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Housing Association Rents and Affordability

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Summary

The Government published its proposals for the reform of housing association finance in September 1987 ["Finance for Housing Associations: The Government's Proposals"].

The housing association movement expressed concern over the implications of the proposals for rent levels and attempted unsuccessfully to get a right to a non market affordable rent inserted in the Bill.

The 1988 Housing Act implemented the Government's proposals. Rents on new lettings were deregulated after 15 January 1989 and the "mixed" private and public sector funding regime came into operation on 1 April 1989. Average grant rates for new developments in 1989/90 stood at 75 per cent of the construction costs.

In 1988 the National Federation of Housing Associations (NFHA) established its Continuous Recording (CORE) monitoring system to measure the rents set on new lettings and the incomes of tenants moving into these properties. From data collected between January 1989 and June 1991 the NFHA concluded that the affordability of association rents had deteriorated since the 1988 Act had come into force ["Housing Associations After the Act", 1992].

Using CORE data from October 1990 to September 1991 the Housing Corporation's analysis of rent levels concluded that "there was no generic affordability problem" ["The Affordability of Housing Association Rents", October 1992].

In November 1992 the Department of Environment's public expenditure announcement set out the Government's objective of reducing grant rates to 60 per cent in 1994-95 and 55 per cent in 1995-96. In response, the NFHA launched a National Affordability Campaign on 10 March 1993 in order to present its case for maintaining average grant rates at at least their current level, ie 67 per cent.

It is the aim of this paper to set out the reasons behind the development of the current "affordability debate" and to look at evidence of affordability trends arising from recent research.

Introduction

A central theme of Government housing policy since the late 1980s has been the development of housing associations, as opposed to local authorities, as the main providers of new social rented housing. The 1988 Housing Act introduced a new financial regime for associations under which schemes are financed by a mixture of public and private sector investment and the tenancies thereby created are free from rent controls. The stated aim of this regime is to increase the number of homes developed for any given level of public expenditure and to create incentives for associations to deliver housing and services in the most cost effective manner.

The Government's proposals for the reform of housing association finance were first detailed in the White Paper "Finance for Housing Associations: The Government's Proposals" (September 1987). The housing association movement responded to this Paper by welcoming the opportunities offered for increased development, but expressed serious doubts over the potential impact of the regime on the ability of associations to continue to provide good quality housing for its traditional client groups at a price they could reasonably afford:

> The Federation's most pressing concern in securing amendments to the policy framework for the future growth of housing associations, is to ensure that the growth of the Housing Association Movement does not happen at the expense of housing those who are currently waiting for association homes. We want to be sure that housing associations will not have to start turning away those homeless families, pensioners and others who cannot afford to pay much higher rents but who are not so poor that their rents are paid entirely for them.

[Source: National Federation of Housing Associations "Rents, risks, rights: NFHA response to the Government's proposals", 1987]

On the issue of rent levels the White Paper stated: "In general, the Government would expect associations to be able to set their rents for newly provided dwellings significantly below the free market level" [para 14] and, "the grant (ie housing association grant) must also be sufficient to ensure that rents on these schemes are within the means of the normal range of those tenants who are in employment and not reliant on benefits to assist with their housing costs" [para 7].

However, the Government rejected efforts by the National Federation of Housing Associations (NFHA) to have a definition of affordability inserted into the Bill along with the suggestion that assured tenants should be given a right to an affordable rent. Current guidance on assured tenancy rent levels is set out in the Housing Corporation's Tenants' Guarantee, which suggests that rents should be below market rents for assured tenancies in the private sector and set and maintained within the reach of people in low paid employment. All housing association tenancies created after 15 January 1989 are assured tenancies and are subject to a market rent.

The NFHA and Housing Corporation have closely monitored the impact of the 1988 Act on rent levels and other areas of association activity since its implementation. However, their research findings have not always agreed over trends in the affordability rate, ie the percentage of income which tenants spend on their rent. The debate on affordability has most recently been brought to the fore as a result of the Department of the Environment's public expenditure announcement, following the Autumn Statement, in which the Government set out its objective of reducing the housing association grant (HAG) rate from an average of 71 per cent of the cost of each home in 1992-93 to 55 per cent by 1995-96.

The Government has since repeatedly stated that no final decision on grant rates for 1995-96 has been taken, but has also clearly signalled its intention to increase the proportion of private finance put into new schemes in future by reducing grant rates to 60 per cent in 1994-95 [HC Deb 1.4.93 c 712]. The housing association movement has responded to this by launching a National Affordability Campaign as it believes that further reductions in grant rates will effectively price associations out of social housing provision.

Capital Funding Prior to 1989-90

The 1974 Housing Act introduced residual housing association grant (HAG) which was a single capital grant payable on the completion of a project once the final out turn costs were known The rents on these developments were "fair rents" set by an independent Rent Officer. The income from each project was determined by calculating annual rental income net of service charges, less an allowance for voids and bad debt, and net of management and maintenance allowances. An annuity factor was then applied to the net rental income to calculate the loan it would service at a fixed interest rate over a period of 60 years for new build, and 30 years for rehabilitation. This was known as the residual loan. The amount of HAG paid was the difference between the qualifying capital costs and the residual capitalised loan.

Under this system HAG payments averaged over 85 per cent per scheme. Scheme costs were controlled through a system of cost limits. Total Indicative Costs (TICs) represented average land and building costs for particular types of development and varied across the country. TICs acted as a guide for comparing scheme costs, payments above the TIC level were only approved after considerable scrutiny and negotiation with the funding agency involved.

This system imposed minimal risks on associations over and above those normally associated with the development process. Indeed, as Helen Cope points out in "Housing Associations: Policy and practice" (1990), the cushioning of associations from risk in order to promote their success and expansion was a central objective of the capital funding system when introduced in 1974.

Critics of the residual HAG regime argued that the lack of risk involved gave no incentive to associations to pursue value for money objectives. The fact that most cost overruns on projects would be met by HAG, combined with the existence of revenue deficit subsidies, left associations open to the charge that they were unduly protected from the need to exercise proper financial control over their activities. In their defence, associations argued that the generous subsidy system was justified by the need to produce housing at rent levels within the reach of their traditional client groups and that the Housing Corporation, through the TIC system , ensured that resources were not squandered. Associations also argued that HAG was really determined by rental income and management and maintenance allowances, both of which were fixed independently by rent officers and the DOE respectively, leaving associations with only limited control over the level of HAG required.

In 1987 the DOE published its consultation paper "Finance for Housing Associations: The Government's Proposals" which set out the following principal objectives:

- To increase the volume of housing that could be provided for a given amount of public money by mixing public and private finance;

- To increase value for money in the funding of housing association development by requiring associations to take on a greater proportion of the development risks;

- To target grant accurately whilst still taking into account scheme costs and ensuring that rents are kept within the means of tenants in low paid employment;

- To simplify the procedures and administrative requirements of the funding system.

The 1988 Housing Act introduced the new financial regime for associations which set out to achieve the above objectives.

Capital Funding Post 1989/90

The 1988 Act ended residual HAG and introduced a system of predetermined grant rates fixed at the outset of a scheme rather than at completion. This effectively fixed the amount of public capital subsidy that associations could receive. Scheme cost overruns and any scheme deficits must now be met from rents or reserves and not, as previously occurred, from public grants. These changes placed associations in a more commercial environment by making them responsible for the risks of development.

The Act also introduced "mixed funding" under which a proportion of scheme costs must be met by private finance. Initially this percentage was set at an average of 25 per cent nationally, the remainder being made up by 75 per cent HAG. Movements in the average HAG rate since the introduction of the new regime are set out below:

Year	**Average HAG rate (%)**
1989/90	75
1990/91	75
1991/92	73
1992/93	71
1993/94	67
1994/95	60 (objective)

In order to enable associations to attract private investment and bear the risk of future cost overruns the Act abolished the regulation of rents on new lettings after 15 January 1989. Since this date new association tenancies have been let on an assured basis and the rents on these tenancies are set by landlords free from external interference in the form of rent officer decisions.

In addition, the Act ended public underwriting of future major repairs funding by abolishing major repair grants on new developments and making associations responsible for funding these repairs from rent. In so doing it has been argued that this has created further upward pressure on rent levels.

The affordability debate and the 1988 Housing Act

The affordability of rents which the new financial regime was likely to produce became a crucial issue in discussions between the NFHA, Housing Corporation and the DOE prior to the Act's introduction. In brief, the housing association movement expressed concern over four features of the new regime which it believed would result in rent increases:

- the reduction in average grant rates and the need to raise a higher proportion of finance from private sources;

- the need to make provision for major repairs;

- the need to cover any cost overruns or unforeseen costs;

- the likely need to mix a variety of low start and conventional loans in order to spread risks, with the result that cost rents would be higher than those produced by the Corporation's grant model which assumed all private funding to be on a deferred interest basis.

NFHA research undertaken during the review of the old regime suggested that rents could only be maintained at an affordable level for housing association tenants with grant levels in the region of 85 per cent. In 1988 the NFHA determined that a definition of affordability should be 20 per cent of the median net income of new tenant households in work, this figure was used as it compared reasonably with interest payments by first time buyers.

The movement lobbied unsuccessfully for the Bill to replace fair rents with a right to a non market affordable rent:

> The Federation believes there are firm reasons why the abolition of the current right to fair rents should be replaced by a new right to non-market, affordable rent levels. These rents would establish a ceiling which housing associations could charge for new lettings and for re-lets. Such ceilings would relate to the known incomes of those likely to occupy the properties. We already have detailed information about incoming association tenants (and, indeed, hope to undertake another Tenant Census in early 1988 to ensure the results of our 1985 Survey are still valid).

[NFHA "Rents, risks and rights", 1987]

Throughout negotiations on the Bill, and until very recently, the Government refused to provide a definition of an affordable rent level as it did not wish to imply a view as to what constitutes an affordable rent in any particular case:

Housing Associations (Grants)

Mr. Battle: To ask the Secretary of State for the Environment, if he will publish the affordability assumption used to determine grant rates to housing associations.

Sir George Young: Outturn rents are determined by housing associations. The Government do not publish the factors and assumptions implicit in the grant rate model or any general definition of affordability, since they do not wish to imply a view as to what constitutes an affordable rent in any particular case.

[HC Deb 22.2.93, c 421W]

While the Government made it clear during consultation over the Bill that rent levels were to be kept "within the reach of those in low paid employment" [William Waldegrave, speech in Warrington, 8.6.88], housing commentators were concerned that, in the absence of an accepted definition of affordability, tenants would find themselves unprotected from future financial pressures.

The Act was passed with the debate over its impact on rent levels unresolved. Since the new regime's introduction the Housing Corporation, DOE and NFHA have monitored rent levels produced under the system, their findings are discussed in the section below.

Evidence on affordability trends

The NFHA's evidence on affordability is drawn from its Continuous Recording monitoring system (CORE) which was established in 1988 and which records, inter alia, rents set by associations and the incomes of tenants moving into new lettings. Information on affordability trends between January 1989 and June 1991 is presented in the NFHA's Research Report 16, "Housing Associations after the Act" (1992).

The NFHA's main approach to affordability has been to concentrate on the rents and incomes of new tenant households with at least one person in work on the basis that it is these people who have been most affected by the move to assured tenancies and mixed funding. An analysis of the affordability rate for new tenants found a steady increase in the rate over the study period, ie from the first quarter of 1989 to the second quarter of 1991 the rate rose from 24 to 28.9 per cent. The affordability rate is defined by the NFHA as a "measure of the proportion of available income (net income plus any estimated housing benefit entitlement) paid in gross rent (rent plus any service charge eligible for housing benefit)". The average affordability rate for all lettings over the same period rose from 21.9 to 25 per cent. Having updated its previous definition of affordability the NFHA's current position is that housing association tenants on average should spend no more than 22 per cent of their net income, including any housing benefit to which they may be entitled, on rent.

The NFHA study also measured affordability using the CORE returns over this period by assessing the residual income of new tenants, ie "the amount of available household income left after gross rent and an allowance for basic living expenses are deducted". Using this measure the NFHA found that average residual incomes for all lettings fell from £51 in the third quarter of 1989 to £35 by the second quarter of 1991. For tenants moving into new lets, average residual income fell more steeply from £52 to £31, a decline of over 40 per cent.

These findings led the NFHA to reach the following conclusions:

The rent increases experienced since 1989 have resulted in a deterioration in affordability of housing association lettings. Higher proportions of net income are being spent on rent and charges and there has been a clear decrease in the amount of income left to tenants once they have paid their rent and an allowance has been made for basic living costs. Moreover, the trend has been most pronounced for tenants moving into newly developed units, and particularly since the end of 1989.

Analysis of trends by household type confirmed that the worsening affordability situation was common to a greater or lesser extent across the sector. At the regional level, there was evidence that overall affordability rates in London, the East and the South East had increased faster than in most other regions. At the same time, London, South East and Eastern regions appear to have suffered some of the largest losses in residual income since the middle of 1989. The West Midlands also showed both a significant reduction in affordability and a decline in residual incomes. On the other hand, Merseyside has seen affordability rates stay relatively stable and residual incomes increase slightly, albeit from a low base.

The new rent regime has been associated with a rapid rise in the level of housing benefit dependency amongst new housing association tenants and a deepening of the benefits trap. Almost half of working tenants moving into new homes coming into management qualify for housing benefit. The overall average housing benefit paid to tenants moving into new homes more than doubled. Despite this, the reduction in residual incomes shows that housing benefit has only partly protected new tenants from higher rents.

The net result is that there has been a sharp shift of the subsidy balance within the housing association sector towards individual housing subsidies and away from capital subsidies.

[NFHA "Housing Associations After the Act", 1992]

The most recent NFHA analysis of affordability trends is contained in its CORE Quarterly Bulletin for the fourth quarter of 1992. Analysis of the CORE returns for this quarter found that the average national affordability rate (based on households with at least one person in work) rose to 27.5 per cent while the rate for assured new lets reached 29.5 per cent. The Bulletin also reports that affordability rates of over 30 per cent were recorded for new assured lets in London, the South East, the North West and the West.

In contrast, the Housing Corporation published its findings on rent movements in "The Affordability of Housing Association Rents" (October 1992) which concluded that "in the period October 1990 to September 1991 there was no generic affordability problem".

The Corporation's research is based on CORE rent returns for lettings made between October 1990 to September 1991, rent-to-income ratios were calculated for three household types: couples with one child under 11, couples with three children; and single persons aged 25 to 29. A summary of the Corporation's general findings on affordability is reproduced below:

> At average national rents for the size of house suitable for their needs, different household types spend different proportions of their net income on rent. Affordability ratios are highest for single people (24% paying over 30% of their income on these rents)and much lower for families with children. For those with one child, 16% pay over 25% of their income on these rents. For those with three children, none pay over 25% at these rents. Affordability patterns vary regionally. For households with children districts in London and the Home Counties show higher affordability ratios than in the north.
>
> The affordability ratio relationship between household types analysed is primarily a function of their income thresholds within the Housing Benefit system.

The report makes no reference to what, in the Corporation's view, constitutes an affordable rent-to-income ratio.

The NFHA welcomed the publication of the Corporation's research as its first detailed public statement on the subject, however, it is critical of several aspects of the Corporation's methodology.

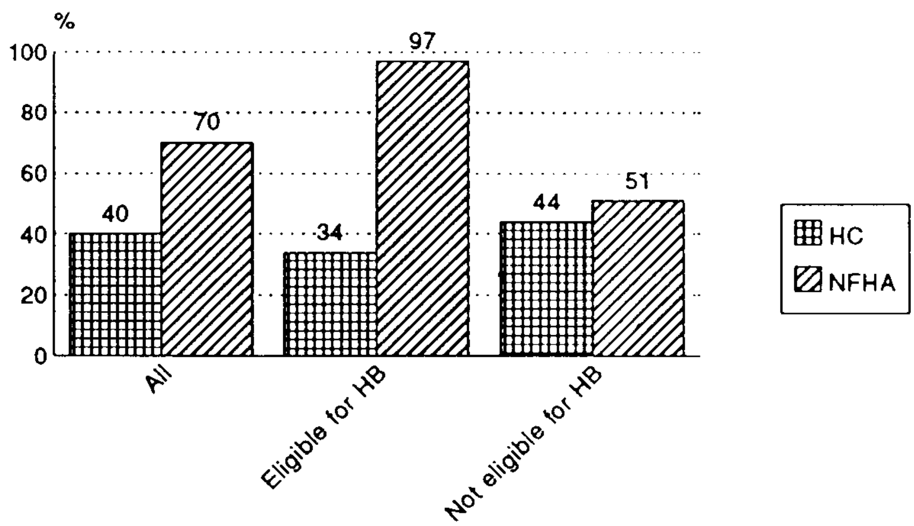
Firstly, the NFHA is critical of the Corporation's treatment of housing benefit. The NFHA uses a "gross rent" approach to measuring affordability by adding housing benefit entitlement to income and dividing this into the rent plus service charges eligible for housing benefit, whereas the Corporation's "net income"approach involves subtracting benefit from net rent and dividing the result by the household's net income. By deducting housing benefit from net rent the NFHA feels that the Corporation is effectively treating it as a direct rent subsidy, rather than as additional income in the form of a rent allowance paid to the tenant(s). The NFHA is also concerned that the Corporation's calculations do not incorporate service charges eligible for housing benefits as it believes that this can have a significant impact on affordability ratios:

> "In calculating rent-to-income ratios, it (the Corporation) only uses average net rents, whereas the NFHA includes service charges eligible for housing benefit. Tenants cannot avoid service charges; from the point of view, they are just part of the rent, and it seems appropriate to make those charges eligible for housing benefit since they are accepted by the government as being part of housing costs".

[Source: Voluntary Housing May 1993 "Affordability: the debate"]

The NFHA's CORE Quarterly Bulletin No 13 April 1993, contains a comparison of the affordability rates produced using its own and the Corporation's methods of calculation. The table, which is reproduced below, shows a comparison of the two methods when applied on a case-by-case basis to the population of working households using CORE data from the fourth quarter of 1992. Households with three or more children, three or more adults and those headed by students have been omitted:

Figure 1: Working households paying more than 22% of income in rent
A comparison of the Housing Corporation's and the NFHA's methods



[Source: NFHA CORE Quarterly Bulletin No 13, April 1993]

The table shows the percentage of cases where the affordability measures exceed the NFHA's affordability benchmark of 22 per cent. NFHA's approach produces a higher proportion of households who pay in excess of 22 per cent of their income on rent than the Corporation's approach. When the analysis is limited to households eligible for housing benefit (42 per cent of all working households) the difference in the results, according to the NFHA, reflects the differing treatment of housing benefit. For households ineligible for benefit the difference reflects only the inclusion or exclusion of service charges from the equation.

The NFHA is also critical of the Corporation's decision to concentrate on the rent and incomes of only three types of household as it believes that single parent families, single adults under 25 and pensioners often face more severe affordability problems. The NFHA has commented "It is difficult to see how the Corporation can conclude that there is `no generic problem' when it has failed to look at all the types of households seriously affected" [Voluntary Housing May 1993 "Affordability: The debate"].

In response to a recent written PQ tabled by Nick Raynsford MP, the Under Secretary of State for the Environment set out the annual increases in average assured tenancy rents for new lettings from 1990-1992:

Average rents: assured tenancy new lettings
England

Year	*Annual increase Per cent.*
1990	+18
1991	+17
1992	+15

Source:
National Federation of Housing Associations CORE data base.

[HC Deb 27.5.93 c 703W]

This compares with increases in the retail price index over the same period of 9%, 6% and 4% and with increases in registered association rents of 12%, 9% and 11% [HC Deb 21.5.93 c 360-1W].

The current affordability debate

The housing association movement regards affordability amongst new tenants as the litmus test for the new funding regime. Research carried out, as illustrated above, had already led the NFHA to conclude that rent increases experienced since 1989 had resulted in a deterioration in the affordability of housing association lettings. Hence last November, when the Government announced its objective of cutting average grant rates to 60 per cent in 1994-95 and 55 per cent in 1995-96, this was greeted with considerable alarm by the housing association movement.

In response the NFHA commissioned City Analysts, UBS Phillips and Drew, to carry out an independent economic appraisal of the elements of the HAG structure. The main findings of this study ["Housing Association Grant Rate Study" March 1993] are summarised below:

- long term interest rates will not decline in the period ahead. HAG calculation is based upon long term rates and not the now significantly lower short term rates

- housing association margins on borrowing may well be too low and only the financially most strong can obtain these

- land and construction costs will remain relatively flat for the first 2 years of the next 3 year period before rising in real terms in 1995/96

- earnings and consumer prices will rise only modestly in real terms: housing association tenants in work earn less than two thirds of national average earnings and their rate of earnings growth appears to be slower than that of average earnings.

[Source: NFHA "The affordable housing campaign: The next steps" 1993]

Using the results of the UBS research and its own rents and grant model the NFHA is predicting that a reduction in average HAG to 55 per cent by 1995 will seriously erode the ability of associations to deliver affordable social housing. The NFHA argues that the effects of a substantially reduced grant rate would be; worsened affordability problems; housing benefit dependency and a re-enforcement of the poverty and unemployment traps. In addition, there is concern over the effect which revenue streams becoming increasingly dependent on housing benefit will have on the attractiveness of associations to private investors. This has become particularly relevant of late given speculation surrounding the future of housing benefit in the light of the Government's aim to cut public expenditure. The NFHA's conclusions on the affordability problem which would result if the Government implemented its grant rate objectives are summarised below:

- increase in 'headline' rents if 55% grant rates emerge: they will go up by over 70% in the next four years

- Housing Benefit dependency will grow: over 85% of housing association tenants will be on full or partial Housing Benefit. For family groups the proportion will be well over 90%. The unemployment trap will deepen substantially. That is especially worrying when housing associations are increasingly housing potentially economically active households

- the more Housing Benefit dependent the revenue stream is the more likely are private lenders to worry about its 'quality' and in particular the political risk of future reductions in Housing Benefit entitlement. Given that lenders cannot 'attach' income streams in the way in which they can take security, it seems to us entirely logical that there will be increased security requirements on associations. This will inhibit the opportunity of associations to contribute to volume development.

[Source: NFHA "The Affordability Housing Campaign: The Next Step" 1993]

During a debate on the affordability of housing earlier this year Tony Baldry, on behalf of the Government, emphasised that no final decision on the grant rate level for 1995-96 had been made [HC Deb 1.4.93 c 712]. The Government has justified the reduction in grant rates to 67 per cent in the current financial year on the basis of falling interest rates and construction costs and has rejected the NFHA's proposition that average association rents are already too high:

21. **Mr Barron**: To ask the Secretary of State for the Environment what assessment he has made as to the likely effect on the building of houses by housing associations of the reduction of housing association grants.

Sir George Young: Increasing the private finance input into housing association schemes enables us to produce significantly greater numbers of new homes with the available public resources. The reduction in the average housing association grant rate for rented schemes from 72 per cent. in 1992-93 to 67 per cent. in 1993-94 was achieved through lower costs without any significant impact on the affordability of rents implied. Associations put forward more than four and a half times the number of schemes that could be supported by the resources available for next year. This clearly demonstrates their confidence in being able successfully to undertake schemes at the grant rates available, and to achieve the higher output that we have sought.

[HC Deb 24.3.93 c 625W]

Sir George Young: I cannot agree that average housing association rents are too high. The average rent is about £40 a week. In my view, that is a reasonable figure. I am aware of the sensitivity of the housing associations about this matter. The subject engaged the attention of the Environment Select Committee for some time when I appeared before it last week, and I await its report with interest. But the hon. Gentleman must accept that by reducing the rate of grants from 72 per cent. last year to 67 per cent. this year, we have achieved an extra 3,300 homes for those in need without any increase in the implied rent, because of the fall in interest rates and in land values. One has to strike a balance between rent levels and the output of new homes, and I think that we have got the balance about right.

[HC Deb 28.4.93 c 954]

Sir George Young gave evidence to the Environment Select Committee's inquiry into the Housing Corporation on 21 April 1993 during which it became clear that, in calculating the effect of grant rate changes, the Government assumes an affordability rate of 35 per cent before housing benefit is applied. This is some 13 per cent higher than that deemed acceptable by the NFHA, though of course actual rent levels currently produced are below this level. The Government has refused to publish advice it has received from the Housing Corporation on current and future grant rate movements.

Conclusion

Housing associations are now the main suppliers of new social housing for rent. The affordability of rent levels in this sector is therefore of central importance to those who wish to ensure that associations provide for people in housing need without condemning them to long term dependence on housing benefit. The NFHA believes that any further reduction in grant rates will have this effect, while the Government emphasises that a balance must be struck between rent levels and the number of homes provided; higher levels of public subsidy will only be provided at the expense of extra output [HC Deb 1.4.93 c 713].

There is no universally accepted definition of affordability and there are difficulties associated with devising such measures. Any definition will involve judgements and assumptions which may not fully coincide with the judgements individual households actually make about what they can and are willing to spend on housing. However, housing commentators have argued that, in the interest of meeting housing need, the funders and suppliers of social rented housing must jointly devise and agree a measure of affordability which will in turn influence the level and targeting of public resources.

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