BME skills in organisation and management (which resulted on some thirty BME associations with more limited asset bases but development capacity).

As importantly for the stability of the market and the lenders the demand for funds varied significantly with policy. As Murie's new history of the Housing Corporation points up, the Housing Corporation budget after 1994 declined significantly as the government strove to create

headroom to cut taxes. With cutbacks in expenditure continuing under the new Labour government in 1997 private finance for HAG funded schemes was reduced. On the other hand, the private finance requirement driven by stock transfer soared with the new government remaining a strong supporter of that route (the 2000 Green Paper for instance set out a case for transferring 200,000 homes per annum), although from 2000 much of the emphasis moved to the development of ALMOs which required no direct private financial involvement.

Changing the regulatory regime

In 1995 the Housing Corporation went through a finance, management and policy review (FMPR) as a prelude to a range of changes which were then brought in via the Housing Act 1996 – an independent ombudsman, the creation of registered social landlords (RSLs) and local housing companies. However from a private finance perspective, the run up to the passing of the Act was itself something of a watershed in the development of this market.

In the clauses in the draft bill the Government moved to protect public investment in housing associations in the event of insolvency. In setting out its proposals (in Clauses 41-48 of the Bill) the government sought to limit the rights of lenders to access their security in such a situation by suggesting the Housing Corporation could appoint a manager and to transfer assets both without prior agreement of lenders. Allen & Overy the City law firm issued a briefing note titled '*Housing Bill – Secured Lending under Threat'*. This prompted a stand off. Overnight the bond market for housing associations effectively closed with funding for associations through long term debentures and index linked issues effectively suspended until the uncertainties were removed. THFC withdrew a £45 million debenture issue for 11 associations and the prices of HA issues traded on the stock market were marked lower with margins rising by up to 15 basis points. It also threatened the planned disposal of the Housing Corporation's £1 billion loan book. In a series of emergency meetings between lenders and the government a new set of clauses were drafted which allowed government to put in place an insolvency procedure while at the same time preserving the ultimate right of lenders to access their security. Although resolved it was an early example of how government had not fully understood the implications of a private finance regime and the ways it would now have to share agendas in the future. Although less dramatically this issue has arisen on a number of occasions subsequently (eg Housing Bill 2008).

Controls on rents

A second major issue has been rent determination. The Labour government introduced a new rent regulation regime by which rent increases were limited to RPI + 1% and then to RPI + ½% p.a. This put a stop to the growth in surpluses through above cost rent increases but to date had had relatively little impact on efficiency incentives. However in the longer term rent control of this type increasingly impacts on the capacity to raise private finance unless greater efficiency can be achieved to offset real cost increases (Smart, 2008).

The rent restructuring regime introduced in 2003 to generate greater consistency between individual property rents also put pressure on HAs that were potential revenue losers to merge with others in areas where rent increases could be maintained.

Housing Benefit

The other fundamental element in stabilising the rental stream has been the availability of Housing Benefit. There have been a number of 'scares' from the point of view of private finance – indeed each time the system changes there is concern about the extent and certainty of the HB stream. Since 1997 these have included:

(i) uncertainty about whether the full rent would always be covered in the social sector as rents rose towards market levels at the same time as limitations were placed on the extent to which private rents were covered;
(ii) concerns about the government initiative to require all HB to be provided directly to tenants; and
(iii) uncertainty about whether the introduction of the Local Housing Allowance which provides only for area based rents would be applied to the social rented sector.

The changing structure of the HA sector

A continuing theme has been the organisation of housing associations themselves, regarding chief executive and board payments, governance, efficiency and effectiveness, mergers and group structures. Over the last decade or more with the growing commercialisation of the sector there have been evident tensions around these issues with lenders raising questions about the quality of internal controls and external regulation via the Housing Corporation (and its equivalents elsewhere in the UK).

More generally, changes in the subsidy and finance regime have also generated very large changes in the organisational and governance structures. In particular only a proportion of HAs were in a position to borrow and develop (and indeed only a proportion wished to do so). Moreover the HC's objectives were better met by limiting the numbers of developing associations. At its height perhaps 300 associations were involved. However mergers and particularly the growth of group structures, involving mixed funded HAs; management only HAs; shared ownership subsidiaries and latterly LSVTs have concentrated ownership and development very considerably. Indeed by 2008 very few HAs operated outside the fewer than 80 group structures that now exist. There has thus been enormous concentration but also diversification compared to a decade before. These changes have been fundamental to the organisation and the risk base of the sector – and therefore to the terms and conditions in which private finance is available.

The effectiveness of the regulatory regime

Perhaps the most important issue has been the changing nature of regulation. Initially most commentators, technically incorrectly, saw the HC as a guarantor not just as providing comfort through their regulatory role. However since 1988 the ways in which problems have been addressed have changed out of all recognition.

Core to the discussion on the appropriate form of regulation has been the issue of co-location. The importance of the co-location of regulation and investment powers within the Housing Corporation as a powerful control was much emphasised even though theory was against it. Within a decade it was to be abandoned (at the very moment when the case for a co-location was strongest. The parallels between the changes in the regulation of the housing association sector and the banking sector are striking).

In 2000 the Housing Corporation went through another FMPR review reflecting a growing question as to whether it had now outlasted its usefulness. Although reprieved, the Housing Corporation subsequently lost its inspection role to the Audit Commission (and in doing so it also indicated a willingness to give up co-location) even though throughout lenders continued to stress the importance of co-location.

From 2001 there was a gradual shift in the Housing Corporation towards risk based regulation and a 'lighter touch'. Lenders did not disagree with this but cautioned that strong controls needed to remain in place. These were just put to the test when the West Hampstead HA became technically insolvent in 2001. With some 2,500 short life tenancies there were real risks its closure could cause major problems. Funders were alarmed but the situation was saved by the Housing Corporation providing, with government agreement, an overdraft guarantee. This allowed lenders to avoid triggering possession action and it showed that in extremis the Housing Corporation would step in to avoid an insolvency. Lenders drew considerable comfort from the rapid action taken by the Corporation.

In December 2005 the Housing Corporation (HC) noted that it had, over a prolonged period, been acting beyond its powers by delegating section 9 and other consents given under the Housing Act 1996. This called into question the validity of a range of land related transactions by associations including crucially the giving of security to lenders in respect of loans. The legal uncertainty this created for lenders needed to be addressed quickly and after complex legal negotiations the Housing Corporation (Delegation) etc Act 2006 completed its passage through Parliament and received Royal Assent on 19 July 2006. This gave the HC the power to delegate its functions "to any of its members, committee, sub-committees or employees" and retrospectively validated action already taken. The Act did not deal with the problem faced by lenders of not being able to rely on the Housing Corporation (HC) seal as sufficient evidence that the HC has carried out its own processes correctly. Lenders continued to have to make their own inquiries. The intention is that these residual problems will be sorted out once the Tenant Services Authority has assumed all the powers that derive from the Housing and Regeneration Act 2008.

As this saga was drawing to a close, lenders were confronted by the collapse of Ujima HA in late 2007. Ujima had been a high profile black association in London that had secured very significant levels of Housing Corporation funding. In 2006/07 it failed to deliver on its development programme and the Housing Corporation removed its partnership status. Subsequent reviews indicated major internal problems not least with governance. Moreover once statutory appointees were in place it became clear there were serious financial problems. A potential merger with London and Quadrant was rejected by shareholders. Ujima was unable to trade and it thus triggered the default on loans and the Housing Corporation's 28 day moratorium cut in. Put in place in the 1996 Act this had never been used before. Although the transfer finally took place to L&Q (on day 27) it revealed the complexity of the process and raised questions about powers and procedures. These issues were taken up in the 2008 Act.

Finally during this period we also had the challenging issue of Basel 2 and how association lending might be classified in the new structure given that it was underpinned by government grant. Under Basel 1 associations were given a 50% weighting. This was reduced to 35% on the standardised approach in Basel 2 with lenders on the advanced approach calculating a much lower weight (15-20%). In theory this should have helped associations. However the current environment of dramatically reduced funding, together with falling capital values, means this is yet to be put to the test.

The new world

The decision to transpose the Housing Corporation into the separate organisations the Homes and Communities Agency as investor and the Tenant Services Authority as regulator followed the Hills and Cave reports into the social housing sector in England and the Barker Review of housing supply. The 2007 Housing Green Paper pointed to the importance now being given to housing by

government and its desire to secure a step change in housing supply and affordability. In this context bringing together English Partnerships and the Housing Corporation and creating a new 'super' investment agency was seen as making very good sense.

As the Bill evolved it became evident that in the changed environment lenders were ambivalent about the retention of co-location and they finally settled on a view that the functions could be separated. The question then was who might be the appropriate provider of the regulatory function that in essence stood between lenders and borrowers. Lenders estimated that regulation reduced loan costs by around 1% although the basis for this calculation is highly questionable. The Audit Commission made a bid to become the new regulator but in the end the decision was made in favour of a new independent regulator, the TSA. Lenders backed the latter and this was key in the subsequent Ministerial decision.

The passage of the Bill was problematic, not least around the question of whether the powers being given to the HCA and the TSA would result in a re-classification of associations as public rather than private sector. This would then have removed the basis on which private finance had been introduced.

Both the HCA and the TSA came into being in December 2008. Lenders through the CML's Social Housing Panel have been active in seeking to set up information sharing protocols and working procedures. Both the HCA and the TSA have a private finance function and both are active in gathering data and views. There is some danger of duplication and confusion despite the existence of a protocol between the two bodies. There are many important issues to resolve but the reality is the agenda has moved forward in a different direction because of the financial crisis.

There has been an almost complete transformation in the regulatory structures around housing associations in the UK over the last two years and this system is yet to be tested. Alongside England Scotland scrapped the previous arrangements (Communities Scotland) and now has a Scottish Housing Regulator and the investment function sits inside the Scottish Government. Wales is in the midst of reform on the back of the Essex Review though both functions remain inside WAG with the Wales Audit Office providing an inspection service. Northern Ireland is also contemplating change on the back of the Semple (2007) and Varney (2008) reviews but for the present DSD provides both the investment and regulation functions. What this indicates in 3 out of 4 countries in the UK government has either retained or taken back considerable control over housing associations.

Thus the sector faces the new world of credit restrictions and recession with new regulatory frameworks both with respect to funding through risk based regulation affecting potential credit availability and with respect to the sector itself. This has generated an additional layer of uncertainty in an anyway massively uncertain world.

The Credit Crunch

By the end of 2007 we had seen quite significant reductions in the funding market. Long established players had begun to be less active in the market – notably Nationwide, HBOS and RBS – all reflecting the low margins being achieved plus the added concerns posed by Ujima.

The situation changed rapidly on the back of the credit crunch not least because of the sharp spike in LIBOR rates. Early on the impact was limited, with major lenders such as Barclays, Lloyds TSB

and Dexia continuing to be active in the market. There were fewer players but generally funding could be secured at competitive prices.

In 2008 this picture changed in a number of ways: all lenders became less willing to provide funds; the focus shifted to existing customers and to meeting funding requests only partially and over shorter periods. Terms and margins moved dramatically with lenders rates going up by as much as 200 basis points. This reflected the fact that the existing £40 billion loan book was proving increasingly unprofitable with funds being lent at well below cost and for long periods with generous terms. Lenders were looking to re-price and restructure their loan books.

The increasing margins encouraged some of the less active lenders to return to the market but this has not lowered prices because overall there is still a 'shortage' of funds. In reality lenders already have large existing commitments through undrawn funds. They are also facing internal constraints in the volume of new funds they might offer not least while their back books remain so unprofitable. Although housing associations remain a relatively safe market in terms of likely default with the overall contraction in funds, lenders can find other more profitable and probably only marginally more risky markets in which to lend.

This situation has meant that lenders have been keen to re-price their existing lending whenever there is a change in the circumstances in their borrowers. This has immediately impacted upon mergers where lenders have been willing under the terms of their loan agreements to sanction mergers but only on the basis of increased funding costs. This has put an immediate and explicit cost on merger activity. Given associations have often only been able to put up weakly articulated arguments for mergers in terms of value for money this new cost has weighed heavily in the decision.

The increased cost of debt finance has opened up the way for bond finance, which in recent years has been unable to compete with debt finance pricing, to re-emerge. A small number of bonds deals have come to market though again the volatility in investor appetite as a consequence of the credit crunch has made this a far from certain route. Private placements are now being considered and a number of life and pension companies are expressing an interest in entering the association market given the much improved returns now possible with continuing low risks. Equally, the HCA and others are seeing bonds as a potential way of levering their funding.

The credit crunch is impacting on associations in other ways, not least through the reduced profits being earned on low cost home ownership and other property sales, many of which were based around Section 106 agreements. A significant number of the larger associations have relied quite heavily on sales to generate profits which can then be used to cross-subsidise rental development (allowing them to bid at lower grant rates). Low sales rates and problems in particular locations have generated immediate pressures. However the major concern must be in relation to the much reduced capacity to cross subsidise and indeed to ensure development of mixed schemes where there are large S106 contributions. In recent months both the cross subsidy and theS106 models have been described as 'broken'. It is perhaps better to see them as 'damaged' and in need of 'repair'. One response has been for the HCA and the governments in the other UK countries to increase grant rates selectively to deal with some of the shortfalls generated. Another has been to rule out LCHO development – an issue which government will need to address.

Lenders will have to work with issues of unsold LCHO stock and particularly with the reduced development programme going forward. Many associations have cut back on their development

plans over the next two to three years. This will impact upon the demand for finance as will higher grant rates.

The weakening of association balance sheets has been further exacerbated by the sudden rush of calls for extra collateral by the providers of what are called 'stand alone swaps'. Most association borrowing is on variable date terms but banks have offered to fix that funding to help associations create a more stable planning framework and one which fits better the framework they operate in. Normally these are 'embedded' swaps offered by the loan provider. However it has also been possible to go elsewhere and deal directly with a swap counterparty in the market. In December the swap market underwent a dramatic and unexpected change with the upshot that providers of long term fixed rate stand alone swaps called upon associations to provide additional collateral. The associations must then either put up property or cash to cover the requirement. In many respects this was an insignificant event but it pointed to the ways associations are now part of a much more complex world.

Given the much less favourable operating environment for associations, we can expect to see more impairments as associations write down the value of assets. There will be more losses as well as more asset sales as associations seek to cover those losses. Impairments can trigger a loan covenant default which in theory could allow the lender to request full repayment of the loan. In addition one recent survey pointed to the fact that there were now 13 out of the top 24 associations where the payments of interest due were greater than the operating surplus requiring sales to make up the difference (although this survey perhaps overstated the degree of the problem).

What all this suggests is that the risk profile of the association sector is worsening, even though as a generality it remains very sound. Given the febrile state of the banking sector it is therefore no surprise to see lenders being more cautious. With a much reduced range of lenders in this market (although Yorkshire Building Society has recently entered) it is hard to see conditions improving markedly in the short to medium term. There is a real possibility this will hold back the HCA's plan to expand the programme (at least without sharp increases in grant rates). The risk/reward ratio has to be re-balanced.

Into the next decade: present imperfect, future tense?

Clearly where we are now is very different than the picture of almost continuous growth over the last two decades. In many ways it could be argued that the current position resembles 1988 all too closely. There are:

- low levels of activity; rising grant rates;
- very limited capacity for leverage; few financial organisations with a full understanding of the sector's capacity and an appetite for lending;
- a growing interest in the potential for bonds as a means of funding rather than debt;
- discussion of the potential for equity investment;
- a government that will need to cut back heavily on public expenditure once there are green shoots; and interest rates back to 200 bp above LIBOR.

Even so the period from 1988 has been in many ways a success story. In particular private finance has raised for both development and stock transfer in the UK over the period 1988 to 2008 of around £50 billion – of which around £30 billion has been for mixed-funded housing associations and £20 billion for stock transfer. This has been achieved using traditional debt financing from a range of lenders across the world. Moreover, lenders have experienced minimal losses and there has been only one insolvency.

Although there have been a number of 'incidents' over the years the market has seen almost continuous growth. Lenders have had to work hard on occasions to defend their interests and government has taken a long while fully to work with the reality of having a strong private sector partner.

Unrelated to the credit crunch there are important continuing areas of uncertainty. The number of lenders active in the sector has declined since its peak and activity is now concentrated around fewer than 10 lenders (with a strong regional lender in both Scotland and Wales). Moreover, market conditions work against major new entrants and product innovation. Equity investment in associations has been rejected by government as a way forward although more are setting up joint ventures with the private sector. Secondly, there are immensely important issues around the change in both the investment and regulatory frameworks which can only be resolved through experience. Further the issue of the definition of public or private remains live, not least because of EU interests in this area.

The credit crunch has significantly affected the situation at least in the short term. Lenders are now acting on a much more unilateral basis and with less concern for customers. The shortage of funds has changed the dynamics of the market place. Equally, associations are in a more vulnerable position than they were previously given the falls in property prices and sales. Overall the risks are higher and the demand for funding less predictable.

This might suggest the association sector will look to reduce its ambitions over the next few years and concentrate more heavily on the provision of social rental homes assisted by higher grant rates. This would help rebuild balance sheet strength and confidence. Lenders likewise are likely to remain cautious but are likely to retain an interest in this market albeit at a lower level.

The difficulty with this scenario is that the government has targets to meet and other objectives to fulfil. In this context they are looking to HAs to play more than their share in supporting the development industry; getting local housing companies and other partnership initiatives off the ground; enabling longer term investment via the HCA; maintaining the potential for households to transfer to owner-occupation and for local authority housing to transfer fully to independent landlords. These objectives will put additional strain on a system which has been badly shaken by the events of the last two years.

Private finance for social housing has been a successful initiative. The market has shown a degree of volatility arising from both policy and market conditions and we are currently undoubtedly in a contraction phase. This is exacerbated by a number of outstanding concerns regarding the future strength of the association sector and its regulatory and financial environment which will undoubtedly condition lender appetite. The next few years should be more exciting than the last – and the need for an annul seminar may well have re-emerged!