Elmbridge Borough Council
Implications of Affordable Rent
and Developer Subsidy

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Background

In 2008 / 09 Elmbridge Borough Council had a Viability Study carried out to provide an evidence base to support the Council in developing affordable housing policies for its Core Strategy. This study used a number of assumptions to test the potential impact of planning policies on development viability at a strategic level including the affordable housing funding mechanism and subsidy arrangements (of either social rent or intermediate tenure). These were correct and reflected practice at the time of undertaking and publishing the study but of course could not have foreseen changes to both Government and Government policy.

Since the publication of the study report, and particularly in recent months, a number of changes have occurred with regard to affordable housing not least of which are significant reductions in the amount of public funding available for affordable housing and the introduction of a new affordable tenure known as “Affordable Rent”. This tenure form is expected to become the main element of the product offer from providers for new supply and social rent will only continue to be supported (through funding) in limited circumstances. A local authority may, if they wish, continue to support the provision of social rent through, for example, the provision of free land or other local funding.

The introduction of Affordable Rent means that Registered Providers will be able to charge up to 80% of gross market rents (i.e. inclusive of any service charges) with fixed term tenancies of at least two years. This is in contrast to the existing model of “social rent” whereby rents are at approximately 40% to 50% of market rent levels and long term security of tenure are the norm. The Minister for Decentralisation has published a proposed revision to Planning Policy Statement 3: Housing (PPS3), clarifying that Affordable Rent is considered to fall within the definition of affordable housing for planning purposes however this is currently subject to consultation.

This paper does not go into the practicalities of providing affordable housing as Affordable Rent as the Council will be considering these wider issues as part of determining its overall approach. However, this paper reviews the implications of the Government’s Affordable Rent proposals and confirmed funding arrangements, and any potential impact they may have on the assumptions made and conclusions drawn in the Viability Study. This paper deals only with affordable housing delivered on S106 schemes.
Implications of Affordable Rent

There is an expectation from the Homes and Communities Agency (HCA) that S106 schemes can be delivered at nil grant input for both Affordable Rent and affordable home ownership. It is expected that for Affordable Rent, the homes will be provided for no more than the capitalised value of the net rental stream of the homes. Obviously we are not party to individual Registered Provider’s (RP) financial constraints, financial benchmarking or other assumptions when calculating how much they can afford to pay for an affordable rented unit but the Viability Study was based on exactly the same premise – i.e. nil grant and capitalised value of the net rent – but in this case at social rent levels (40% / 50% of market rents) compared to up to 80% of market rents with Affordable Rent. As the study acknowledged, aside from tenure variation individual RPs will have varying views and approaches – and those may also vary dependent on scheme types and location, timing, etc.

If all other factors were equal, for example the level of risk the RP is willing to be exposed to, other assumptions on payback periods, internal subsidy and yields (returns) remained the same (and lender requirements and rates remained unchanged) then it is likely that we would see an affordable rented unit return a higher “price” than an equivalent social rented unit. On this basis therefore, the Elmbridge Viability Study already looks at what we consider to be the likely the worst case scenario for the level of revenue that an affordable dwelling will contribute to overall scheme finances. A change in tenure (across all affordable housing on the scheme types studied) to affordable rent in place of social rent would be likely to lead only to viability outcomes that were no worse than assumed for that study. In other words, the price a developer would receive for the completed affordable units would be at least no lower than assumed within the viability study, and would probably be higher.

However there are points to consider related to the above: will the funding / risk reward / assumptions and parameters remain the same? There has been anecdotal evidence from and very early stages reactions by RPs to date suggesting that private finance may be harder to arrange or be on less favourable terms given the varying nature of the investment.

Although further time will be needed to assess full reactions to the HCA’s recently issued funding framework, the potential for increased financial risk in affordable rent has also been mentioned anecdotally by RPs. The potential increased risk could ultimately lead to more conservative assumptions when running a detailed financial appraisal to test the price that an RP could pay for an affordable rented unit. This logically leads to a reducing of the likely offer price compared with continuing to apply the same assumptions on such factors. This is because, although 80% of market rent produces a significantly higher value rental stream than the equivalent social rent, it is very possible that RPs (and potentially their funders) will look to measure proposals against shorter target loan payback periods or other altered financial benchmarks when it comes to testing the financial health of a scheme.
Ultimately, whether this reduces the offer price to beneath that assumed for social rent within the viability study is impossible to say definitively, especially given that individual RPs’ and funders criteria will vary. Nevertheless, even after allowing for these different factors associated with varying the nature of the investment and probably the risk profile, it is highly unlikely that the prices paid for affordable rented homes will fall below the equivalent price for a social rented unit at the levels assumed within the viability study where no grant is assumed in either case.

The form of tenure cannot be separated from the grant assumption so the relative starting point is crucial here. The nil grant base assumption as applied as the key basis in the Viability Study remains appropriate and in fact the recent developments have reinforced the relevance of that as a starting point.

Overall, we are forming an initial view that on comparison with social rent on a consistent no-grant basis, outcomes are very likely to be no less favourable for overall scheme viability, and could also be better.

In fact, recent discussions between the Council and one of their developing RP partners has suggested that, affordable rent could lead to improved viability.

In our opinion the Council’s policies in terms of the proportion of affordable housing sought overall and the thresholds to which the policies will apply are likely to remain robust (although of course viability will still need to be seen in a site specific context with policy applied flexibly and with the Council willing to negotiate where it is shown that scheme viability is compromised – as would have applied in any event). The Council’s policies also rightly establish a reasonable balance between the opposing tensions of affordable housing need and continued development viability. They also have the potential to create a more equitable approach to affordable housing provision on market sites through the lowering of the thresholds at which polices apply.

As discussed above, it is unlikely that the price paid for affordable rented units will be any lower than what the study has assumed (for social rent) - as both approaches assume nil grant and capitalised net rental stream approach. Therefore the conclusions and recommendations of the viability study would remain valid. In fact it is possible that viability would end up being improved from the position assumed within the viability study if it is shown that the capitalised net rental stream of an affordable rented product produces a higher value than for an equivalent social rented unit (both without grant). However we would not recommend higher targets, even in the event of this turning out to be a regular reality.

It appears that the Council are right to defer detail of affordable tenure to SPD. The type of affordable housing required across Elmbridge is the subject of the Strategic Housing Market Assessments carried out and updated periodically. The introduction of Affordable Rent cannot have been factored into those SHMAs and therefore it is assumed that the Council
will need to review local needs levels based on a new affordable rent model alongside existing models for affordable housing and the local relevance / demand / need.

The consequence of the Council’s proposal in the short term is that by referring to the most up to date SHMA (prior to the production of a new or updated version or ultimately the SPD) that the reference will still be to social rented properties. The Council would need to consider how that would work if Affordable Rented homes are to be provided on S106 sites? The latest SHMA is nearly 4 years old and suggests a requirement of between 75% and 50% social rented housing with obviously no reference to Affordable Rent. We note that the Council is considering preparing an addendum to the SHMA which will apply in the interim.
Developer Subsidy

The document recently published by the Homes and Communities Agency (HCA) – 2011-15 Affordable Homes Programme – Framework confirms that the assumption for the price paid for Affordable Rent units will be no more than the capitalised value of the net rental stream. There is a potential issue here in that the requirement for a developer to provide free land (as currently specified within the supporting text to Policy CS21) when related to “social rent” may not provide as much developer subsidy as received through limiting RP payments to the capitalised net rental stream principle. A good example is a recent discussion had with one large RP where they stated:

“Having appraised recent schemes on the basis of "nil grant", the out-turn price amounts to around 35-38% of Open Market Value. With the price generated being so low, we are not able to pay out land prices, only build costs - and even then they are quite a bit lower than the rates the developer procures with their contractors meaning we can only afford to pay less than cost; in effect the developer is subsidising our build as well. Landowners may have to revise their expectations about what their land is really worth?”

The Viability Study approach was to assume that the amount paid by the RP for completed affordable housing units for social rent reflected the capitalised net rental stream approach with nil grant as above. There is a potential difference between a free land approach and a capitalised net rental stream approach generally. As the example indication from the RP as above shows, actually without grant they cannot afford to cover the build costs and so to enable them to do that under a free land approach would also require some form of public subsidy as a top-up. As HCA funding is (likely to be) precluded from S106 sites either for affordable rent or social rent then it means the free land approach would only work with internal or other funding added (e.g. Council funding). It seems that this may be contrary to the HCA Framework which states that the expectation is that the price paid for affordable rented units will reflect the capitalised net rental stream approach. It remains to be seen how this will be interpreted and applied, and will pan out generally.

If, however, the financial benchmarks and views taken by RPs / financiers etc mean that affordable rent can produce higher prices than social rent (as expected) and these are not too heavily off-set or even out-weighed by the potential appraisal downsides associated with varying risk assessments etc (all as above) then there is the possibility that build costs may be met through this route.

From a more practical point of view, whilst the reference to funding structures within the box below the policy was intended to provide clarity, in order for the Council to give sufficient consideration to recent changes and their implications, it is suggested that reference to this is removed and instead make reference to this being dealt with in the SPD.
This also fits well with the proposal to remove reference to a specific tenure mix target as discussed above.

In reality, affordable funding scenarios / availability / mechanisms etc will no doubt vary over the life of the Core Strategy – perhaps several times even. Guidance will very likely fit better with the follow-on layers that will explain the detail of the approach in practice (and will be the subject of more targeted / appropriate consultation that can deal with the detail implementation aspects) via SPD or similar.

Affordable Rent & Developer Subsidy Paper ends.
7th March 2011.