Future options for rents and rent setting

A report from CIH and L&Q

12 September 2012
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Introduction

Changes in policy and funding for affordable housing have created uncertainty about the future of rents and rent setting. The current dual system - rent restructuring and Affordable Rent - may be subject to further changes following the 'Pay to Stay' proposal. The affordable housing sector and government needs to debate and agree how all sub-market rents will be set in future in particular as we get closer to the end of the restructuring regime (2011/2012 for housing associations and 2015/16 for local authorities). The nature and coherence of the approach is particularly important for financial planning but it also affects the fundamental purpose and objectives of sub-market housing.

CIH and L&Q are seeking to better understand recent government-led changes in low-cost/sub-market rent policy and the drivers behind different rent levels observed in practice amongst landlords. A different approach from the two we are currently familiar with could be beneficial for a range of reasons.

We have captured some ideas, lessons, parameters and principles to inform future debate on how rents are set. We are exploring two ideas in more detail to illustrate the possibilities offered by different approaches. We are now calling for debate and engagement with these ideas. A more detailed report on these issues, supported by financial modelling will be published shortly.

Focus on linking rents to household income has grown, and although concerns are common we must remember that there are problems with the current approaches too.
Whatever the form, the main objective of a sub-market rent system must be to enable long term provision of affordable housing.

Challenges in the current situation

It is widely acknowledged that rent restructuring increased consistency and transparency in the way social housing rents are set. In addition the target rent formula, with rent convergence and its RPI link, gives long term certainty to providers' income streams. Although the target rent policy allows providers to set individual rents within 5% of the target rent, many providers feel that they should have more flexibility when setting rents.

Other elements of the target rent policy such as the 1999 values that inform the target rent formula, and the way different sized properties are treated, increase feelings that the current approach to rent setting may no longer be fit for purpose.

In terms of more recent policy changes the current dual system of rent convergence and Affordable Rents presents some inconsistencies, is difficult to explain to tenants and poses challenges for landlords to operate within their financial systems.

Fit with wider housing policy

Rent setting needs to be seen in the context of the official and/or perceived role of social/affordable rented housing because any approach to rent setting has implications for that role.

For example, the language and ideas around 'pay to stay' reinforce the perception that the social sector should be a temporary service rather than a sector in which tenants can expect to make permanent homes. This is a critical issue in the UK compared to other countries where social sectors tend to have more clearly defined roles either in providing affordable housing for a wide group of people (at one extreme) or (at the other) a narrow 'ambulance service'. In the UK the social sector has a 'safety net' role which in a sense means it could be tilted in either direction by a combination of change over time, political pressures, and the sectors' responses to them.

Objectives of a rent system

The objective a rent setting system aims to achieve has direct implications for its design, characteristics and targeted client group. A housing sector round table for this project identified that the range of desired characteristics and practical outcomes for an efficient rents system include:

- Simplicity
- Attractiveness for investors
- Transparency and comparability
- Competitiveness
- Consistency
- Equity / fairness
- Provides incentives for work
- An element of choice in terms of price, location, characteristics of the property
- Create mixed communities
- Curtail expenditure on housing benefit.

Understanding of the current approach to regulation, financial institutions and the sector itself suggest a desire for clarity about the role of social housing and who is it for; its funding regime; and how the different rent setting mechanisms interact and align with the funding mechanism. Also important is policy coherence, which reinforces the sector's reputation and high credit rating.

Key factors & interests in a debate on approaches to rent setting

Affordability and ways to assess it

L&Q's particular interest in exploring the future of rent setting was based on their concerns around rental affordability.

It is important to have an agreed measure of affordability:

- The most commonly used affordability measure is the rent to income ratio – rent should be no more than 25% of gross or 35% of net income
- Residual income illustrates whether there is an adequate amount of income after housing costs. This is generally considered to be the minimum standard of living.
- The residual income measure is more difficult to work with because it requires more detailed household income data, but for low cost households it gives a more realistic measure of rental affordability.

Assessing social rents as a proportion of local or regional market rents has drawn attention to the fact that some tenants are living near poverty levels (Fenton, A., Tang, C.P.Y. and Whitehead, C. (2011) Market-pegged social rents and local income distributions. Cambridge: CCHPR) , and the desire to avoid this is strong.

An approach to rent setting which causes increased housing benefit claims could also be problematic.

Funding for landlords

- Linking rent to RPI is a key feature that attracts current funders to the sector
- It is important to consider the ability to attract new investment and to ensure new investors are not deterred by aspects of rents setting
- Landlords have suggested they need the ability to tailor approaches to their customers so that they remain competitive and thus protect their income streams
- There would be a significant impact if the historic grant held by housing associations is affected by their approach to rent setting
- Clarity about what any new rental income can be used for – does it have to be new supply of affordable housing?

Ensuring the health of the sector (enabling effective regulation)

- Stability of the sector's operation and reputation matters. Rents policy (and housing policy more generally) needs to remain and be perceived as stable, because policy incoherence and instability can damage the sector's reputation. One of the elements that determine investors' trust is the stability provided by the regulator.
- The regulator currently seeks and provides assurance that providers conform to the rent standard and are in strong financial positions. A rent system that takes more account of incomes requires increased data monitoring by the regulator to ensure the rent standard is respected. Given the intention of the current government to reduce bureaucracy, such a move could be curtailed by the need to keep costs down.

The relationship between social and private rents

Clarity on the desired relationship between the market and sub-market rented sectors is important. If social/affordable rent is intended to be a challenge to private rents in terms of price, quality and 'offer' to tenants, rents are closer to but still a little cheaper than private rents. Where social rent is intended to be a distinct alternative, rents and access policies tend to be heavily regulated and significantly different from market rent.

Welfare reform

Welfare reform will have unknown effects on income streams, business models and relationships with tenants. Meanwhile, there is growing awareness of a likely reduction in housing affordability especially for larger households, driven by welfare reform. Any new approach to rents needs to recognise this and avoid adding additional uncertainty or significant financial change.

International experiences

We can learn some general lessons from international experiences of changing rent systems. In countries with 'differential rent' schemes where rent increases with income e.g. Ireland, managing the impact of what is in effect a high marginal tax rate has been a challenge because it provides a disincentive to tenants improving their incomes.

An alternative approach which increases incentives rather than decreases them, is giving a fixed term sub-market tenancy that assumes income will have improved by the end of the tenancy and therefore does not allow for tenancy extensions e.g. USA.

In France and Germany there are provisions to charge 'supplementary rents' on top of a core rent when income passes a certain threshold, but they are infrequently used because of concern about impact on social mix and the administrative costs of checking on incomes. In Hong Kong where there is greater cultural tolerance of the state knowing about personal circumstances charging supplementary seems to work.

Experience from other countries and views from stakeholders highlight a wide range of difficulties when designing and implementing rent systems that link to individual incomes:

- High administrative costs often outweigh the potential benefits from charging higher rents as tenants' incomes increase
- Rents based on income, contrary to the current formula for target rents, make landlords' income streams uncertain and pro-cyclical (linked to economic change)
- A particular issue relevant to low-income households is the frequent change in personal circumstances and certain conditionality in their attitude to work – they are often in and out of low paid jobs.

However, landlords are keen for increased flexibilities and a stronger focus on affordability when setting rents, so we continue to consider all options.

Options for more flexible approaches to rent setting

Maintaining a link to the property, taking into account affordability, and keeping the link to the RPI for rent increases seem to be the major elements that an effective rent setting system should have.

There are several ways a system with these characteristics could work. We are exploring two in more detail.

Regional rents

Affordable Rent has started to move sub-market rent setting to a more market driven system where rents are closer to economic levels. Several years ago, John Hills argued that this approach would involve far fewer of the downsides of the provision of sub-market housing as a rationed resource but would represent a cost to the taxpayer because of increased benefit costs.

Implementing Affordable Rent has shown that the impact of moving towards a system of rents closer to economic levels, in terms of household affordability, additional landlord revenue, and additional welfare burden varies between areas where differences between target rents and market rents are not very high and those where the differences are high.

Alternatively it is possible to enable regional flexibilities using policies where either:

- The formula to calculate target rent is kept and a fixed rent is applied in addition
- Rents are allowed to be within 15% of a formula
- The regulator could set maximum/minimum levels of rents regionally, and landlords keep their rents within these limits.

Redistributive rents

To make sure rent is truly affordable and disincentives for moving into work are removed, a redistributive system that increases rent for those easily able to afford it and decreases it for those facing affordability challenges can be considered.

Modelling by CIH/L&Q is underway to explore how equitably additional rental income could be raised from higher income households, taking into account the local housing markets and rent levels.

Using knowledge of tenants' incomes, household composition and existing social rent levels, the modelling will also consider the potential to rebate rents for lower income households so that they spend only an amount of disposable income which is defined as affordable.

The current environment and the job market for lower income households suggests that bringing rents down seems a more feasible option than moving incomes up.

This idea seems attractive and in exploring it further we will consider how much flexibility landlords can have in reality when setting their rents in a different way from target rents but which remain below market rents.

Potential for introducing a different system

Current regulation

There are regulatory restrictions that stop housing associations from charging higher/different sub-market rents for different individuals.

Private registered providers have to comply with regulatory requirements on rent setting and rent increases. The rent standard requires providers to comply with government directions to the regulator on social and affordable rents. To get more flexibility the Secretary of State would have to issue a direction to the Social Housing Regulator to amend the standard on rent.

The 1985 Housing Act gives local authorities wide powers to set rents and this would enable them to charge different rents for different individuals/groups, but this area has not been tested.

Income assumptions built into the self-financing settlement were based on current policy for councils that their rents should 'converge' with target housing association rents in 2015/16. Local authorities are free to depart from these rent assumptions but must of course balance their books.

Current tenancy law and landlords' practice

If the Rent Standard was made more flexible, the main constraints housing associations would face in changing approaches to rent setting are:

- The Housing Act 1988 – which put restrictions on altering existing tenancies
- General provisions of consumer law and charity law , especially regarding existing tenancies
- Their own internal policy constraints, especially in terms of tenant views and the need to respond sensitively to the growing impact on tenants of welfare reform
- Possible triggering of provisions in lending contracts that would allow lenders to revisit loan terms

Local authorities have wider discretion but excessive rent increases could be challenged by judicial review. In practice, tenants' views and local political constraints are likely to be heavily influential in determining how much rents can be increased.

Current and future welfare rules

Local authorities are subject to the 'rent rebate subsidy limitation' (RRSL), which means that above a certain average rent level they would not be paid the full subsidy for housing benefit. Some councils have in the past breached this limit, and they can choose to breach this if they carry the cost themselves.

The introduction of universal credit, and the anticipation of further welfare reforms, means that the interface between rent setting and welfare rules is increasingly difficult to establish.

Conclusions

Having more flexibility in rent setting is attractive for providers. This is also in the spirit of the Localism Act which gives landlords and local authorities more flexibility to take their local conditions into account around tenancies and allocation policies. Rent flexibility seems to be the next building block that requires attention from policy makers and practitioners – in terms of future finance and wider objectives of sub-market housing. Rather than introducing piecemeal changes such as the pay to stay proposal, a joined up approach is needed, which enables rent policy to fit within the wider social housing policy and its funding.

The government and the housing sector need to have a conversation about the future of rent setting. We intend to publish more detailed findings from our research on rent setting to inform this debate shortly.

About CIH

The Chartered Institute of Housing (CIH) is the professional body for everyone involved in housing and communities. Our goal is simple – to provide housing professionals with the advice, support and knowledge they need to be brilliant. Our work is driven by a passionate belief that our contribution as housing professionals is vital to making communities great places to live and work – and that everyone is entitled to a decent, affordable home in a thriving, safe community.

CIH is a registered charity and not-for-profit organisation. This means that the money we make is put back into the organisation and funds the activities we carry out to support the housing sector. We are a membership organisation with a diverse and growing membership of over 22,000 people who work in both the public and private sectors, in 20 countries on five continents across the world.

About L&Q

L&Q is the largest housing association in London and the South East and builds high quality, affordable homes across a mix of tenures – including general needs rent, intermediate market rent, part buy/part rent (affordable home ownership) and outright sale. This includes building new homes as well as refurbishing old ones.

L&Q is involved in large scale regeneration projects across London, is committed to increasing resident satisfaction, and invests every penny of its surplus in homes, services and communities. For more information visit www.lqgroup.org.uk