THE LONDON HOUSING CRISIS: A SOCIAL HOUSING BOND

INTRODUCTION

We recognise at the Financial Inclusion Centre that London isn't the only region in the UK facing a housing crisis. But, for a number of reasons, the crisis does seem particularly acute in London and requires special interventions.

We take the view that four policy interventions are needed to tackle the housing crisis in London:

- Efficient funding mechanisms to fund the necessary increase in supply of housing in London;
- Targeted rent controls to protect renters, reduce the amount spent by taxpayers on housing benefit, and to address the high rent/ buy-to-let/ high house price spiral (this could also be addressed through prudential regulation of buy-to-let mortgages);
- A decent consumer protection regime for renters with similar rights and protection available to financial consumers; and
- Reforms to property and land taxes, and the planning system.

In this discussion paper, we focus on the need for efficient funding mechanisms to fund new supply of social housing. Specifically, we are floating the idea of establishing a **London Housing Authority (LHA)** and developing a **London Social Housing Bond** to raise funds from large institutional investors and ordinary Londoners to build new social housing. Papers on the other interventions will follow.

BACKGROUND TO THE HOUSING CRISIS

Many concerns have been raised about the growing housing crisis in London. Specifically:

- The difficulty many people (even on comparatively good incomes) face getting on the property ladder because of high property prices;
- The high cost of private rents;
- Abuse by private landlords, the poor quality of homes for rent;
- The lack of supply of affordable housing, the failure of housing starts and completions to keep up with housing need; and
- Abuse of the planning system[1] which pushes up costs and restricts the development of affordable social housing.

[1] See for example: http://www.theguardian.com/cities/2015/jun/25/london-developers-viability-planning-affordable-social-housing-regeneration-oliver-wainwright

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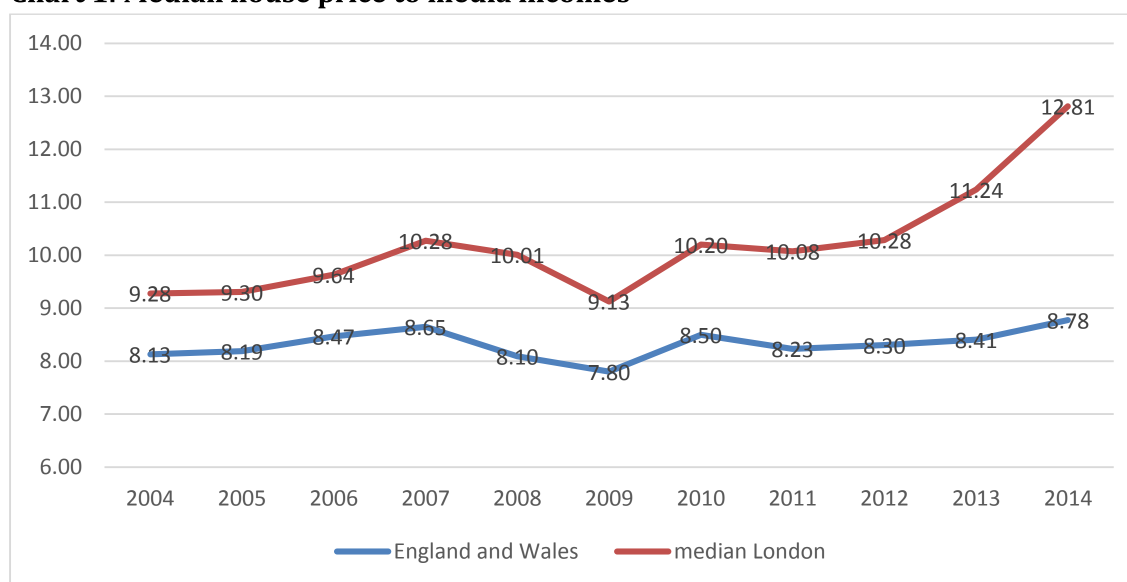
In this paper, we focus on affordability, conditions in the private rental sector, and demand for new housing.

House price affordability

According to the ONS, the ratio of median house prices to median income is 8.78 in England and Wales. Looking at the data for London boroughs, the median price to income ratio is 12.81. In some London boroughs the ratio of prices to incomes is over 20 times.

As the chart below shows, the gap between London and rest of England and Wales has widened over the past ten years.

Chart 1: Median house price to media incomes



Source: ONS, FIC calculations http://www.ons.gov.uk/ons/rel/regional-analysis/housing-statistics-portal/housing-summary-measures/rpt.html#tab-3--Affordability-of-Home-Ownership

Private rental sector conditions

London has the highest proportion of private rented housing in England – 26% compared to 17% nationally[2]. Around one third of private rented homes fail to meet the Decent Homes Standard[3]. The median rent in London is £1,350 a month – more than twice the rent for England which stood at £600[4]. Rents have risen faster over the past ten years in London compared to England as a whole – 32% compared to 22%[5]. The median monthly private rent in London as a percentage of the median **gross** monthly salary is 57%[6]. In eight of London local authority districts we looked at the ratio of rent to gross income is greater than 60%.

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[2] http://www.london.gov.uk/sites/default/files/Bleak-Houses-Final-Report.pdf p38
[3] http://www.london.gov.uk/sites/default/files/Bleak-Houses-Final-Report.pdf p44
[4] Figures collected between April 2014 and March 2015 for all types of property https://www.gov.uk/government/statistics/private-rental-market-statistics-may-2015
[5] http://www.ons.gov.uk/ons/rel/hpi/index-of-private-housing-rental-prices/october-to-december-2014-results/iphrp-stb-oct-to-dec14.html
[6] Based on analysis of data for all London local authority districts ONS, http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-411659 Table 6: median monthly rent price as a % of median gross monthly salary by local authority district, England 2014

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Need for new homes

London already faces a housing crisis which will be exacerbated if population trends continue. There are around 3.4 million households in London. According to the Homes for London Strategy[7] produced by the Mayor of London, this is projected to rise to around 4.2 million over the next 25 years - an annualised growth of around 40,000 households. The main trends are an increase in one-person households (projected to rise by 160,000 between 2011 and 2035) and couple households (projected to rise by 475,000).

The total backlog of housing is estimated at around 349,000 households. However, only around 121,000 of these require actual additions to the housing stock - others need a different size or tenure of home, but will free up their own home for another household when they move.

Overall, it is estimated that 48,800 new homes a year between 2014/15 and 2034/35 are needed broken down by tenure and size set out in the table below. Analysis suggests that 48% of this need will be met by the private sector/ market based, with 20% classified as intermediate and 32% social rent. All in all, around 25,000 intermediate/ social rent homes would need to be built every year.

Table 1: How many homes are needed?

	1 bed	2 bed	3 bed	4 bed	Total	% of total
Market	2,798	5,791	8,545	6,083	23,217	48%
Intermediate	3,357	2,240	2,506	1,799	9,902	20%
Social rent	10,225	1,003	1,774	2,720	15,722	32%
Total	16,381	9,034	12,825	10,602	48,841	100%

Source: Homes for London Strategy

Note that these forecasts could well be much too optimistic and the numbers of new homes might be much greater. These figures assume that the housing backlog is fully cleared over 20 years, that all those needing affordable homes have their needs met, and that overcrowding and homelessness are cleared.

Cost of building homes

According to the House of Commons library, the cost of building a social housing unit is between £160k-£180k. This excludes the cost of buying land. So any analysis included here relates to just the cost of building the social housing unit.

Table 2: cost of building homes

Number	Cost £millions
10,000	£1,700m
20,000	£3,400m
30,000	£5,100m
40,000	£6,800m
50,000	£8,500m

Meeting the full housing need of 48,800 a year would cost £8.3bn a year – a huge sum.

[7] http://www.london.gov.uk/sites/default/files/Draft%20London%20Housing%20Strategy%20April%202014_0_0.pdf

HOW SOCIAL HOUSING BONDS COULD HELP FUND MORE AFFORDABLE HOUSING

Much of the cost of building new housing would be met by the private sector in its various forms. But, it still makes economic sense to fund as much as is practical using the collective financial clout provided by central organisations (whether at state or local government level).

Put simply, public agencies can borrow to invest in public infrastructure at lower costs than the private sector so it makes sense for a significant share of the housing need to be funded using public agencies.

One idea would be to establish a dedicated agency – London Housing Authority (LHA) – under the control of the Mayor to plan, oversee and co-ordinate housebuilding to tackle the housing crisis in the capital. In effect, the LHA would play the same role for homebuilding as Transport for London does for transport in the capital. One possible mode[8] would be the Municipal Bond Agency set up by the Local Government Association to produce economies of scale to reduce local authority funding costs[9].

In terms of funding the building of new homes, we are proposing the idea of a LHA Social Housing Bond. This briefing paper sets out some very preliminary thinking on how a social housing bond might be constructed to raise funds to build new homes in London.

We had three guiding principles in mind:

- what is the most cost effective basis possible for raising funds to build a large number of homes;
- realistically, how much could be raised via a public agency; and
- how to get community buy in for any major infrastructure programme.

In developing this preliminary proposal, we looked at a range of issues including:

- cost of various wholesale and institutional funding mechanisms;
- the potential capacity and demand in the markets for a bond aimed at institutional investors;
- the level of interest rate a community bond might have to pay to attract citizen-investors; and
- the potential demand for a community bond.

A hybrid structure

We think a hybrid funding structure would be the most effective and suitable structure that would raise funds cost effectively and also promote community buy-in.

The hybrid structure would consist of:

[8] We can provide further details on the proposed structure and governance of the LHA. For now, this paper focuses on the funding costs.
[9] http://www.local.gov.uk/documents/10180/11531/MBA+Business+Case+Summary+Mar+14+v3+cover+sheet.pdf/3acfbec9-b33d-46b6-8f27-422ba4658d71

1. The vast majority of the funding would be raised from institutional market investors through issuing a bond similar to the bonds launched by Network Rail, Transport for London, and housing associations described below. As the examples below suggest London Housing Authority is likely to be able to raise funds from institutional investors at very attractive rates. Alternatively, central government could issue a special social housing bond but allow the London Housing Authority to administer and oversee the allocation of the funds raised.

2. A small part of the funding raised through a London Housing Authority Community Bond aimed at London citizen-investors. As we explain below, retail funding would be more expensive than institutional funding. But the purpose of the retail element is different – it is to get buy-in from Londoners to build long term support for a major homebuilding project.

It is genuinely very difficult at this stage to estimate how much could be raised from institutional investors without further market testing. Attempting to raise too much at once can affect liquidity in the market (which pushes up the funding costs) – particularly for a new entity such as London Housing Authority. Phasing in the homebuilding and fundraising by issuing smaller tranches of bonds is likely to be most effective method.

The cost of funding 10,000 homes each year would cost £1.7bn per annum (based on current prices). A six year programme on this scale would require just over £10bn to be raised. This would allow 40% of the social housing need to be funded this way (10,000 of the annual 25,000 requirement).

Please note that we have had to make a number of assumptions. The analysis is very much based on preliminary estimates and much more work would need to be undertaken. For example, we have not yet been able to assess what credit rating might be awarded to London Housing Authority by the influential credit rating agencies. This affects the cost of funding.

But, despite the uncertainty around precise costs, we can say with confidence that raising funds through a public agency such as proposed here would be more cost effective than, for example, asking pension funds and insurance companies to provide the funding. Persuading long term investors to invest in housing would require offering them a premium over and above the prevailing government bond rates. It would in all likelihood require some form of cross-subsidy – perhaps in the form of underwriting cash flows/ rents. By definition, this means funding the same unit of housing this way would be more expensive than through central borrowing. The higher cost would be borne by taxpayers and/ or renters.

Cost of funding

The key assumptions we have used to try to gauge the potential cost of funding through this new funding vehicle are as follows. Major housing associations are able to borrow (in form of issuing bonds) at a rate of 1.57% above medium-long term gilt rates. London and Quadrant raised £250m[10] in 2012 at 4.65% for 20 years (at the time Gilts were yielding 3.03%). Based on the same margins, the current cost would be closer to 3.9%. Note that the order book for this issue was £600m which means the issue was more than two times oversubscribed and illustrates how attractive this form of investment is to institutional investors.

[10] http://www.lqgroup.org.uk/services-for-residents/media-centre/news/news/2012/3/30/landq-raises-250m-on-bond-market/

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If the working model proposed is based on London Housing Authority acting as the lead agency the bond issuer in this case is likely to be able to borrow at significantly cheaper rates. For example, Transport for London recently raised £400m through a ten year bond with a coupon of 2.125% - this is just over half of one per cent above the 10 year gilt rate[11]. Previously, TfL has been able to issue a 33 year bond at a cost of just 0.6% above Gilts[12]. However, if some form of government underwriting was possible, this would reduce the cost even further. Network Rail bonds have been priced at just 0.3% above Gilts[13].

However, as this would be a new venture, the London Housing Authority might not be able to attract such low cost funding immediately. It may be reasonable to assume that at the outset, the margin above Gilts would be closer to 0.8% rather than 0.5%. This would reduce over time as the market became familiar with the new agency.

When we did this analysis, 10 year Gilts were yielding 1.7%, 15 year Gilts 2.0%, with 20 year Gilts 2.25%[14]. Therefore, this implies the cost of borrowing from institutional investors in the current climate could be 2.5% for 10 years, 2.8% for 15 years, and 3.05% for 20 years.

Note also that the margin above Gilts would depend on the size of the bond issue. TfL raised £2bn over the period 2012-2014. But this was done in smaller tranches of £200-300m at a time. 85% of all tranches issued in the UK corporate bond markets between 2011-13 were in the range £200-500m. There were a limited number of larger tranches – 36 were greater than £500m with just 8 greater than £1bn. Raising larger sums would cost more as potential investors would be concerned about liquidity.

But, it is worth pointing out that Network Rail raised £1.250bn from a bond maturing in 2035 paying just 0.28% above Gilts.

However, if central government was to issue a special social housing gilt then clearly the total cost of funding above the prevailing gilt yield would be marginal. This would remain the lowest cost option for funding large scale house building – although there may be other considerations to factor in over and above costs such as getting community buy in.

'Retail' funding

If we want to raise a part of the funding direct from London citizens (the retail funding) the critical point we have to address is how to strike the right balance between producing a bond that pays a rate of interest attractive enough to incentivise potential retail investors but also provides capital to homebuilders at a reasonable cost.

There are a number of potential competitors for a community housing bond[15]:

National Savings and Investment (NS&I): the market leading NS&I product is the Pensioner Bond which is currently paying 4% guaranteed for 3 years. However, this is obviously restricted to pensioners and not available to the wider public. The basic NS&I income bond is currently paying 1.26%.

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[11] http://www.ft.com/fastft/309992/transport-london-green-bonds
[12] http://www.room151.co.uk/interviews/tfls-simon-kilonback-on-bond-issuance/
[13]See page 36 http://www.local.gov.uk/documents/10180/11531/MBA+Report+Final.pdf/037bbcf0-e7f5-4f06-946e-98e7e824ce49
[14] https://www.fixedincomeinvestor.co.uk/x/bondtable.html?groupid=3
[15] Based on rates as at 15th April 2015

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The best buy retail bonds are currently paying 2.19%-2.26% - these bonds have to be held for 4-5 years.

A major housing charity – Golden Lane Housing – raised £11m in 8 days through a 7 year retail bond paying a coupon of 4.375% and was heavily oversubscribed[16]. Even more impressive, Hightown Housing Association raised £27m through a 10 year retail bond paying a fixed rate of 4.4%[17].

There are other options such as peer-to-peer (P2P) lending and crowdfunding schemes which claim to offer anything between 5-7%. However, these involve much higher risk than a community housing bond.

Taking these into consideration, we take the view that a retail housing bond would need to be offering at least 4% interest to overcome investors' concerns about risk. Again we have to make a number of assumptions here. For example, if the investment was underwritten by central or local government, the rate of return offered could be lower.

However, it is important to note that the cost of building homes using capital raised through a retail housing bond would be more than 4%. The annual management charges and initial/ ongoing marketing, promotion and distribution costs would need to added. It is difficult to say what these costs might be without further analysis and market research. But based on industry costs, we think it would be sensible to assume that the total annualised costs spread over the term of the bond would be in the region of 0.75%-1% per annum (the annualised cost depends on the length of the term as upfront costs spread over a longer term would be lower).

Therefore, we believe that it would be reasonable to assume that the effective cost of raising capital through a retail bond would be in the region of 4.75%-5% per annum.

The potential market for a Retail Housing Bond

This is very difficult to assess without undertaking proper market research. However, we have some examples to draw on. As mentioned above, Golden Lane Housing raised £11m in 8 days through a 7 year retail bond paying a coupon of 4.375% and was heavily oversubscribed[18] and Hightown Housing Association raised £27m through a 10 year retail bond paying a fixed rate of 4.4%[19].

We cannot say for certain of course but it must be feasible for a retail housing bond of the kind envisaged would raise at least the amount raised by Hightown. So we think that £30m would be the bottom end of any assumptions. However, properly marketed a bond such as this might be able to raise twice that amount.

Raising £30m would need 30,000 people investing £1,000 each on average. Looking at the profile of the London population we can see that should not be a very challenging target.

There are around 5.4 million adults over the age of 25 in London. We are assuming this would be the natural market for any community housing bond. However, clearly only a fraction of this population would actually invest in a bond. To estimate the potential number of investors we have to make some assumptions. Please note these assumptions are not based on actual market research with

[16] http://allia.org.uk/what-we-do/retail-charity-bonds/
[17] http://www.thirdsector.co.uk/hightown-praetorian-churches-housing-association-raises-27m-retail-bond/finance/article/1343744
[18] http://allia.org.uk/what-we-do/retail-charity-bonds/
[19] http://www.thirdsector.co.uk/hightown-praetorian-churches-housing-association-raises-27m-retail-bond/finance/article/1343744

potential community investors so these are rough estimates. The key contextual assumptions we have made are as follows:

We think it is not unreasonable to assume that a London wide (live and work) community bond properly marketed and promoted could achieve an overall penetration rate of 1% of the population[20]. To put this in context, around 1% of the London adult population are members of credit unions.

Applying these penetration rates to the overall population produces an estimate of 55,000 potential investors in the bond.

Note that this is based on an assumption that just 1% of London adult population would subscribe to a bond. To reiterate, we cannot say with any degree of certainty without further research but it seems reasonable to assume that such a bond might achieve higher penetration rates. A 2% penetration rate would deliver 110,000 investors, with 3% penetration rate delivering over 160,000. Considering the attractiveness of the retail bonds and the success of NS&I Pensioner Bonds, these do not seem to be unrealistic targets. Furthermore, it may well be that a bond could attract smaller numbers of better off investors willing to invest higher amounts.

Next steps

These are very much preliminary ideas. A great deal of further work would need to be done to develop the legal structure of the LHA Social Housing Bond, how the bond would be marketed and distribution, pricing, and most importantly estimating more accurately how much could be raised from institutional investors and ordinary households.

But, we think it is critical to start a debate on how to fund the necessary housing in the most cost-effective way. We are concerned that, for whatever reason, more expensive options such as using pension funds and insurers are being heavily promoted. This will be to the detriment of ordinary households (who will foot the bill) and/or renters who could end up paying higher rents than is necessary.

We would very much welcome collaborating with interested parties on developing the bond and investigating other ways of addressing the housing crisis in London.

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[20] this penetration rate would not be evenly spread. Propensity to save and savings levels tend to increase with age. Therefore, we have assumed the following distributions: 25-29, 0.6%; 30-39, 0.8%; 40-49, 1.2%; 50-74, 1.3%; and 75+, 0.8%.