Briefing Paper

Housing Associations and Loan Finance

June 2013

Introduction

Private loans are a major source of finance. Usually loans are long-term at fixed rates of interest. Housing Associations typically borrow £6billion a year from the private sector, with 80% being provided by banks and building societies. At December 2012 there were £67.9billion of borrowing facilities arranged by housing associations of which £55.8billion had been drawn down.

Borrowing Strategies

In planning and managing their loans Housing Associations pursue a mix of objectives including:

- Cheapness – low interest rates
- Certainty – fixed interest rates
- Coherence – matching of cash flow with debt servicing
- Renewability – seeking options to extend loans
- Redeemability – seeking options to cancel loans
- Security – seeking a balanced portfolio in terms of loan types and terms

In negotiating loans Housing Associations consider their legal and managerial competence including powers to borrow, ability to service debt and the relationship of new loans to loans already outstanding. Lenders usually seek 'covenants' – that is, conditions regarding the financial performance of the Housing Association. Housing Associations also consider matters including collateral and cover ratios – the links between assets and income flows, the relationship between fixed and floating charges and the interest cover ratio.

An example of a Housing Association's debt portfolio is shown below:

Funder	Borrowing £million	Rate %	Fixed/ Variable	Maturity	Total Facility £million
Loan Facilities					
Royal Bank of Scotland	10.0	6.45	F	2030	10.0
Nationwide	5.0	6.15	V	2015	5.0
Nationwide	5.0	5.99	F	2017	5.0
Royal Bank of Scotland	5.0	5.96	F	2017	5.0
Royal Bank of Scotland	2.2	4.46	V	2025	20.0
Sub-Total	**27.2**	**6.06**			**45.0**
Overdraft					
Royal Bank of Scotland	0.5	7.20	V	n/a	0.5
Total	**27.7**	**6.08**			**45.5**

It will be seen that the portfolio of loans includes fixed and variable loans of different loan periods with staggered repayment dates. Furthermore, of a total loan facility of £45.0million, only £27.2million has been taken up.

An example of cover ratios is shown below:

	Minimum Cover %	Valuation Required £,000	Actual Valuation £,000	Margin %
March 2009	105%	25,410	29,150	14.7%
March 2010	105%	27,510	30,490	10.8%
March 2011	105%	29,085	34,370	18.1%
March 2012	105%	33,285	37,800	13.5%

It will be seen that the funder requires the Housing Association to maintain a minimum cover such that assets are valued at 105% of loans. In practice the Housing Association has maintained a position whereby asset values exceed that required by margins of between 10.8% and 18.1%.

Gearing

Loan covenants related to gearing are common in the loan agreements of traditional housing associations. It is calculated in a number of different ways. All calculations measure the proportion of debt to equity in a provider's financial structure. A common definition is to measure loans as a proportion of the sum of grant and reserves. Most loan agreements that use this definition set a maximum gearing level of between 60% and 80%.

Sector level gearing measured using loans as a proportion of the sum of grant and reserves was 86.1% in 2011 and 90.1 in 2010. For traditional housing associations the ratio is 62.1%; for stock transfer providers, it is 320.9%.

Loans Since 2008

Bank lending is still fragile as a result of the recession. However, nothing has fundamentally changed in the housing association sector. There is still government support, regulation and robust cash flows; and banks have not made losses in the sector. However, this has not stopped banks from leaving and re-entering the housing association market. Those banks that remain in the market though have increased their margins and are looking to renegotiate loans.

Key lenders, such as Natwest and the Royal Bank of Scotland, have stayed in the market. The Royal Bank of Scotland, for example, lent housing associations £700million even during 2008/09. However, the problem that the banks have with housing association loans is the rate of interest. Most housing association loans are at rates of interest only 0.4% about the London Interbank Offer Rate whereas banks are now looking to charge interest at about 1.5% above this rate. This is still below the level of interest on most commercial loans. This is having an effect on the ability of housing associations to afford loans for developments and improvements.

Banks are looking to move from long-term loans to short-term loans. Banks will generally now only lend for a five or ten year term and insist on re-pricing options even when they are willing to lend for a longer term. Most housing association loans are currently long-term. However, large housing associations with large debt portfolios can cope with shorter term loans. For example, the Royal Bank of Scotland recently made a three year loan to a large London housing association. This method of financing is especially problematic for stock transfer associations as they are looking for a large loan to fund a long-term project.

During 2010/11 new loan facilities were lower than during previous years as financing conditions continued to be difficult. The number of lenders has reduced and active banks are enforcing lending caps – the maximum loan they will provide for new facilities – and restricting further lending to existing borrowers.

The Tenant Services Authority estimated that over the period 2012-16 housing associations will need around £8billion to fund development through the affordable housing programme. Refinancing facilities of at least £3billion and financing of £1billion for stock transfers will also be required. The total requirement will therefore be about £12billion.

In March 2011 the average length of time that providers estimated their facilities would fund their businesses was 11.4 years. Excluding stock transfer associations this figure came down to 6.4 years. Nine of those providers had funding of less than twelve months, exposing them to greater financing risk than the Tenant Services Authority regards as prudent.

In assessing the credit worthiness of a housing association, a bank will pay particular attention to governance. The nature of the Board and Executive team play a big part in the bank's analysis of a housing association. This affects the credit rating and the price. The quality and robustness of the business plan and its assumptions and sensitivities are also factors; as are the quality of financial information and the condition of the stock.

Banks are reluctant to lend for shared ownership mortgages as there is insufficient volume. It is considered that a large market is needed to justify a product.

In March 2012, Mark Webster, Head of Housing Finance at Nationwide Building Society wrote in the Global Accounts of Housing Providers published by the Tenant Services Authority that:

"Nationwide has a long history of being a leading funder of affordable housing and has committed over £9.5billion to the sector. We will look to lend some additional funding to our customers and provide deposit accounts as part of developing broader and sustainable relationships.

"The funding of associations will remain the same for the foreseeable future: low levels of grant with short term bank facilities and most of the long term funding provided by the capital markets.

"Existing lenders will probably continue to lend but will be dependent on securitization and renegotiating existing loan margins to make further lending sustainable. Higher capital and liquidity costs and the need to de-leverage balance sheets will reduce lending appetites.

"Despite changes, the overall low risk profile of this regulated sector and the relative attractiveness of the UK means there is potential for strong associations to generate diverse funding sources.

"Continuing public sector funding constraints means the biggest challenge is to generate and acquire sufficient capital to develop more homes with rents that are affordable. Gearing can only rise so far.

"Less predictable cash flows will arise from Welfare Reform, Affordable Rents and Supporting People. IFRS changes threaten to create P&L volatility whilst increased borrowing costs, pension fund deficits and refinance risks arising from short term funding will all challenge associations.

"Associations require strong governance and risk management with Boards and managers having the appropriate skills and expertise.

"Identifying the right balance between growth and services to tenants, whilst not creating undue risk is fundamental. Exploring whether objectives can be achieved without owning more housing stock should be considered.

"Associations need to be innovative and collaborative, managing their assets, resources and structures with greater efficiency; scale must deliver results. They need to seek new funding partners, but also work with their current lenders to achieve ongoing support."

Whereas in the past it was common for housing associations to take out 25 year loans, most banks are currently offering loans with a maximum term of five years. However, in February 2013, the Yorkshire Building Society became the first bank since 2011 to offer housing associations ten year loans of between £5million and £50million. It plans to increase its lending to the sector from £100million to £1billion. John Inglesfield, Head of social Housing at the building society was quoted in 'Inside Housing' as saying:

"We are a mutual and we feel comfortable working for not for profits… Our main membership base is about helping people purchase homes and we see this as a natural extension."

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There was a reduced level of new loan facilities in 2010/11. From April to June 2011 Banks provided only 11% of finance for housing associations. 89% was provided through bond issues. Nine providers have funding in place for less than twelve months. In June 2012 Banks ceased providing long-term loans to stock transfer associations. In July 2012 Legal & General entered the market offering long-term fixed rate loans. In September 2012 Lloyds and Royal Bank of Scotland offered cheaper loans to housing associations as part of government initiative for small businesses (funding for lending scheme) and in January 2013 Clydesdale Bank and Yorkshire Bank pulled out of Housing Association market.

In September 2012 the Government announced a £10billion loan guarantee programme of which £2.5billion is for affordable homes. Housing Associations are to be able to borrow at lower rates of interest because of government guarantees (including bonds). It is estimated that 15,000 new affordable homes could be delivered but there is uncertainty about how the scheme will operate (see section on housing and growth).

The Housing Finance Corporation is an independent, specialist, not-for-profit organisation that makes loans to Registered Social Landlords. It funds itself through the issue of bonds to private investors and by borrowing from banks. It therefore acts as an aggregating financial intermediary, so diversifying risk for those who make funds available to them and reducing the cost and standardising the loan terms for those Registered Social Landlords that borrow from them.

Interest Rates

The sector holds a third of its debt at floating rates and two thirds at fixed rates. This means that the sector has not been able to take full advantage of the low interest rates currently available on short-term loans. Effective interest rates reduced from 5.1% to 5.0% from 2010 to 2011 despite London Interbank Interest Rates being about 1%. There are some associations that are increasing their floating debt but most are reluctant to do this as they expect rates of interest to increase in 2014 or 2015.

The banks have also been increasing the margins above London Interbank Interest Rates at which they lend. Loan margins have traditionally been low but have now been increased significantly. This has affected both new and renegotiated debt. Banks are looking closely at how housing associations observe their covenants as any breach of a covenant would enable the bank to increase its margins on the loan.

Credit Ratings

In February 2013, rating agency Moody's downgraded the credit ratings for almost all English housing associations, citing a 'weaker regulatory framework' among its reasons for the decision. It did so less than 24 hours after UK sovereign debt lost its AAA rating.

While the loss of the top rating was a catalyst for a review of the sector's credit worthiness, the one-notch downgrade has also come about because of 'a reassessment of the potential provision of extraordinary support' for housing associations.

A note sent to rated landlords also referenced the continuing uncertainty over the future of Cosmopolitan Housing Group as a reason for downgrading issuers. The note said the downgrade 'largely reflects a somewhat weaker regulatory framework, particularly in light of an evolving situation concerning a housing association in financial distress'.

Moody's will continue to monitor the situation and did not rule out further downgrades for the sector as the impact on balance sheets of welfare reform begins to be seen in the coming months. It also said that 'further weakening of the UK government's credit profile' could have a knock-on effect on the sector.

Until the downgrade, Moody's had given eleven housing associations its third-highest Aa2 rating. These included Affinity Sutton, London & Quadrant, Midland Heart and Sanctuary. A further thirteen providers had the fourth best Aa3 rating, while Genesis Housing Association and B3 Living had an A1 rating – the fifth highest.

One housing association chief executive, who wished to remain anonymous, was quoted in 'Inside Housing' as saying:

"It is unclear how investors will react to this as perhaps they have already taken the perceived risks of landlords into account when investing. The United Kingdom downgrade is the trigger for this, but the bigger concern is what Moody's thinks in terms of regulatory weakness at the Homes and Communities Agency. This is a big concern as it shows there is a real worry that an association could go bust and that investors could lose money.

"Some associations have been very risk averse and stuck to the knitting, but we are not all in the same position. Some… have been more adventurous. I'm sure we'll now see a wider range of bond pricing for housing associations as a result."

Future Loans

Housing Associations' Borrowing requirements for 2012-16 are estimated to total £12billion, including £8billion for development, £3billion fort re-financing and £1billion for stock transfers. Mark Webster, Head of Housing Finance at Nationwide Building Society said:

"The funding of associations will remain the same for the foreseeable future: low levels of grant with short term bank facilities and most of the long term funding provided by the capital markets… Existing lenders will probably continue to lend but will be dependent on securitisation and renegotiating existing loan margins to make further lending sustainable. Higher capital and liquidity costs and the need to de-leverage balance sheets will reduce lending appetites."

Partnerships and Regeneration

London & Quadrant Housing Association announced in January 2013 that it would set up a £100million fund in partnership with smaller housing associations that would enable them to build new homes. The intention is for ten small association to contribute £1million each, London & Quadrant to contribute £10million and for £80million to be borrowed based on London & Quadrant's net assets. It is calculated that the fund could finance 400 homes that would be developed by London & Quadrant's investment arm – the London & Quadrant Foundation. On completion the homes would be sold or transferred to the partner associations.

Regeneration schemes have been affected by the difficulties that Housing Associations face in accessing loans on appropriate terms. For example, in early 2012, the Metropolitan Housing Partnership was unable to secure an appropriate refinancing deal for its regeneration scheme at Clapham Park. This is a £416million scheme carried out in partnership with Clapham Park Homes and Lambeth Borough Council. In July 2012 the Homes & Communities Agency expressed concern about the association's reliance on market sales to make the scheme viable. Lenders agreed and the association was unable to raise appropriate finance.

However, in February 2013 the association was able to reach an agreement with Barclays and Lloyds Banks to borrow £117million after redrafting the business plan and injecting £61million of their own money into the project - £51million as a loan to Clapham Homes and £10million as a loan to the Clapham Park Development vehicle.

The scheme is designed to provide 1,272 open market homes, 361 new homes for social and affordable rent, 59 homes for shared ownership and 704 refurbishments of existing homes.

Diversification of Borrowing

Standard and Poor, the credit ratings agency, had said that it expected Housing Associations to make more use of capital market funding. It said:

"High demand means the sector as a whole is borrowing more from private funding sources… Furthermore, as Housing Associations grow through merger and organic growth, diversifying funding sources to include capital market funding would seem the most logical avenue for the largest Housing Association borrowers".

As funding requirements increase it is considered inevitable that Housing Associations will seek to diversify their sources of borrowing.

It is considered that banks may be reaching the limits of what they are prepared to lend to Housing Associations. Consequently, it is expected that in future Housing Associations will make greater use of the capital markets. Conventionally, Housing Associations have approached capital markets by making bond issues. However, other methods are potentially available including:

- Private placements
- Corporate Paper
- Real Estate Investment Trusts
- Stock Market Flotation

Bonds

During 2010/11, providers have continued to use the bond market for financing. Six bond issues were completed during the year, totalling around £940million, compared to five issues totalling nearly £990million in 2010. The issuers were: Notting Hill, Hyde, Sanctuary, Circle Anglia, Peabody and The Housing Finance Corporation. Further bonds have been issued during 2011/12.

During October to December 2012, housing associations arranged £1.2billion of new facilities of which 84% came from bond financing.

In March 2012 London & Quadrant issued £250million of bonds at 4.62% interest. In May 2012 Saxon Weald Housing Association launched a £225million bond issue to replace its bank debt. In September 2012 the Government announced that it will guarantee housing association bonds and encourage the Housing Finance Corporation to act as an aggregator so smaller associations can issue bonds. In September 2012, the Housing Finance Corporation issued a £127million bond at 4.99%.

In October 2012 Affinity Sutton issued £250million of bonds at 4.25% interest. In November 2012 WM Housing Group issued £200million in bonds through WM Treasury plc to be used for debt repayment and new development by Whitefriars Housing Association.

In December 2012 Notting Hill Housing Trust issued £250million of bonds at 3.78% interest - the cheapest ever own name housing association bond. In February 2013 GB Social Housing, a bond aggregator, issued £85million of bonds on behalf of three housing associations: North Hertfordshire Homes, Paradigm Housing and Teign Housing. The rate of interest was 5.19%, 1.99% above gilts. At the same time B3 Living raised £68million through a secured bond issue at 4.82%.

Private Placement

A Private Placement is similar to a bond, but offered to a select group of investors. Such arrangements can bring in new investors and spread risk but the terms can be more restrictive than a bank loan and harder to negotiate. Sanctuary Housing Association took out private placements during the 1990s totalling £90million. Metropolitan Housing Association took out private placements more recently with some investors coming from outside the United Kingdom.

Commercial Paper

Commercial Paper programmes are often used for short-term debt by commercial companies. They are at lower margins than bank loans, are unsecured, need a good credit rating and are used for borrowing of less than a year. The Housing Finance Corporation has a £300million commercial paper programme and on-lends the money to Housing Associations. It is understood that Affinity Sutton is also considering a commercial paper programme.

Real Estate Investment Trusts

Real Estate Investment Trusts were recommended by Ms. Kate Barker in her report on affordable housing as a way of encouraging wider investment in affordable housing. It has been possible to establish them since January 2007.

Real Estate Investment Trusts are for-profit companies that rent properties with tax breaks (especially exemption from corporation tax) and that pay investors a dividend. They have the potential to bring money into Housing Associations from investors who are new to the market. However, homes at market rents would give investors a higher return than social housing. Consequently, attempts are being made to ensure that they are beneficial for shared ownership and refurbishment.

They can borrow funds, buy property and attract investment for potential shareholders. They can also act as refinancing vehicles or as an alternative to the private finance initiative. Under the scheme, Housing Associations sell their properties to the Real Estate Investment Trust thus making a capital gain, while at the same time retaining management of the homes.

To set up a REIT one or more housing associations put properties into it. If they are already tenanted the permission of the Homes & Communities Agency is needed. If there is a loan charge the permission of the lender is needed. It is usually considered that to be cost-effective REITs need to borrow at least £40million to £50million from investors.

The first social housing real estate investment trusts began to operate during 2007. It is understood that 22 Housing Associations have contributed £250million to the project. An investment bank is being invited to join the partnership to help to spread the risk. Further investments are expected after the launch from the initial 22 members and from other Housing Associations.

It is planned to sell shared ownership homes into the real estate investment trust so that they can be covered by the 'tax breaks' on offer.

The Finance Act 2012 changed the REIT regime to make it more attractive – principally by allowing REITs to be registered on AIM or foreign stock exchanges rather than the London exchange and abolishing the 2% tax that used to be paid on the value of transferred assets.

In the summer of 2012, Places for People announced that it was considering setting up a £500million Real Estate Investment Trust for future social and affordable housing, and in February 2013 it announced an intention to launch a trust for private rented sector homes. London & Quadrant uses REITs to deliver off-balance sheet private rented housing and Hyde & Family Mosaic is likely to follow.

Tenants may regard REITs as risky as they are for-profit landlords with tradable shares that could therefore be taken over by new owners. They may therefore be more appropriate for new development or market homes.

Sale and Leaseback

In 2011, Derwent Living entered into a sale and leaseback arrangement with Aviva to purchase 1,000 properties from Home Group for £45million. A further £25million was raised in November 2012.Under the scheme the investors buy the properties and lease them back to the housing association. Investors then receive an inflation-linked return on their investments. The scheme is cheaper than conventional borrowing and as the funding is not secured against assets does not affect the gearing calculation.

The Homes & Communities Agency has expressed concern about financial arrangements that are linked to inflation but are understood to be happy with the arrangements made by Derwent Living. Jonathan Walters, Deputy Director for Operations at the Homes & Communities Agency was quoted in 'Inside Housing' as saying:

"We would want to monitor the level of retail price index exposure that is built into business plans… If the government does something different to rent policy post 2015 then we could end up with the retail price index increasing costs but rent not going up by the retail price index."

European Investment Bank

In December 2012 the Housing Finance Corporation secured a £400million loan from the European Investment Bank that it intends to lend to housing associations in tranches of between £20million and £50million over up to thirty years between then and March 2013. The loans are available for retrofit projects and new development. Interest rates are 1% to 1.5% lower than the bond market. Loans can be drawn down for three years after they are agreed. The previous occasion when the European Investment Bank leant to the Housing Finance Corporation was 2009.

Social Equity Fund

The Social Equity Fund was proposed by London & Quadrant in September 2012. The proposal is to increase rents on 5% of social homes tenanted by better off tenants not on benefits by the rent limit until they reach affordable rent levels (80% of market rents). It is calculated that this would unlock £3.8billion a year to fund 42,500 new homes a year. Furthermore, the conversion of 1% of social homes to shared ownership would unlock a further £1.8billion. London & Quadrant compared the Social Equity Fund with three other models for post-2015 affordable homes programme and found it would deliver 170,000 new homes a year at the lowest cost to the taxpayer

Flotation

In January 2007 'Inside Housing' led with the heading 'Landlord Explores Flotation' and reported that:

"England's largest Housing Association has held talks with the Housing Corporation about floating the company on the stock market. Places for People have sounded the corporation out in a number of informal meetings about the practicalities of becoming a public limited company. The negotiation could herald a fundamental change to the nature of Housing Associations.

"Places for People's talks with the corporation have centred on issuing an initial public offering – selling shares in the company to public investors. The major advantage would be the large sums of money that could be raised."

The idea is that Housing Associations would 'float' on the stock market and raise capital through investors buying equity stakes in the Housing Association. This is not currently allowed within the legislative framework, but that could be changed following the Cave review of social housing regulation.

Zenna Atkins Chairman of Places for People was also quoted in 'Inside Housing' as follows:

"As an innovative organisation 'Places for People' will always explore ways of attracting much needed non government investment to build and sustain the communities of the future. However, to be clear, the group is not currently exploring flotation… and current legislation would preclude it from doing so even if it was deemed a good idea.

"In our response last year to a housing corporation consultation document on investment and regulation, we detailed a range of issues that we thought could be tackled in order to improve the efficiency of the sector.

"One of those options was the status of government grant becoming equity, and on the back of that, the possibility that organisations could raise equity via various means.

"Clearly if one accepts the notion that we need to identify ways of bringing equity finance into organisations in order to allow them to expand and provide more affordable housing, then all options should be considered.

"While the issue of equity investment in social landlords is not a new one… I believe the sector needs to have (a debate) if we are to generate the investment needed to deliver the housing requirements of the future. Everyone accepts that current levels of house building, especially affordable homes, are inadequate. The question is: what can we do to increase output and improve services to existing and future customers? We will be working with the Housing Corporation, Professor Martin Cave and anybody else with an interest in these issues to identify the best set of opportunities for the future."

David Cowans, Chief Executive of Places for People was quoted as saying:

"The only point is how do we get the best number of properties at the best quality… I understand that even if (flotation) were attractive it would be very, very difficult, if not impossible to do at the moment."

The flotation of Housing Associations on the stock exchange would prove controversial, raising questions regarding 'privatisation', the distribution of profits as dividends and the relative influence of tenants and shareholders. Austin Mitchell MP, Chair of the House of Commons Council Housing Group was reported as saying:

"They would be serving a purpose to their shareholders not the tenants and I hope the Housing Corporation says no."

Adrian Waite
Managing Director

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