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NATIONAL HOUSING FEDERATION

Briefing

Briefing on consultation on reforms to the real estate investment trust (REIT) regime

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Summary

This briefing sets out our proposed response to the HM Treasury (HMT) and Communities and Local Government (CLG) consultation on reforms to the real estate investment trust (REIT) regime. We welcome early views from members on our proposed response. Please provide any comments by Friday 15 June 2012.

We encourage housing associations who support alternative funding options for new homes delivery to submit their own response. The deadline for responding to the consultation is 27 June and the full document can be found at http://www.hm-treasury.gov.uk/d/condoc_reforms_to_reit.pdf. Please note we have not responded to the consultation questions related to the 'REITs investing in REITs'.

1.0 **Funding new homes**

We welcome HMT and CLG's proposal for REITs to support the funding of the social housing sector. In a period when the outlook for the economy remains uncertain and social housing grant funding has been cut drastically to help reduce the fiscal deficit, it is important we explore all alternatives for funding new affordable homes. If a model can be found that would make social housing REITs a viable option, we believe they could play a role in providing the sector with a more diversified range of funding sources to deliver new affordable homes in the future.

The consultation document rightly highlights the high demand for affordable homes and the desperate need to increase new supply. Of course tackling the housing crisis and getting the right mix of homes over the long-term will always need to involve investment from government. However, as we look to drive growth during tough economic times, we need to ensure that private finance will also be available to fund new homes in the future. Housing associations are sound businesses that are readily able to secure funding from a variety of sources.

We support the Government's ambitions to deliver 170,000 affordable homes over the next four years. Housing associations will be delivering the vast majority of these homes. The new investment model, as set out in the Affordable Homes Programme (AHP), leads to a greater level of development risk being transferred to housing providers and requires higher levels of borrowing. Housing associations will be borrowing £10bn to support the delivery of these homes. We believe the current model is unlikely to be sustainable far beyond 2015 as the financial capacity of housing associations erodes.

2.0 Background on REITs

REITs are tax-efficient holding structures for property. A REIT is a normal UK company or group of companies that has elected to benefit from an exemption from corporation tax on rental profits and meets a number of conditions, including that its shares are listed on a ‘recognised’ stock exchange. In return for the tax exemption, a REIT is required to pay out at least 90% of rental profit each year as a taxable dividend to shareholders. If the shareholder is tax exempt, then no further tax is paid on the dividend, meaning that REITs are particularly attractive investment vehicles for tax exempt investors. Since their inception in 2007, only 20 UK REITs have been established, with holdings of several tens of billions of pounds of UK property. So far, all have a focus on commercial and retail property. No purely residential REIT has yet been created, although some commercial REITs do include residential property.

Securing institutional investment in residential property has been the ‘holy grail’ of innovation in financing new housing supply for a number of years. Despite a number of government and housing sector initiatives, institutional investment has not been available in significant amounts. The need to unlock investment to support new housing supply has never been more pressing and REITs may be a vehicle to help deliver this. Residential REITs also offer an opportunity for the retail investor.

The Federation strongly supports the changes proposed in the *2012 Finance Bill*, which include a number of measures designed to improve the prospects of a developing a successful residential REIT. In particular, we welcome - the abolition of the 2% conversion charges for companies joining the REIT regime, relaxed regulation on listing requirements and introducing a three year grace period for the diverse ownership rule. Alongside these changes we welcome the *2011 Budget* revision of stamp duty on bulk purchase of residential properties, meaning that stamp duty on the purchase of more than one property will be calculated by the average value of the properties rather than the bulk value. Whilst this will not automatically result in more institutional investment in residential properties, it will make a considerable difference to the potential rate of return and will help make the market more attractive.

The Government’s current consultation on REITs, issued on 4 April 2012, explores ways in which changes to the regime could provide an opportunity for institutional investment in affordable housing. We welcome recent Government efforts to improve the REIT regime and believe they have the potential to encourage institutional investment to help support the expansion of the property sector and stimulate the construction industry. Housing associations have the potential to play a significant role in this market, whether building homes for market rent, managing rental property or investing in REITs. The proposals we make here are designed to ensure any changes will help housing associations achieve this.

3.0 REITs as a vehicle for funding affordable homes

Institutional investors, in particular pension funds and life companies, but also potentially sovereign wealth and opportunity funds, typically require a yield of around 7% on their investment. Indications suggest that investment performance for residential let properties in England has provided an average return well below this rate, at approximately 3.5%. Recent volatility in the financial markets and diminished opportunities for such a high level of return on investment has resulted in an increased appetite for lower yield but more secure returns. This includes an interest in long leased properties, preferably with index linked rent as liability matching assets.

In the past, some housing associations have attempted to establish a social housing REIT. Despite substantial investor interest it failed to take off due to the high risk and intensive start up costs.

We believe the forthcoming changes to the REITs regime have the potential to unlock greater institutional investment for market rent homes where strong rental markets offer possibility of attractive investor returns. However, due to the lower level of revenue from social and intermediate housing, no model has yet been developed which offers returns attractive enough to encourage investors, despite social housing rental income being index linked. In our response we have suggested further changes to the REITs regime that may help address these issues.

There are also regulatory implications that need to be carefully considered where properties with embedded grant are to be moved into a REIT. Any REIT model will also need to be carefully structured to protect new and existing tenants.

4.0 Proposed response to consultation questions

Question 1: Does a financial constraint exist for social housing providers? If so, please elaborate

Housing associations provide the majority of social homes in England and will build the vast majority of the new social and affordable homes financed under the AHP 2011-15. Housing associations have committed to deliver over and above the Governments target of 150,000 homes and have signed contracts to develop 170,000 homes. However a number of financial constraints exist for the sector, including:

- The limited capital investment in the Affordable Homes Programme
- Housing associations’ borrowing capacity
- The financial impact of the changes from the Government’s welfare reform bill
- The increased regulation of the banking sector and
- The appetite of the capital markets.

Affordable Homes Programme

To deliver this number of new homes, housing associations have had to take difficult strategic decisions. The level of borrowing needed to fill the gap between the reduced level of grant, at around 20% per home, and the cost of developing a new home, is higher than at any time since large scale housing development by housing associations started more than 30 years ago. Although the new affordable rent regime offers the sector increased revenues which should bring about increased borrowing capacity, the sector's funders are unconvinced.

For lending purposes, housing association property is valued on the net present value of income streams and the Federation is aware of a number of banks that are not taking into account the higher affordable rent levels in these valuations. Using the higher forecast earnings from affordable rent (at up to 80% of market rent), rather than lower social housing rent, would enable housing associations to increase their borrowing due to the increased capacity to service more debt. The reluctance of lenders to use this higher value restricts the potential borrowing capacity of housing associations. Lenders argue that although properties let at affordable rent will bring in higher revenues, there are also higher risks of increased voids and arrears due to potential issue with reletting and rent collection.

Borrowing capacity

Housing associations have had to draw down significant levels of borrowing to develop the 170,000 homes across this four year period. If the current level of grant continued into the next AHP, housing associations would reach their borrowing capacity sometime during the next parliament. The political, social and economic ramifications of housing associations being unable to develop affordable homes are obvious.

Welfare reform

The sector's banks are watching closely the impact of welfare reform and other political changes. The combination of the under-occupation penalty, the benefit cap, introduction of Universal Credit and direct payments, supporting people cuts and other cuts to health, education and community budgets, may affect the sector's borrowing capacity. Increased bad debts and arrears, increased costs, decreased asset values and decreasing surpluses are issues that associations will need to monitor closely if they are to avoid the inevitable consequences of these changes.

Banking regulation

Changes in the UK banking sector may place a significant strain on housing association finances. The increased capital requirements set out in Basle III could enable lenders to take advantage of clauses in loan agreements to increase costs charged to housing associations. When coupled with the impact arising from the Vickers report, which recommends the separation of the retail and commercial arms of high street banks, and with UK banks approximate £200bn exposure to Portugal, Italy, Ireland, Greece and Spain, it is clear that UK bank lending will remain constrained, and possibly tighten further, in future.

Appetite of the capital markets

As explained in the consultation document, housing associations are increasingly using capital markets to secure funding as these loans offer long-term funding at attractive rates. However, it is believed that there are around 10 institutional investors that purchase the vast majority of these bonds and it is unclear whether these investors will continue to be attracted to the same grade of investment in the long-term. Furthermore, at some time in the future, local authorities are also expected to sell bonds into the market, which could affect investor appetite for housing association bonds. And more broadly, with global financial markets likely to remain turbulent for some time, the extent to which capital markets will be able to fulfil financing requirements into the medium-to-long term could be questioned.

Q2: What sources of finance are housing providers currently using to support affordable housing development?

Housing associations have typically used three principal forms of finance to fund the delivery of new affordable housing – their own resources, public subsidy and private finance.

The funding that housing associations contribute from their own resources largely comes from rental income from existing and newly developed homes. Homes developed for social rent (established by the rent formula) make up the majority of any housing association existing stock and the income it provides is key to servicing the debt described below. The rental income from newly developed homes, now primarily at affordable rent, is fundamental in determining the point at which developments ‘wash their face’. Both will feature heavily in any assessment of development viability on a scheme-by-scheme basis. Also, importantly for both, rent increases are index-linked, rising by RPI (retail price index) + 0.5%, and are eligible for housing benefit in full. However, changes introduced under the Welfare Reform Act, namely Universal Credit, the overall benefit cap and under-occupation penalties, threaten to undermine the security this offers.

In addition to rental income, the tenure mix, that is the capital receipts from property developed for sale, is also used to assess development viability. Housing associations have typically used the receipts from the first tranche shared ownership sales, and increasingly outright sale on the open market, to cross subsidise social and affordable rented homes. This contributes to funding the cost of developing homes for rent. However, the extent to which they are factored into financing arrangements is unclear, as their link to wider housing market trends can make receipts difficult to predict. Combined, these sources of income help determine the level of public subsidy and private finance needed to make the development of affordable housing viable.

Public subsidy has taken two main forms – government grant and section 106 planning gain. To date, our members have received in the region of £43bn of government grant. Pre-1988, this accounted for almost the entire development cost. Importantly, when social housing is disposed of out of the sector, the embedded grant must be recycled into the provision of further new affordable homes. The introduction of a mixed funding regime saw a gradual decline in the level of government investment going into each home. Housing associations filled the gap by attracting a significant amount of private finance and using their own resources. The introduction of the affordable rent model has seen the balance shift further towards private finance. Under the 2010 Comprehensive Spending Review, the capital budget from Government to build affordable homes was slashed by 63%. The Government has allocated resources of £4.5bn for the AHP over the next four year period to deliver up to 150,000 homes. The gap left by this cut in capital grant will be filled, in part, through higher revenues derived from the introduction of new affordable rents – to be charged for most newly built homes and a proportion of re-let properties. This means housing associations will be matching every £1 of government grant with over £6 of their own resources.

The second source of public subsidy comes via the planning system and section 106 planning gain. This subsidy is primarily delivered in-kind through discounted or free land and/or homes. The total value of affordable housing obligations delivered in 2007-08 was £1.3bn.

Private finance has commonly been available from two sources – conventional corporate debt provided by financial institutions and bond finance (publically listed or privately placed) from the capital markets. Up until December 2011, housing associations had total private finance facilities of £64bn. The overwhelming majority of this came from traditional debt finance, which was the most cost effective way of housing associations funding the needs of their business. Housing associations' low risk category historically allowed them to secure long-term loans from banks at exceptionally favourable rates. Prior to 2008, this commonly equated to 25 to 30 year loans at a rate of between 25 and 75 basis points above LIBOR.

However, since 2008, increasing volatility and liquidity problems in the financial markets has seen this situation change, with additional funding becoming more difficult to arrange. Banks are under considerable regulatory pressure to reduce the terms of these loans as they seek to match the lifetime of their assets with their liabilities. Many lenders are of the view that there will be an increasing move towards shorter or medium-term finance of between five to seven years. The lenders which continue to make long-term loans to housing associations are likely to include regular break clauses giving them the opportunity to re-price at intervals of five years. For many housing associations this may represent a risk they are unwilling to bear.

Housing associations are increasingly using the capital markets to source long-term debt. Bond finance is a well established means of funding affordable housing delivery. To date housing associations have issued almost £10bn of bonds since 1987. Since 2008 alone, the sector has issued £5.4bn of bonds and, tellingly, in the first five months of 2012, £1.58bn has been raised. These typically pay investors a return of between 4.5% and 6%. Even in a volatile market, there remains good institutional appetite for housing association bond finance from the current investor base, with many bond issuances being over-subscribed. In fact for the first time, during the first quarter of 2012, housing associations sold more bonds than they raised in loans. While larger housing associations will typically raise finance via the capital markets by selling bonds in their own name, bond finance is not limited in this respect. The Housing Finance Corporation (THFC) acts as a conduit for smaller and medium-sized housing associations to access the capital markets by issuing an aggregate bond that fulfils their individual funding requirements. There is also an active private placement market, which enables smaller issues of debt to be placed with individual investors.

The situation described above could lead to the funding of affordable housing moving to a more polarised position, with the banks providing short-term finance and capital markets and institutional investors being the main source of long-dated debt.

Q3: What new sources of finance are housing providers exploring to support future development?

Providers of affordable housing are increasingly looking at alternative ways of funding development. Two of these are linked to the planning system – the new homes bonus (NHB) and the community infrastructure levy (CIL). The NHB is intended to stimulate competition between local authorities in new house building. It aims to incentivise housing delivery by enabling local authorities to receive grants ‘matching the council tax raised on increases in effective stock’, for the following six years. Some local authorities may seek to ring-fence this revenue for further housing delivery. CIL is a mandatory charge payable by developers. It contributes towards the cost of local and sub-regional infrastructure which has been identified by the council or local community, such as new schools, health centres and parks. It is intended to provide infrastructure to support development across an area rather than to simply make individual planning applications acceptable. The levy will be charged on almost all development. Government has exempted affordable housing from paying CIL, but local authorities could ring-fence CIL monies for affordable housing provision.

Recently, some housing associations have explored and introduced sale and leaseback models. Housing stock is sold to an investor and then leased back on a fully repairing and insuring basis, often for between 40 and 50 years, with a reversion option. The rent paid by the housing association to the investor is generally index-linked. This type of structure is usually ‘on-balance sheet’, relatively inflexible and slightly more expensive than debt. While it can be useful in certain circumstances, it is still a form of debt finance which will deplete housing association financial capacity. Derwent Living has become the first housing association to initiate this arrangement in a deal worth £40–45m with Aviva. Aviva will give Derwent a 50-year lease over the properties it sells to the fund, in exchange for which Derwent will pay Aviva 4% of the gross purchase cost per year, increasing annually at the rate of RPI. The freehold will revert to the landlord at the end of the term for a nominal re-purchase price of £1, meaning that effectively the asset amortises to zero over time.

Some housing associations previously explored the idea of establishing a residential REIT. In 2007, a consortium of over 20 housing associations (including large housing associations such as Affinity Sutton, Genesis and Peabody Trust) attempted to establish the first residential REIT in the UK, which was to be known as the ‘HA REIT’. The consortium pledged £250m worth of properties to the ‘HA REIT’ and it was envisaged other housing associations would be able to sell properties to the REIT or manage properties on behalf of the REIT. It was estimated that the initial associated start-up costs would run into millions of pounds. Despite the fact the consortium was said to have started negotiations with a major investment bank to secure the necessary finance, around 10 housing associations were reported to have withdrawn from the consortium and the REIT was not formed.

Question 4: Does the size of the housing association impact the financing opportunities available to it? If yes, please explain

Yes. The size of an organisation can be critical in its ability to access funding from banks, building societies, and, in particular, capital markets. As other funding sources are currently small scale it is difficult to assess whether the size of a housing association would have an effect on the opportunity to secure funding from one of these alternate sources.

Bank and building society lending

The vast majority of housing association’s lending, until now, has been drawn from banks and building societies (‘banks’). From the largest housing associations with over 50,000 properties to the smallest with less than 100 properties, the sector has borrowed billions of pounds from these institutions.

In deciding whether to lend to an organisation, banks consider a number of factors, including the size of the organisation. Larger organisation have more assets, tend to have larger surpluses (due to economies of scale benefits) and tend to have more diversified businesses, potentially reducing the risk of failure.

Capital market lending

As set out elsewhere in this response, housing associations are increasingly turning to the capital markets for funding. In recent years the amount secured through the capital markets has been increasing at a steady rate, with the total raised through this source expected to exceed £1bn during 2012. When a housing association seeks funding from the capital markets using an own-named bond it will aim to raise between £100m and £250m. Raising this amount means a sufficient number of investors would be interested in the bond and would generate a competitive market which keeps the rates required by investors, and the overall cost of funds, at the lowest level possible. This favours larger housing associations with larger development programmes and greater and more urgent need for larger sums. Although medium-sized housing associations (in excess of 15,000 properties) could raise large amounts on the capital markets, with smaller development programmes, the cost of carry (the difference between the interest paid and the interest received on deposited funds) is often prohibitive.

Smaller housing associations can use an aggregated bond provider, such as THFC or GB Social Housing. These offer housing associations the opportunity of accessing the capital markets at interest rates similar to those achieved by own-name bond issues. However the amount of security required by these aggregators is often too onerous for many housing associations.

Q5: How attractive is affordable housing as an investment for institutional investors? What, if any, are the barriers?

Affordable housing represents a potentially very attractive opportunity for institutional investors. Housing associations are exceptionally financially viable and can offer investors the necessary scale for their investments. The most recent Global Accounts for the year 2010/11 show the housing association sector currently owns or manages in excess of 2.5m homes. Within this, 64 providers own or manage in excess of 10,000 homes each. This contributes to considerable balance sheet strength, with the book value of the sector’s assets sitting at £109bn. The sector’s pre-tax surplus rose to over £1.1bn in 2010/11 (representing a pre-tax margin of 9%) and turnover also increased to over £12.6bn during the same period.

The attractiveness of the affordable housing sector is further enhanced by the fact that its revenue stream is index-linked. Social and affordable rent increases are established by the formula of RPI + 0.5%, and underpinned by housing benefit. Housing associations have a long successful record of public-private partnership and a strong reputation and experience in housing management to safeguard returns.

Despite the advantages for investment in affordable housing, there remain considerable barriers which must be overcome before this potential can be realised. Most notably is the rate of return, which is discussed in more detail in question 9 below. The position of the social housing regulator could also present a challenge in attracting investors to the affordable housing market. The implications of housing associations transferring their charitable assets into a 'for-profit' company listed on a stock exchange must be considered. Questions also remain over the status of historic government grant in the sector - firstly, the transfer of social rented units with grant embedded into a REIT, and secondly, the continuing debate over its reclassification.

Q6: What role is there for REITs to play in social housing for either low cost rental or affordable home ownership accommodation?

As set out in this response, REITs represent a potentially useful way for housing associations to attract institutional investment to support the delivery of social rented or affordable home ownership homes. The investment will be off-balance sheet and, as it is equity as opposed to debt, does not add to the housing associations indebtedness, which will become a growing issue for the sector. As with the other new and alternative sources of funding, REITs should be seen as a vehicle for supporting existing funding streams rather than a 'silver bullet', substituting government investment.

Question 7: In what circumstance might REITs be an attractive means of accessing finance compared to existing finance options?

In the short term, social housing providers have a plentiful supply of medium-to-longer-term financing at all-in rates of between 5 – 6%. These rates are consistent with the long range assumptions in many housing association business plans.

We believe the squeeze for housing associations in the medium-term arises from the introduction of the new investment framework, rather than liquidity concerns. The increased levels of private finance, being used to partly cover the cut in grant subsidy, increases housing association interest costs. One of the ramifications of this is housing association balance sheets are now less buoyed by subsidy and are becoming more highly geared. This jeopardises housing associations' ability to continue to service loan interest and their ability to satisfy loan covenants.

However, the biggest issue is likely to be the ability of associations to continue to provide security to take on new debt. On average, it costs £150,000 to build each new affordable home for rent. This encumbers, on average, nearly three existing homes as security to support the borrowing requirements of each new one developed. This rapidly erodes the sector's borrowing capacity. As set out in our response to question 1, we believe housing associations would reach their borrowing capacity sometime during the next parliament if the current grant level continues into the next AHP. The political, social and economic ramifications of housing associations being unable to develop affordable homes are obvious. REITs may help to partly address this issue because, as set out in question 6, the investment will be off-balance sheet and, as it is equity as opposed to debt, does not add to the housing associations indebtedness. In the short term, this may make REITs particularly appealing to highly geared associations. That said, the setting up of a REIT requires the seeding of property into the REIT, which will affect the gearing calculation and some lender covenant compliance.

Q8: What would the social housing REIT business model look like to generate attractive returns?

A social housing REIT could be set up in a number of ways. For example, one or more housing associations could sell part of their existing portfolio of social rent and LCHO properties into a company which lists as a REIT and raise more capital from investors. This subscription money could then be used to repay the housing associations for the property or buy more stock from them. The housing associations are likely to retain the management contract for the properties and/or a significant equity stake in the REIT, which would provide a continuing source of income from the portfolio and allow a degree of control over the management of the property.

An alternative model has been proposed by Places for People, which would see around 5,000 existing rented properties purchased by the REIT, including social rented properties that have been converted into affordable rent when they fall vacant. The funds generated by the sale of properties into the REIT would be used to finance additional development of new homes in affordable rented and market rented tenures, and once occupied these new homes would then be sold onto the REIT. This process could be repeated a few more times until the REIT needs to be reseeded or restocked with existing residential properties.

Q9: What level of return would be considered attractive to your investors?

Institutional investors, in particular pension funds and life companies, but also potentially sovereign wealth and opportunity funds, typically require a return of around 7% on their investment. However, there is now reason to believe that these demands may be revised. Recent volatility in the financial markets and reduced opportunities for high level returns on investment has resulted in an increased appetite for a lower, more secure yield. The strength and security of the housing association sector outlined above, combined with the index-linked returns it offers, may mean investors would accept a yield somewhere between 5% and 6%. This would of course be in line with the returns on bonds.

Nonetheless, indications suggest that the performance of investment in residential property in England has provided an average return of around 3.5%. So, the challenge remains to bridge the gap between return and investor expectation.

Q10: What reforms would be needed to enable REITs to support a social housing model?

We believe further reforms to those already proposed may enable REITs to support a social housing model, as follows:

- An exemption of Stamp Duty Land Tax
- Consideration of changes to the 90% distribution rule to ensure that sufficient funds are available to upkeep the asset. Any changes to the distribution would need to be balanced carefully with investor interest.
- A lowering of the profit: financing costs test ratio. Currently if the ratio of profit : financing costs falls below 1:25, a tax is charged which reflects the extent to which the ratio is breached.

We are currently exploring and modelling these measures in more detail and welcome your views.

Q11: What benefits and risks should be considered as a consequence of changing the REIT regime?

We have highlighted the benefits of changing the REITs regime throughout this consultation response. We believe the main risk that may arise as a consequence of changing the regime is that REITs are seen as a significant source of funding that can replace, rather than complement, existing funding streams. As set out elsewhere in this response, we believe tackling the housing crisis and getting the right mix of homes over the long-term will need investment and commitment from Government.

Q12: What practical issues that affect implementation should be considered?

There are a number of practical issues that may affect the implementation of changes to the REIT regime, not least the role of the regulator, as set out in our response to questions 13 and 14. It is important to consider any lessons learnt from why previous attempts to set up a residential REIT failed and how a REIT model can be structured to protect new and existing tenants.

Q13: Are there particular social housing regulations that might be affected by the introduction of REITs? Q14: What role should social housing regulators play in regulating REITs in this sector?

There are a number of implications of housing associations transferring their charitable assets into a ‘for-profit’ company listed on a stock exchange. Questions also remain over the status of historic government grant in the sector; firstly, the transfer of social rented units with grant embedded into a REIT, and secondly, the continuing debate over its reclassification. These issues must be carefully considered in determining the role of the housing regulator in regulating REITs in this sector.