Southside Housing Association's response to the Consultation "Better Value from Housing Association Grant" "Changes to Grant From 2008/09" issued by Communities Scotland in February 2008

1.0: Introduction

Southside Housing Association welcomes the opportunity to comment on the 'Changes to Grant in 2008/09" issued by Communities Scotland.

Southside Housing Association also recognises that Registered Social Landlords have an important part to play in realising many aspects of the following visions as contained within the document ***Firm Foundations*: *the Future of Housing in Scotland.***

- An increased supply of housing across all tenures, all of which is delivered on the basis of higher environmental and design standards
- More choice of housing that is affordable to those on lower incomes
- Housing developments that contribute to the creation of sustainable, mixed communities
- Social housing that provides better value for public expenditure

The proposed changes to the approval of grant is intended to increase the number of new homes provided for rent for each £1 invested prior to the introduction of new competitive arrangements for subsidising social housing. The document proposes that they should apply to projects approved from April 2008.

2.0: Proposed Changes

The major proposed change is the increase in the rental growth assumption from RPI only to RPI plus 1%. This will change the way the private finance is calculated and instead of having a constant value for the loan multiplier which is applied to the "net income" to calculate the loan a different multiplier will be applied to income and costs. This means the loan multiplier in the traditional sense will vary according to the rent level. Without going into technicalities the effect for a newbuild house costing £100k with a rent of £3k would be to increase the loan from £30k to £40k an increase of 33% with an effective loan multiplier of 23.64.

At current levels of private finance many RSLs have difficulty with funders security valuations on an "existing use basis" not matching the levels of private finance required. Some are using valuations such as "existing use with sales" and "market value tenanted" to access private finance. This indicates that the level of private finance required exceeds the value of these properties when used for social renting. The increase in private finance generated by the proposed changes can only exacerbate the situation. It is also likely that funders will perceive these investments as higher risk with higher gearing and combined with the widely discussed credit crunch is likely to lead to higher lenders margins and increases in funding costs.

This is likely to consolidate grant funded development with large, resource rich developers who can either fund development from their own reserves, from cross collateralisation of unencumbered stock or who can cross subsidise newbuild with rent from other properties.
It is suggested in the consultation that management and maintenance costs for newbuild housing are lower than for the sector as a whole although this is not quantified. Intuitively one would tend to agree with this. However, new development is evaluated over thirty years and it would be expected that over an extended period costs and voids levels would reflect the profile of the sector as a whole.

In the consultation document it is suggested that average secure rents have risen by RPI plus 2% over the last 5 years. We would suggest that the inclusion of GHA from 2003 with higher rents than most other RSLs would explain this apparent inflation. If we were comparing it on a like for like basis, and given the commitment of many stock transfer landlords to RPI only increases, the true figure is probably somewhere between RPI and RPI plus 1%.

The proposals for 2008/09 suggest long term funding costs of 6% and RPI inflation of 3%. This long-term interest rate is not far removed from current rates. Most RSLs at this time with bank base at 5.25% can probably access variable rate funding at around 5.8% inclusive of lenders margin although with recent market volatility if loans are Libor denominated then costs may be significantly higher. There is no allowance for arrangement fees, legal and valuation costs which can be substantial.

The discount rate takes no account of risk, which is substantial when projecting over a thirty-year period. Treasury Guidance has suggested that an appropriate risk factor for private sector projects is 2%.

The timing and phasing of expenditure is often critical in evaluating such projects particularly in relation to major repairs expenditure. The current model takes no account of this and extrapolates a notional set of values evenly over a thirty-year period.

There are several references in the consultation to the financial strength of the sector with the implicit assumption that RSLs have the ability to subsidise new development from their reserves.

At a time when rents have been rising at less than RPI plus 1% and unit costs have been rising at around RPI plus 2% this has led to a significant deterioration in RSLs operating position and a level of net surplus which is barely able to sustain the commitment to meet capital repayments on loans. Hardly an indicator of the claims of financial strength described in the consultation! In Communities Scotland's own appraisal of the sector based on 2005-06 accounts the opening remarks tell us "the operating surplus reduced… to the lowest level in recent years" and "the sector recorded its first net deficit".

A large proportion of the reserves built up by RSLs are designated reserves, which are required to pay for future major repairs. Reserves may not be cash backed although it may be an indicator of capacity for additional borrowing.

Funding new development from reserves is not financially sustainable and can only continue until those reserves become diminished.

Diminishing reserves will reduce the financial strength of the sector, may lead to a perception of higher risk by funders and combined with the well publicised credit crunch is likely to lead to an increase in long term funding costs.

It seems obvious that the aim of the consultation is to try and build 17% more houses with the same level of grant. It seems unrealistic that this can be achieved without significant rental growth above RPI inflation.

3.0: Conclusions

There is strong evidence that cost growth is already outstripping growth in rental income in the sector, that surpluses are declining and that RSLs are already cross subsidising new developments from existing property portfolios and / or reserves.

Cost growth in the sector is running at around RPI plus 2% per unit per annum. The current proposal would require rental growth of RPI plus 3-4% if new development were to be financially sustainable.

Increased loan funding and increased financial gearing will lead to increased funding costs.

The proposal is likely to further concentrate development with larger organisations, which have the capacity to cross subsidise new build from other properties, activities and/or reserves.

The methodology and assumptions underpinning the calculation of loans and grants must be realistic to protect the financial health of the sector and if the model is to have any credibility.

The proposal will increase new house building by around 17% without any increase in public subsidy.

The sector may want to consider increasing use of organisational models which attempt to incorporate the advantages of small community based organisations but utilise development and financial advantages of larger groupings.

There is a trade off between levels of grant and rent. The solution will depend on whether it is deemed more important to increase the scale of new house building or to keep rents low.