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FINAL REPORT
Living Rents – a new development framework for Affordable Housing

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JRF JOSEPH ROWNTREE FOUNDATION

NATIONAL HOUSING FEDERATION

savills

Foreword

We have a housing crisis.

At its heart is the reality that we haven't built enough of the right homes, at the right price and in the right places for a generation or more.

The labour market has also changed. It is not just that more than half of people experiencing poverty now live in working households. It's also that many people move between low-pay and no-pay in a highly volatile labour market. The evidence tells us that this fundamental shift in the labour market is here to stay.

While everyone feels the pressure of rising housing costs, the poorest bear the biggest brunt of these changes with an extra 3.1million people finding themselves in poverty once their housing costs are paid.

Social housing has traditionally helped to reduce the impact of poverty on people's lives, providing a secure foundation for people to build their lives and achieve their economic potential. Recent research underlines the importance of rent levels being set close to social rents to help people escape benefit dependence in areas of high housing costs.

However, current policy links 'affordable rents' to a dysfunctional housing market that those on low and insecure incomes cannot afford to access. Deepening the poverty trap.

Poverty is real, but it is not inevitable. Our organisations came together to challenge this status quo and to develop a sustainable model to reconnect rents with incomes, to deliver the genuinely affordable homes we need to tackle the housing crisis.

Here, we set out that model - a bold yet practical approach that we call the Living Rent.

Developed in consultation with the housing associations and local authorities who will provide it, and with the engagement of developers and lenders, the Living Rent model can deliver thousands of new homes at rents linked to local incomes. It is a long-term, sustainable model that responds to our dynamic labour market.

We believe it is a compelling offer. But to make it a reality, we need the right level of investment from government, with active enabling at the local level and action to unlock the potential of England's housing providers.

If these elements are in place, housing providers stand ready to become Living Rent Landlords, delivering housing that is truly affordable to those on low incomes. It is part of the shift we need to tackle poverty and a crucial element of the long term plan we need to end the housing crisis for the next generation.

David Orr, NHF
Julia Unwin, JRF

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Executive Summary

Unless more homes are built that people can afford, poverty rates in England are likely to rise significantly and the relationship between poverty and housing deprivation will become stronger.

This research looks at how building homes at rents designed for low-income households might address this situation, at the same time as providing wider economic benefits. The research focuses on:

- Building more homes that are genuinely affordable for those that cannot access the housing market
- Re-establishing the crucial links between housing and the labour market and between rents and the ability of people on low incomes to afford them.

A changing society

As a nation we are not building enough new homes. As a result, the costs of housing in England for its occupants are escalating. The face of poverty is also changing. More than half of people in poverty now live in working households. In many instances this involves a 'low pay/no pay' cycle of insecure employment, little in terms of real wage rises in recent years and a fall in real terms in the value of in-work benefits.

As a result, an increasing proportion of the population now has to meet higher housing costs, with lower relative incomes. Some 1.3 million households on low or middle incomes are spending more than 35% of their income on housing costs.

When this is seen alongside the reduction in available social housing for people in poverty, the number of decent housing options that they can afford is decreasing. Many have to rely on the expanding private rented sector, with its short tenancies, higher rents and use of existing homes rather than new, additional properties. Moreover, private sector rents are forecast to rise by more than 20% over the next five years.

The old presumptions of housing and labour market progression and stability no longer apply. As a result England needs a larger supply of genuinely affordable homes to help people manage in a more flexible, less secure labour market.

The benefits of low-cost rented housing

One of the key benefits of social housing – the main tenure of housing support for people on low incomes – is that, with its secure tenancies and lower rents, it acts as a platform for those on low incomes to build their lives. It is a potential 'stepping stone' out of poverty and a buffer for people whose life circumstances change.

It is vital that these benefits are maintained and expanded to help meet the housing and economic needs of a changing society.

Improving affordability: Living Rents

This report contends that the focus on affordability has been, to a large extent, lost from the current low-rent housing supply system and rent setting policies. A key piece of research for this project was therefore to develop a mechanism to re-establish the crucial links between:

- Housing and the labour market and
- Rents and the ability of people on low incomes to afford them

This has developed a rent-setting mechanism that links rents to the earnings of households in poverty. The rents arising from this mechanism we call 'Living Rents'.

In most areas of England, Living Rents are considerably lower than Affordable Rents - which link rent levels to a maximum of 80% of market rents. As Living Rents are set relative to local earnings this difference highlights the fact that in many areas Affordable Rents are beyond the budget of households on low wages.

When compared to social rents - the main rent for existing social housing tenants - Living Rents deliver a larger rent differential between property sizes and a range of variations depending on location.

For individual landlords, the financial impact of adopting Living Rents would depend very much on the level of earnings in the communities in which they work, the range of sizes of properties in their portfolio and some of the asset management decisions they make about their stock. An approach involving Living Rents being applied to relet properties and new homes developed with government support would, while not being without its challenges, allow landlords to plan a move to charging Living Rents.

A move to Living Rents would produce three big opportunities:

- Adopting Living Rents rather than Affordable Rents would give a long-term, annual saving to the housing benefit bill and improve affordability for tenants
- Building more homes let at Living Rents offers the potential to reduce the dependence of low-income households on the higher rents in the private rented sector
- Living Rents would provide a stable base for working households to access a dynamic labour market, as well as security for those who are unable to participate in the jobs market

Living Rents are designed to be a modern, flexible response to the need to provide housing that is affordable to people on low earnings.

Developing new homes

It is crucial that significantly more new homes are built in England. In doing so, it is vital that policy focuses, not just on the numbers of houses provided, but on their affordability and tenure. Public investment needs to ensure better housing options are provided for those who experience serious problems of access to and affordability of decent housing.

Organisations that develop new homes for people on low incomes are deterred from building more properties by low levels of government subsidy, which rapidly reduce their capacity to develop new homes, and by the relatively high rent levels required to access such subsidies. These Affordable Rents are often unsuitable for households in poverty and create barriers to their entering the labour market.

There are four key foundations to developing an approach to ensure more homes are built that can be let at lower rents and which responds to the current and future needs of society:

Being clear about the number of homes required

If we are to meet the housing needs of those who cannot access the housing market, then 80,000 sub-market cost homes should be built each year. Letting 40,000 of these homes at Living Rents would be a significant step in helping meet the needs of households on the lowest incomes.

The right level of government investment

Producing the 80,000 homes mentioned above would require sustained government investment of around £3 billion per annum. This investment in housing let or sold at sub-market levels would double the number of homes produced and significantly improve the affordability of rented homes, which in the long term, would reduce the housing benefit bill.

Maximising the full capacity of social landlords

Investment through capital subsidy at the right level is crucial to providing more homes. By enabling housing providers to leverage their asset base, raising debt at rates that supports long-term construction, they would be able to build new homes at rents which people can afford at predictable and continuous levels. There are a range of other ways in which the government supports delivery and helps social landlords maximise their development capacity - access to low-cost debt, access to free or discounted land, use of the planning system, etc. – which can supplement capital subsidy.

It is important to note that if the government provides £3 billion of investment housing associations and local authorities would still be meeting at least 70% of the cost of building these additional homes from their own resources.

Political leadership

There is a clear role for central and local government to create the vision and provide the leadership and strategy to deliver new approaches that aim to make sure everyone is adequately housed. The ability of local authorities to be more proactive would be helped if they were given enhanced powers in terms of the ability to borrow against their resource base, land assembly and compulsory purchase orders. It would also be beneficial if local authorities were encouraged to focus more clearly on ensuring housing affordability through the planning process.

Housing investment works for the economy

The construction of housing to be let at sub-market rents is a key component of public infrastructure investment, particularly at a time when low interest rates mean the cost of debt is relatively cheap. It has crucial advantages in terms of:

- Improving housing affordability and boosting incentives to enter the labour market
- Increasing housing supply
- Levering in and further stretching private investment to build homes
- Providing better value in the long run for tax payers' money than spending on housing benefit
- Increasing resilience to a drop in household income by ensuring people have a secure home at an affordable price

The introduction of Universal Credit (UC) means the benefit 'taper' – the extent to which benefits are withdrawn as income rises – is less steep but it extends further up the income scale, affecting more people. This increases the risk of more people being disinclined to seek to increase their earnings. Lower rents would mean more people could avoid relying on benefits and being trapped by such work disincentives.

Moreover providing a consistent level of new housing supply helps reduce the peaks and troughs in the volatile English housing market - this is good for construction supply chains, particularly small businesses.

A Living Rent framework

Living Rents are not intended as an obligatory, formulaic approach to rent setting. Rather they could be used to help develop a more sophisticated and flexible way for landlords to develop their approaches to housing affordability in their local markets.

Given the very different circumstances that prevail in individual landlords' localities, housing providers should be encouraged and given the flexibility to develop their own robust rent-setting policies, based on assessing affordability at a local level.

Living Rents offer a number of advantages for landlords, not least because they would help them deliver a genuinely affordable offer for their tenants. Living Rents would be a valuable mechanism to inform the way social landlords set rents for low-income households. They could develop their own approaches, or adopt Living Rents, to provide an affordable option for those in poverty, at a local level, as well as providing other homes at a range of rents to meet different housing needs.

A landlord's current rent income would act as a ceiling within which it determines its rent-setting policies. This 'rent envelope' would be increased by a maximum of the Consumer Price Index (CPI) plus 1% each year, in line with the current rent settlement.

For those in poverty, a Living Rent framework would significantly help address the shortage of affordable, decent housing. Linking rents to local incomes would tackle the current housing affordability gap, while the provision of high-quality and stable housing would ensure that tenants can thrive, whatever their employment circumstances.

Such a Living Rent framework could be part of a more coherent strategy on renting in England. It could be a crucial part of a comprehensive, long-term plan to build the homes we need, in the right places and avoid locking low-income households out of affordable homes.

1. The market background

Housing is a basic need and also, for many households, their biggest expense. On average, the poorest households spend more than a quarter of their income on housing[1], so the cost of housing can be a major influence on poverty. Renters are particularly affected as they are three times more likely to be experiencing poverty[2]. The face of poverty is also changing with more than half of people experiencing poverty now living in working households[3].

The basic proposition of this report is that, as a nation, we must commit to provide decent, affordable homes for all citizens - including low-income households. This is critical to the social fabric and economic success of England – which this report principally addresses – and the UK as a whole.

This research looks at how we might deliver more effective housing responses to people on low incomes, focusing particularly on:

- Building more homes that are genuinely affordable for those that cannot access the housing market
- Re-establishing the crucial link between housing and the labour market and between rents and the ability of people on low incomes to afford them

Four key trends

1: A changing housing market

The table below shows the changes that have taken place in housing tenure at the household level since the onset of the recession in 2007 and the projection from Savills of tenure development over the next five years:

Year	2007	2014	2019
Homeownership	15.1 million 69%	13.9 million 62%	13.8 million 59%
Private renting	3.2 million 14%	4.6 million 18%	5.7 million 25%
Social renting	3.9 million 18 %	3.9 million 17%	3.8 million 16%
Total	22 million	22.4 million	23.3 million

While homeownership is set to decline further, the private rented sector (PRS) is expected to have almost doubled between 2007 and 2019. The latter point is reinforced by figures from the most recent English Housing Survey[4], which show the increase in private renting between 2012/2013 and 2013/14 was 10.6 per cent or 421,0000 households.

This coincides with a period when we are also starting to see changes in the social rented stock. In recent years up to 2011/12, there were reasonable net increases in social rented stock. However, following the 60% reduction in 2010 in investment in new social housing in England, combined with increased right to buy incentives and the introduction of the higher Affordable Rent regime, social rented stock is now beginning to reduce. In the year ending April 2013, the stock of social rented homes in England fell by 19,189 dwellings. The fall in the year to April 2014 was more than twice this, at 43,850 homes.

The 10 years between 2001/02 and 2011/12 have also seen important shifts in poverty for renting households. In 2001/02 the number of social renters in poverty was 2.5 million - higher than any other tenure. By 2011/12 however there were almost as many private renters in poverty as social renters.[5]

[1] Abigail Davis et al: a minimum income standard for the UK in 2014. JRF 2014

[2] MacInnes, T.et al. (2013) Monitoring poverty and social exclusion 2014 York: JRF

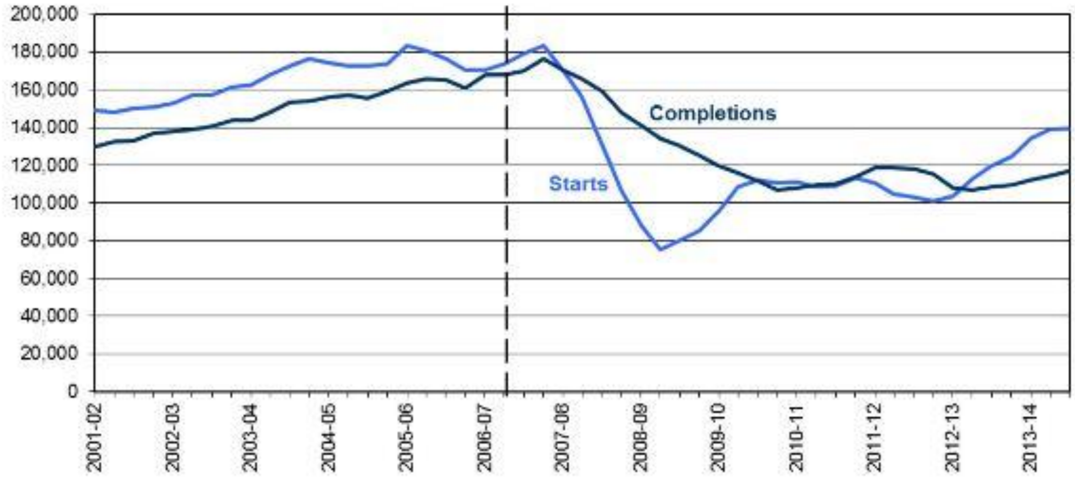
[3] ibid

[4] DCLG: English Housing Survey 2013-14. February 2015

[5] MacInnes, et al (2013) Monitoring poverty and social exclusion 2014 York: JRF

2: Not enough new homes

It is generally acknowledged that the present rate of house building in England is too low to meet existing and anticipated demand. As can be seen from the graph below these numbers are substantially lower than the 232,000 extra homes per year which the 2010/11 government strategy statement *Laying the foundations* said were needed (see graph of supply across all tenures in the past decade). This in itself was a lower estimate than that of Alan Holmans[6] of the University of Cambridge's Centre for Housing and Planning Research, who estimated in 2013 that England needs 240,000–245,000 new homes each year, around 80,000 of which should be social housing.



Source: DCL G housing statistical release. December 2014

One difficulty here is that the part of the market that is increasing, the PRS, is principally growing on the basis of the conversion of existing properties from other tenures, rather than new building. An expanded, professional, purpose-built PRS sector could make a valuable contribution to UK housing supply and sit alongside the supply programme proposed in this report.

3: A changed labour market

In recent months, real wages have begun to grow, as the rate of inflation has fallen and nominal wages have increased. As a result, the Office for Budget Responsibility is now forecasting that "we expect real earnings growth to rise in the near term… and over the medium term as productivity growth returns to more normal levels. This implies that the real consumption wage will not rise above its pre-crisis peak in the third quarter of 2007 until the end of 2018"[7]..

Yet this relatively positive news follows a four-year period where real wages fell - the longest sustained period since at least 1964[8].

In addition, even with a return to sustained average real earnings growth, those at the bottom of the earnings league may not see the same benefits in terms of rising wages. The OBR says that "growth in wages and salaries has not been spread evenly across the income distribution" and a recent report has found that "wages in low-pay occupations do not vary as much as the cost of living in cities…meaning that rates of 'real' pay for low-wage workers are lower in some of the UK's most economically buoyant cities"[9].

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[6] Interim Revised Estimates of Future Demand and Need in England in 2006 – 2026 with 2008-Based Demography CCHPR 2012 and New estimates of housing demand and need in England, 2011 to 2031 TCPA 2013

[7] Economic and fiscal outlook Office of Budget Responsibility, March 2015

[8] An Examination of Falling Real Wages, 2010 – 2013. ONS 2014

[9] Clayton et al: Unequal opportunity: how jobs are changing in cities: Centre for Cities. 2014

John Philpott, wrote in December 2014: "In a labour market still oversupplied with people desperate for whatever work is on offer, employers unable or unwilling to improve working conditions will continue to have no difficulty in hiring staff to minimum-wage jobs or on zero hours contracts. This will serve to further widen what has become a clear structural "workforce divide" within the UK's flexible and lightly regulated labour market."

This raises the concern that the jobs market may have permanently changed with low pay and insecurity an ongoing feature of the working lives of those at the bottom. The statistics in the box below further illustrate this point.

1.4 million adults are in part-time work, as they can't find full-time work[10]

In 2013 26% of female and 16% of male employees were paid below the living wage[11]

Opportunities for people to progress from low-paid work are increasingly difficult. Only one in five people have escaped low-paid work after 10 years[12]

The ONS estimates that 697,000 people were employed on zero hours contracts in their main job in 2014 - 2.3% of the workforce

Half of the 13 million people in poverty live in a working family.

Those on the lowest incomes have also lost out as a result of changes in direct taxes, tax credits and benefits over the last four years. A recent report has shown that "the poorest twentieth lost nearly 3% of their incomes on average (not allowing for VAT and other indirect taxes) and the next five twentieths lost approaching 2%".[13]

[10] MacInnes, T. et al (2013) Monitoring poverty and social exclusion 2014 York

[11] MacInnes, T. et al (2013) Monitoring poverty and social exclusion 2014 York

[12] ibid

[13] John Hills: The Coalition's Record on Cash Transfers, Poverty and Inequality 2010-2015. CASE/LSE 2015

4: Rising rents

Although wage rates have been low in recent years, rents have generally risen more rapidly:

- Local authority rents have risen by 4.6% a year on average from 2007/8 to 2013/14 and housing association rents by 4%[14]
- Private Rented Sector (PRS) rents appear to have been increasing by around 2% a year on average since 2007[15].

Moreover, rents are expected to continue to rise. Savills forecasts that PRS rents will rise by 20.5% over the next five years, saying:

"Our forecast for rental growth in the mainstream market over the next five years is a little ahead of expected wage growth, as tenants either pay more of their income to secure properties in locations with good amenities and transport links, or make greater use of sharing to maximise individual budgets"[16].

Social housing rents are also set to rise on the basis of a government formula that allows rents to rise faster than inflation. In addition, an increasing number of properties are moving to Affordable Rents, which are set at up to 80% of the market rent level, but still allocated to low-income households.

What these trends show

An increasing proportion of the population must now meet higher housing costs with lower relative income. Some 1.3 million households on low or middle incomes are spending more than 35% of their income on housing costs.[17]

The Social Mobility and Child Poverty Commission[18] says "the effect of high housing costs on living standards must be addressed, because over the period 2010-15 housing costs have pulled extra families with 1.4 million children into relative poverty".

Rising rents put particular financial pressures on tenants in low-paid work. Many of these tenants are in a 'low pay/no pay' cycle of insecure employment and are seeing the value of in-work benefits fall in real terms.

This also creates a significant disconnect between government welfare and housing policy. Welfare reform sees cutting the benefits bill, including that for housing benefit, as a major objective. Yet at the same time rent rises and policies such as Affordable Rent are increasing the benefits bill.

The financial return on providing homes for those on low incomes is not sufficient to incentivise the market to increase the supply of such properties, without additional financial support. At its simplest this requires either reducing the cost of housing or increasing the income available to allow people to pay for housing at market rates. The main focus of government policy in England is currently on supporting rents through state benefits rather than reducing the cost of housing through capital grants. Indeed it is important to recognise that the introduction of the Affordable Rent regime represents a shift in government policy from capital support for new homes to one where higher rents are expected to provide more income for new supply.

[14] UKHR. CIH 2015

[15] Robust rents data on PRS rents over longer periods is not readily available. However looking at three indices which do provide figures does give an indication of the rises over time. The LSL Property Service index shows average rental growth of 2.9% per annum across England and Wales between December 2010 and October 2014.The (reweighted) IPD index shows average rental growth of 1.7% per annum across the UK between 2000 and 2013. The ONS Index of Private Housing Rental Prices puts the annual rent inflation rate in England from January 2011 to December 2014 at 2.1%.

[16] Spotlight: Prime Rental Markets: Savills 2015

[17] Home truths. NHF 2014

[18] State of the Nation 2014: Social Mobility and Child Poverty in Great Britain (2014): The Social Mobility & Child Poverty Commission

What if these trends continue?

A recent study for JRF[19] took existing trends in housing and poverty between 1991 and 2008 and projected how these will change up to 2040. This found that:

- Homeownership will decline further
- Social renting will decline to house only a tenth of the population
- Private renting will grow to house a fifth of the population
- Compared to 2008, private rents will rise by 90 per cent – more than twice as fast as incomes

The conclusion from this work is that poverty is likely to rise by 2.6%, meaning 5.46 million poor households by 2040, with the relationship between housing and deprivation becoming even stronger. The report also predicts significantly more poorer people being housed in the private rented sector, where rents are already higher on average than social rented housing and expected to rise significantly (see table).

People in poverty:	Social housing	PRS
2014	1.15 million	1.2 million
2040	1.25 million	2.71 million

Note: the remaining poor households are in the home ownership sector.

This is about more than frustrated aspirations of home ownership from Generation Rent. The reality facing many working households and vulnerable people is a life below the poverty line because of the rising cost of keeping a roof over their heads. Addressing the rising cost of housing is therefore crucial to tackling the high levels of poverty.

The importance of low-cost renting

One of the key benefits of social housing – the main tenure of housing support for people on low incomes – is that, with its secure tenancies and lower rents, it acts as a platform for those on low incomes to build their lives. It is a potential 'stepping stone' out of poverty and a buffer for people whose life circumstances change, meaning that they require housing support. As research for JRF has shown, good-quality, low-cost housing has, at least partly, broken the link between poor housing conditions and poverty in the UK.[20]

Yet, as we have seen above, the number of social rented homes available is declining and new government-supported building is set at rents higher than is affordable for many low-income, working households.

Significant numbers of social housing tenants are in employment. The latest English Housing Survey shows that more than half of working-age social tenant households include someone in work. Yet in 2014, one third of working households in the social rented sector needed housing benefit to meet their housing costs, up from 20% in 2009-10.

The average housing benefit claim by a tenant of social housing has risen by 17.5% over the last four years. This has occurred before the main impact of the Affordable Rent policy has fed through into increased rents for social landlords, so the trend is likely to worsen. JRF research estimates that "setting social rents closer to market rents could put an extra 1.3 million people in poverty by 2040. This is likely to be an underestimate as even this would require £20 billion extra in housing benefit".[21]

[19] Stephens et al: What will the housing market look like in 2040? JRF 2014

[20] Tunstall, R. *et al:* (2013) The links between housing and poverty. York: JRF.

[21] Stephens et al: What will the housing market look like in 2040 (2014). JRF

Meeting the challenge

If we are to ensure that we have good-quality housing for all our citizens, this means tackling some of the trends outlined above. This requires a more coherent strategy on renting in England, as a crucial part of a comprehensive, long-term plan to build the homes we need in the right places and avoid locking low-income households out of affordable homes.

The rest of this report explores how we might reconnect the affordability of rents to earnings and provide the investment needed to provide new homes let at these rents. In doing so it sets out an approach to a 'Living Rent' that could:

- Reduce the drain of housing costs on people's pockets
- Provide a platform for participation in a dynamic and low-wage labour market
- Assist people in avoiding poverty as a result of high housing costs
- Help make local housing markets work more effectively for those on low incomes

2. Living Rents - Developing rents that are affordable for those on low incomes

The current approach to setting social housing rents in England has provided a clear framework for 12 years for landlords and tenants. However, there are now a number of issues which mean this no longer provides clear links between the rents being set by social landlords and their affordability for their tenants:

- As we saw in chapter 1, the above inflation rent rises, at a time when earnings growth has been weak, has undermined the formula's original link to earnings
- The introduction of higher Affordable Rents for many new homes and relets, as part of the development framework overseen by the Homes and Communities Agency and the Greater London Authority, means higher rents are being charged for properties allocated principally to people on very low incomes
- There is now improved, more localised data on earnings available than was the case when the formula was drawn up

Over this period we have also seen a wider range of affordability problems develop for people on a range of incomes. Housing need can therefore be seen as a scale rising up the income gradient which housing policy needs to accurately reflect. Affordability is also very different in different markets. There is now a wider range of needs based on affordability than was the case when the formula was introduced.

The use of the rent formula has also meant that social landlords have generally not had to develop rent-setting and allocations policies linked to local circumstances. This has begun to change as landlords have introduced Affordable Rents.

We therefore need to consider what an alternative framework for rents for social housing would look like. Such an approach needs to involve both a modernised formula linked to those on low earnings and consideration of how this might underpin more sophisticated rent policies by landlords.

In this chapter we look at what a modernised formula might look like and in chapter 6 we consider how this might be the basis for a different kind of framework for rent setting for landlords.

Living Rents

The key research for this project was therefore to develop a mechanism to re-establish the crucial links between:

- Housing and the labour market and
- Rents and the ability of people on low incomes to afford them

One option would be to move to a system where rents are linked to tenants' individual incomes. However, a review of international experience shows that tying rents directly to incomes raises concerns about work incentives and social mix, as well as increased administration costs.

Instead we looked for a mechanism for linking rents to the average real earnings of those who are being housed by social landlords - the 'Living Rent' proposition.

Our starting point – what rent?

There are two conflicting challenges in trying to develop a way of linking rents to earnings:

- The real circumstances of households vary so much - wages, numbers earning, tax, national insurance, child care, benefits, location, costs, etc - that it is hard to reflect this complexity within a practically implementable rent policy
- It is important to have a level of simplicity and transparency and this will require having an available income data source which is regularly updated, has localised information and which all relevant parties can access

The aim therefore was to find some transparent mechanism which:

- Broadly reflects the type of households accessing social housing
- Produces rent levels affordable for households with someone in full-time employment, working the average number of hours worked per week and earning the minimum wage

At this point, it is important to be clear that, in linking rents to earnings, we are seeking to establish a crucial link between housing and the labour market. The rents arising would be aimed at improving the ability of all people on low incomes to afford them – whether they are working or not.

The present national formula in England for setting social rents was based 70% on wages and 30% on property values adjusted for property size, with increases linked to inflation. This was developed more than 10 years ago and, although the inflation measure used has changed from RPI to CPI, the formula has not been updated to take into account the better data available on wages. The Living Rent approach uses an alternative method to reflect property size and removes the link to property values, as it seems contradictory to include property value in a formula aimed at providing rented housing for people who cannot access home ownership.

The Living Rent model links starting rents directly to an index of earnings and uses a recognised equivalence scale to allow for household income and property size, to produce what we describe as a Living Rent (LR). The index of earnings that we are using - the Annual Survey of Hours and Earnings (ASHE), compiled by the Office of National Statistics - has the advantage of providing localised earnings figures which are updated annually.

The ASHE lower quartile national figure for gross weekly pay for all employees equates to the earnings for a household with someone in full-time employment, working the average number of hours worked per week and earning the minimum wage.

We used information from CORE[22] and combined it with the OECD-modified equivalence scale[23] to adapt the figures arising from ASHE to:

- Reflect the differing composition of households in different sized properties
- Allow for the fact that household income for low-paid families with children is likely to be enhanced by government support

[22] The continuous recording of lettings and sales in social housing in England. DCLG

[23] Equivalisation scales are used to show how the incomes of households are compared, adjusting a household's income for size and composition. The OECD-modified equivalence scale is the standard scale for the Statistical Office of the European Union (EUROSTAT) and several government departments in the UK use it for key household income statistics

The Living Rents for this work are therefore based on:

- Annual Survey of Hours and Earnings (ASHE) lower quartile earnings[24]
- Adjustment for property size by recognised equivalence model
- Starting rent set at 28% of net earnings (see supporting background paper for full explanation of this figure)
- Rents based on local authority areas

Rents arising from the formula

Living Rents deliver a larger rent differential between property sizes than current social rents and there is a range of variations from current rents, with some producing increases and others leading to reductions.

The rents demonstrate that, even in areas where housing costs are low, rents can be problematic in terms of affordability for many households if earnings are also low.

We worked with seven social landlords across a variety of locations in England to test our Living Rent approach. Some examples from our case studies showing some of the variations involved compared to Affordable and private rents are:

Sheffield	1-bedroom/week	2-bedroom/week	3-bedroom/week
Living Rent	£62	£80	£99
Affordable rent	£75	£83	£98
PRS rent	£97	£110	£115

Birmingham	1-bedroom/week	2-bedroom/week	3-bedroom/week
Living Rent	£71	£92	£113
Affordable rent	£82	£104	£116
PRS rent	£98	£121	£133

Charnwood	1-bedroom/week	2-bedroom/week	3-bedroom/week
Living Rent	£70	£91	£112
Affordable rent	£78	£99	£113
PRS rent	£87	£110	£127

Cornwall	1-bedroom/week	2-bedroom/week	3-bedroom/week
Living Rent	£55	£72	£89
Affordable rent	£82	£106	£129
PRS rent	£102	£127	£150

[24] Table 8.1a Weekly pay - Gross (£) - For all employee jobs ONS 2014

Tower Hamlets	1-bedroom/week	2-bedroom/week	3-bedroom/week
Living Rent	£101	£131	£161
Affordable rent	£164	£185	£219
PRS rent	£250	£310	£418

Richmond-on-Thames	1-bedroom/week	2-bedroom/week	3-bedroom/week
Living Rent	£102	£131	£161
Affordable rent	£166	£197	£212
PRS rent	£231	£306	£391

Source: Affordable rents were drawn from the HCA's 2014 Statistical Data Return and PRS rents are the lower quartile figures from the ONS index of PRS rents as at December 2014

A full list of Living Rents by local authority area for 2014 can be found here.

In most parts of the country Living Rents are considerably lower than Affordable Rents. As Living Rents are set relative to local earnings this difference highlights that in many areas Affordable Rents are beyond the budget of households on low wages.

As the current focus of the government's sub-market rental supply model is on Affordable Rents, a move to developing new homes let at Living Rents would need more capital subsidy for development than is currently available. Dealing with the implications of this is the focus of chapters 3 and 4 of this report.

It is important to recognise that service charges are an important aspect of rent-setting. At the present time these are outside the model used for setting social rents. The modelling here takes the same approach. However, landlords developing affordability approaches based on Living Rents would need to consider service charges as part of the whole affordability package.

Living Rents and social landlord business planning

It is clear that moving to a different rent system could change the rental income for social landlords. If rental income falls this could have an impact on the business plans of existing social landlords, which, could in turn have negative effects on existing tenants and the ability of landlords to develop. We worked with a range of landlords operating in different markets and locations, to test out how this might work in practice in terms of the rents to be charged locally and the effects on their business planning. In doing this we assumed Living Rents would replace the proposed rents upon which their plans were currently based.

In terms of the direct effects on landlords' business plans of introducing Living Rents, the level of earnings in their communities was clearly an important factor. This is in contrast to the approach taken under their currently planned rents. The differences in the size of properties in their portfolio, the level of concentration of their homes and some of the asset management decisions they had made about their stock - for instance in terms of the extent to which they were introducing Affordable Rents - also had an effect.

For those organisations with Living Rent income higher than projected in their current business plans, there were potentially gains. However for landlords at the other end of the spectrum the opposite was true.

The research considered the effects of a phased approach that would involve Living Rent being applied to relet properties and new homes developed with government support. While not being without its challenges, such an approach would allow landlords to better plan a move to Living Rent.

Two aspects of Living Rents would help landlords deal with the challenges they would face in altering their rental approach:

- Landlords – particularly in high-value areas – would be able to mix relets between Living Rents and intermediate rents, based on local affordability
- Landlords would be able to see their Living Rent average across their stock as an 'envelope', rather than a precise calculation for rents. They would be able to vary individual rents within that envelope

These points would also give landlords some flexibility in terms of local circumstances and being able to reflect the relative attractiveness of particular areas or properties.

Uprating Living Rents

The mechanism by which rents for existing homes are increased annually is important, as the value of a landlord's rental stream is more dependent on the overall level of rent increase than relet rates. A 1% change in relets has a relatively small impact on values compared with the effects of rent upratings across a landlord's stock.

The logic of what we have done in basing the rents on wages suggests that they should be uprated annually in line with the lower quartile ASHE annual changes to local wages. However, in our research discussions with various parties there was concern that lenders were likely to be nervous about moving away from the present inflation-linked rises, principally because:

- Lenders prefer the transparency and predictability of an inflation link, particularly those who have products that their lending to housing associations supports which were also linked to inflation indices
- Wages have been more volatile than inflation indices in recent years

Taking this into account, we instead propose linking Living Rents to the Consumer Prices Index (CPI) for the first five years and then rebasing rents based on ASHE changes. This might take the form of rebasing all a landlord's Living Rents every five years, or it could be a rolling programme of 20% each year. It may however be necessary for a rent floor to apply so that rents remain flat at rebasing, rather than fall, until they increase past the rent floor once again. Further testing would be needed on this point to identify the best approach.

Living Rents and the wider policy environment

As well as looking at social landlords' business plans, we tested this idea by discussions with local authorities, lenders and representatives of national representative bodies. The clarity of a formula based on clear principles was welcomed as providing consistency - unlike the current confusion over affordability - and the potential for a move away from an increased reliance on housing benefit was particularly welcomed.

We also found considerable support for the Living Rent proposal in terms of linking starting rents to incomes and encouraging people to live in properties that are appropriate to their needs.

This all suggests that it would be possible to introduce a Living Rent approach which would improve affordability and not be detrimental to landlords' business plans.

While we are confident in the conclusions from this work, as stated at the start of this chapter, the introduction of Living Rents would need to include consideration of a more sophisticated and flexible approach to housing affordability by landlords. We return to this topic in chapter 6

Further background reading on the research we carried out on Living Rents can be found here.

3. Living Rents and housing benefit

As discussed in the previous chapter, a move to Living Rents would need more capital subsidy for development than is currently available. This is due to the current focus of the development programme in England on properties being let at higher 'Affordable Rents'. So what might the interrelations be between Living Rents, housing benefit and capital subsidy?

As we have seen above:

- The private rented sector (PRS) is continuing to grow and this is happening principally by the conversion of existing homes from other tenures
- Rents in both the PRS and in social housing are continuing to rise

The ability of low-income households to pay these rents is underpinned by housing benefit support. While this is important, it can be seen as a subsidy for the consumption of housing rather than incentivising the building of new homes.

Currently twice as many housing benefit recipients live in social housing than in PRS properties. On average however individual private tenants receive more in housing benefit than social tenants, given the higher rents in the PRS. If more housing benefit recipients are housed in the PRS this will have an impact in terms of increasing the housing benefit bill further.

At the start of 2014 the average housing benefit awarded to claimants in the private rented sector was £106 a week. This is £22 a week higher than unemployed social rented claimants (£84) and £34 a week higher than housing benefit claimants in work (£72). This has important implications for government spending as well as households' housing options.

High housing costs create work disincentives as the steep 'taper' on benefits means claimants effectively retain only 35 pence of each extra £1 earned. It also means higher income levels are needed to no longer require benefit support. This is important as almost twice the proportion of working households received housing benefit in 2013-14 than in 2008-09[25]

The introduction of Universal Credit (UC) will not solve this issue of work incentives. The benefit taper is less steep for UC but it extends further up the income scale, affecting more people. Lower rents would mean fewer people would rely on benefit support and hence avoid the challenge of overcoming the disincentive to work outlined above.

We asked Professor Glen Bramley of Heriot Watt University to use the forward forecasting model employed in the *What will the housing market look like in 2040* report mentioned in previous chapters, to look at the implications of different rent scenarios on housing benefit. This showed that:

- If there were no change in the current approach, by 2040 the rise in households who are poor in the PRS – because of the growth of the sector and the 90% rise in real rent levels – would mean the total housing benefit bill would have almost doubled in real terms to £37 billion a year
- The move to Affordable Rents for new and relet social tenancies would mean social housing rents would increase by 45%. However, a move to Living Rents would reduce this considerably. Moving from Affordable Rents to Living Rents would save £5.6 billion a year by 2040, at 2011 prices

Glen Bramley in doing this work pointed out that: "The exercise underlines the weighty issues which face us as a result of the major tenure shift to private renting. This appears to be associated with both a sizeable increase in poverty and a very large increase in the cost of housing benefit. The former might be regrettable, the latter is clearly unsustainable, given the general range of scenarios for future public spending. Therefore, more fundamental 'welfare reform' and/or rent regulation seems to be inevitable."

[25] DCLG: English Housing Survey 2013-14. February 2015

This tension between higher rents in both social housing and the PRS and the need to restrain benefit bills is vital. Unless rents are kept at affordable levels there is the danger that local housing allowance (housing benefit for private tenants) and benefit caps could be used to try to suppress rents. Such a move would be likely to have serious implications for tenants in poverty.

The Social Mobility and Child Poverty Commission[26] has warned that “all major parties have signed up to the overall welfare cap announced in Budget 2014. If the policy response were to include measures to secure higher wages and contain housing costs, this could be compatible with achieving poverty targets. But if it is simply to make further cuts in benefit entitlements, poverty will get worse”.

Challenging the private rented sector

As we have seen, on the basis of current policies, the PRS will increasingly be the main source of housing for those who are poor. The difficulty with this is that there is no real market for housing the poor without housing benefit.

A recent report by Civitas[27] argues that housing benefit inflates private rents at the lower end of the market to local housing allowance (LHA) levels saying that “the more people there are who claim LHA in any given area, the more difficult it becomes to discern what would be the market price without it”.[28]

The report also adds that “the security of tenure available from private landlords, usually of just six or 12 months, is inadequate for families and those shut out of owner-occupation and social housing who are increasingly having to make their home in the private rented sector”.

This issue is particularly important for families. The Social Mobility Commission[29] has said that “the current private rented sector offer – developed in 1988 – is not fit for its new purpose of housing families with children over the long term”.

Moreover, as another recent report[30] has pointed out, PRS homes are typically older and a higher proportion do not meet modern standards. When compared with those in other tenures the report says that there is “a particular issue at the bottom end of the market where unscrupulous landlords are able to exploit vulnerable tenants who have limited housing options”. The termination of private rented tenancies is also now the most common cause of homelessness[31].

The majority of the PRS is providing satisfactory housing which provides a level of flexibility and choice for a range of people. However, at the bottom end of the market housing benefit appears to be subsidising unsuitable accommodation for those in poverty, without real market mechanisms to determine price, in homes that might well have been bought by potential home owners.

As the current legislative framework for the PRS dates back to 1988, well before the significant growth of the sector, it makes sense to review the current regulatory arrangements to see if improvements can be made.

However, whatever regulatory changes might be made, building more properties let at Living Rents would provide a better option for poorer households and in so doing help to check further increases in the housing benefit bill.

Efficiency of government investment

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[26] State of the Nation 2014: Social Mobility and Child Poverty in Great Britain (2014): The Social Mobility & Child Poverty Commission

[27] David Bentley: The future of private renting: shaping a fairer market for tenants and taxpayers. Civitas, 2015

[28] ibid

[29] State of the Nation 2014: Social Mobility and Child Poverty in Great Britain (2014): The Social Mobility & Child Poverty Commission

[30] More than a roof: How incentives can improve standards. Resolution Foundation 2014

[31] Statutory homeless figures released in October 2014 show that private landlords terminating contracts now accounts for 30% of statutory homeless cases. This figure has doubled since the same quarter in 2010

The move to Living Rents does therefore produce two big opportunities for housing benefit savings:

- Adopting Living Rents rather than Affordable Rents gives a significant saving in the housing benefit bill and improves affordability to tenants
- Building more homes at Living Rents has the potential to reduce the dependence of low-income households on the PRS, with its higher rents

A key question therefore is whether providing capital subsidy to support a programme of new Living Rents homes would be more cost-effective in the long-run than continuing housing benefit support.

While it may seem challenging to propose more public investment in housing for those in most need, higher grant rates may have advantages, particularly in terms of the long-term efficiency of the use of public resources.

Although the current Affordable Homes Programme (AHP) has lower up-front capital grant costs, it leaves government with a long-term spending commitment and erodes the existing social housing base. As we have seen above, social rent inflation and the move to Affordable Rents plays a significant role in driving up the housing benefit bill. A known up-front amount of capital investment - instead of an unknown and difficult to control stream of future benefit payments - also gives greater planning certainty for the public finances.

In the last 20 years, housing investment has fallen to 10% of public sector capital expenditure, from 22%.[32] The 2015-18 Homes and Communities Agency funding round commits only around £3 billion in public capital investment, compared with a forecast housing benefit bill over the same period of over £75 billion.

Yet capital investment appears to provide better value for money in the long-run. The *Numbers Game*[33] report by PWC modelled a number of scenarios and concluded that "while 100% revenue subsidy is more effective over the medium-term… (requiring government investment of around £15 billion over 10 years compared with £23 billion for higher capital grant), higher capital subsidies are more cost efficient over the longer-term (requiring £40 billion government investment in present value terms compared with £53 billion for 100% market rent and £45 billion for Affordable Rent)."

The National Audit Office compared the 2011-15 Affordable Homes Programme against the option of retaining the higher grant rates of its predecessor programme and concluded: "Continuing with the previous programme's funding model offered potentially better value for money over the 30-year costing period."[34]

These pieces of work strongly suggest that grant funding is more economical in the longer term than consumption subsidies.

Direct capital funding by its up-front nature is also more likely to drive high levels of housing supply (see next chapter). This is important in terms of providing the homes we need. Ted Ayres, the chief executive of house builder Bellway, told the Financial Times in October 2014 that: "I don't believe we are going to get more than 200,000 homes [a year] off the back of ourselves and our peers. The industry isn't going to hit government targets. We're doing a reasonable job between us in upping the volumes, but it's going to take extra funding in the affordable housing area."

In addition, as a recent JRF report[35] has shown, as many housing associations are charities, they have to be careful to properly assess the increased risks of building homes with low levels of government investment. Higher investment levels will help them to deal with such risks and as a result lead to a more expansionary attitude.

This all suggests that a programme of building more homes let at Living Rents has two major advantages:

[32] Wilcox S (2013), Housing Finance Review 1999/2000 and Housing Review

[33] PWC (2012) *The Numbers Game: Increasing housing supply and funding in hard times*. L&Q/PWC

[34] Financial viability of the social housing sector: introducing the Affordable Homes Programme (2012). NAO

[35] Lupton, M. and McRoberts, D. (2014) *Smaller housing associations' capacity to develop new homes*. York: JRF.

- Ensuring poorer people are housed in more affordable and suitable accommodation than would otherwise be the case
- These homes would be funded by increased capital subsidy, which would be more cost-effective for the taxpayer in the longer term

The key issue therefore is what a development framework for achieving such a programme would look like and what level of government investment would be required, which is examined in the next chapter.

4. A sustainable framework for the supply of homes let at Living Rents

There is now a broad consensus that we need to build more homes. The chancellor, George Osborne, has said: "It is an exhortation to the entire political system: we have got to get more homes built, and if we don't, we are not meeting the aspirations of the people we claim to represent."[36] However, there are ambiguities about who the homes should be for and the actual purpose of government interventions. There needs to be clarity about the balance between increasing supply, supporting the labour market and rebalancing the housing market.

In particular we have seen that the incentives for higher rents in the current Affordable Rents system, the lack of a clear strategy for renting and the decline of social-rented housing are potentially creating long-term problems for those in poverty and hence for our society generally.

It is therefore vital that policies to significantly increase house building should include plans to produce homes let at rents that are affordable to those on the lowest incomes.

There are four key foundations to developing a model to do this.

Foundation one: being clear about the number of homes required for people on low incomes

The most credible recent estimate of the number of homes needed in England has been provided by Alan Holmans[37]. Based on government household projections, Holmans estimates that 83,000 units of social housing will be needed each year as part of an overall average annual output requirement of 240,000–245,000 new homes.

This estimate did not, however, include a figure on the demand for intermediate products. There is a wide range of affordability problems for people unable to access market housing and therefore considerable demand for good-quality housing that is affordable for those on low to median incomes, particularly in high-price, market areas. This should be accurately reflected in housing supply models.

Shared ownership and intermediate rented products can therefore make an important contribution to housing supply by ensuring a variety of homes are available at different price points for those with particular affordability problems. They also have the potential to cross-subsidise the cost of delivering sub-market rented housing. The 83,000 figure needs therefore to include a mix of Living Rent homes and intermediate products.

There is also the need to be clear about the capacity of the current providers of social and affordable housing to actually produce new homes. Work by Savills and the NHF suggests that housing associations and local authorities may be able to produce around 70,000 new homes a year in England in the current operating environment (a paper with further details on the basis for this can be found here).

A realistic estimate of the number of homes to be produced at Living Rent, which also allows for the additional provision of intermediate products in meeting the spectrum of affordability problems experienced in different places, is therefore likely to be around 40,000 homes a year. This would be part of an overall aim of producing 80,000 homes available at below-market prices, the other 40,000 being a mixture of shared ownership and intermediate rented products.

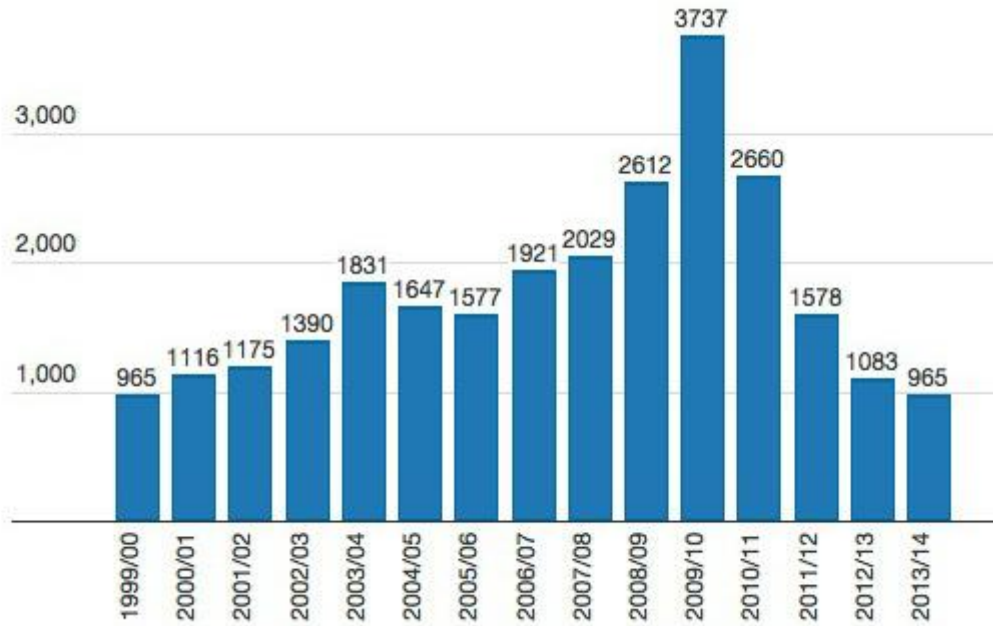
Foundation two: the right level of government investment

Government investment in Living Rent would be an essential component of an ambitious supply programme and, at the right level, would enable housing providers to leverage their asset base, raising debt at rates that supports long-term production. This is important to retain an active pool of long-term developing providers of affordable housing.

[36] RES lecture, Bank of England, Wednesday 14.1.2014

[37] *Interim Revised Estimates of Future Demand and Need in England in 2006 – 2026 with 2008-Based Demography* CCHPR 2012 and *New estimates of housing demand and need in England, 2011 to 2031* TCPA 2013

The current level of government investment in affordable housing has declined to its lowest level since 1999/00 as the graphic below at 2013/14 prices shows:



Source: DCLG response to parliamentary question

Over time, the level of government contribution to building individual homes for people on low incomes has decreased – in the last decade from 60% of the costs of producing a home to 20%. The average grant per home in the first instalment of the 2015-2018 AHP programme announced by the HCA in July 2014 was £20,000 outside London and around £33,000 in the capital. This contrasts with social rent grant levels of around £55,000-£65,000 outside London and £100,000 inside London in the 2008-11 funding round.

These low levels of grant support under the Affordable Rent supply model present challenges. The model relies substantially on housing providers being willing and able to take on high levels of debt and to cross subsidise the construction of new homes from other parts of their business. The former point substantially increases the debt per unit and therefore drains financial capacity for further house building. The latter cross subsidy point – arising from surpluses, including from sales and commercial activity – is not uniformly or reliably available from all potential housing provider development partners. The programme also assumes for the vast majority of the country the conversion of existing social rented homes to higher Affordable Rents when they become vacant and are ready to relet. However, in a small number of areas there is little, if any, difference between social and market rents.

Providers face a choice. Do they accept grant funding, based on new homes and relets being let at Affordable Rents, taking on more debt and reducing the amount of homes let at social rents at a time when benefits are being reduced? Or do they instead maintain their current social housing stock and use their development capacity to develop other – possibly social, possibly market-related – products? Many social landlords have indicated they could build significantly more homes if the incentives to do so were stronger. In the absence of such incentives, a number of social landlords have added they plan to scale back their participation in the Affordable Rent programme in future.

The principle barrier to increased housing supply lies in the shift by the government from capital to revenue funding. This comes at a time of welfare cuts and landlords holding genuine concerns for the ability of tenants to afford homes let at Affordable Rent, as opposed to social rent. There are also concerns about the impact on business plans due to the increase in debt required to build as part of the Affordable Rent regime. Landlords are also worried about diverting sizeable resources to growth at a time of significant uncertainties in the wider operating environment. These uncertainties include: the impact of Universal Credit, the possible extension of right to buy for housing association tenants and the impact on customers of further cuts to welfare benefits. There are challenges too around the terms on which grant is available and the lack of incentives to include schemes resulting from planning gain or 'section 106' in grant-backed programmes.

So, while social landlords continue to participate in HCA programmes, supported by more commercial activity and 'asset-sweating', there are serious doubts over the financial sustainability of the model in the medium term, given that:

- Providers are taking on more debt per unit, increasing gearing and therefore reducing their long-term financial capacity for house building
- Rents are increasingly unaffordable for people living in social housing
- There are concerns that the level of 'asset-sweating' by providers to release further development capacity, will have an adverse effect on balance sheets
- The current Affordable Rent policy relies on significant increases in housing benefit

Modelling the investment needed

The Affordable Housing Programme for 2011-15 has just been completed. The figures for the first three years of the programme are:

	Affordable housing completions	HCA/GLA Investment (million)
2011/12	51,731	£1,576
2012/13	36,733	£1,083
2013/14	36,352	£965

At the time of writing the figures for 2014/15 were not available but it does seem likely that the target of producing a total of 170,000 homes over these four years will have been achieved.

£2.95 billion has been allocated to fund the AHP 2015-18 – just under £1 billion a year.

While the government has an "aspiration" to build more homes, past performance, indications from landlords and our own modelling suggest it is likely that 40,000 homes each year may be achieved, consisting of shared ownership and Affordable Rents.

The current £2.95 billion, three-year investment would therefore reach half way to the target of building 80,000 affordable homes each year. If these 40,000 home are seen as the intermediate products required, then there would be a need for 40,000 more homes to be built to be let at Living Rents.

We have estimated the level of government investment required to support an annual programme of building 40,000 homes to be let at Living Rents. The assumptions behind this estimate include:

- Calculating the government investment required to support Living Rent, using estimated funding and production costs and typical development appraisal assumptions
- Using a regional distribution pattern which matches the initial HCA/GLA 2011-15 allocations

(A paper with further details of the assumptions behind this can be found here).

This work suggests that an annual programme of 40,000 homes each year let at Living Rents requires an estimated £2.3 billion capital investment per annum. This equates to an average of around £76,000 per unit in London and £46,000 per unit elsewhere in England – equivalent to approximately 30% (35% in London) of the assumed total cost of each home.

The investment programme we are proposing would therefore involve:

40,000 intermediate rented and shared ownership	£0.8 billion
40,000 Living Rent	£2.3 billion
Total	£3.1 billion

This could be regarded as an upper level of government investment. Increasing the supply of affordable homes produced through the section 106 system would reduce the level of capital investment required, as would access to cheap debt. Building this volume of homes to be let at Living Rents could significantly improve the affordability of new homes for those unable to access the market. This would produce wider benefits including, as demonstrated in the previous chapter, the long-term reduction of the housing benefit bill.

Government investment at this level - 30-35% of the total cost of providing new homes – would also provide the support and certainty needed to enable housing providers to stretch and sustain their financial capacity for increasing housing supply over the longer term.

Access to cheaper debt would help providers stretch capacity further. However, it is not a complete solution, as the issues of gearing and interest cover would remain.

Cost of debt	6%	5%	4%	3%
Outside London				
Grant per unit required	£46,000	£38,500	£30,000	£23,000
%	33%	28%	21%	18%
London				
Grant per unit required	£76,000	£65,000	£56,000	£50,000
%	35%	30%	26%	23%

Capital grant or/and other types of subsidy

Capital investment at Living Rent levels would have the major advantage of improving incentives for building and stretching borrowing. Traditionally, government capital contribution has been in the form of grant. This has the advantage of levering in debt at sustainable levels, which maintain financial capacity among providers to participate in government-backed house building programmes in the long term.

One possibility in future is for the government to provide equity funding for house building, rather than grant. This would be in line with the shift by the Treasury towards 'recoverable investment' rather than 'embedded' capital grant. Equity funding is repayable and its classification as a 'financial transaction' means it does not contribute to the annual national deficit – although it does add to public debt.

The difficulty with such an approach is that, even if it were subordinated to private lending, a provider's balance sheet would be more heavily geared and lenders would view the equity as debt. It would therefore use up housing association borrowing capacity even more quickly than the current Affordable Homes Programme.

According to a recent National Audit Office report[38] "the Department for Communities and Local Government is moving away from having, predominantly, a grant-giving role and is using new and innovative ways to fund its programmes, including the increase in use of 'financial instruments'". CLG currently has three programmes totalling £24 billion in operation:

- £10 billion for financial guarantees to housing associations and the PRS
- £9.7 billion for the Help to Buy equity loan scheme
- £4.2 billion for other loans and investments - the majority through the Build to Rent and Large Sites schemes

Such financial instruments do not count as public spending and borrowing[39] and potentially some may make a return. These innovations are helpful and have resulted in very competitive borrowing costs. For instance, Affordable Housing Finance's debut Affordable Housing Guarantee bond produced a spread over gilts (the amount above the cost of government bonds) of 0.37 and an all-in cost of 3.93% interest. However, the window for this type of loan and cheap debt more generally may not continue in the long term. It is also important to recognise that such instruments are not sufficient in themselves to produce sub-market rented homes, which still require a level of embedded investment to make them financially viable.

[38] Departmental Overview: The performance of the Department for Communities and Local Government 2013-14. NAO (2014)

[39] Accounting for assets is different from accounting for grants. Unlike a grant the Department expects, at the point it makes the payment, that it will receive a financial return in the future. Financial assets are, therefore, included in the Department's annual accounts on its statement of financial position until the benefit is received or is no longer likely to be received. The Department discloses in its accounts a value that is an

In addition, such approaches may encourage a higher level of risk. As Julian Ashby, chair of the HCA's regulation committee, has said: "With less grant and a greater emphasis on support through financial instruments, development of new housing will require substantial levels of debt at a time when some associations are coming closer to covenant boundaries. This leads to diversification into commercial activities and to a desire to circumvent constraints in a variety of innovative (but potentially risky) ways."[40]

One area where guarantees might have a role is in terms of assisting housing associations to refinance and restructure balance sheets, which could help streamline their lending and add to their development capacity.

So while there may be scope for guarantees to support investment, grant funding remains crucial for government investment in affordable housing, given its ability to lever in private funding, facilitate delivery and target investment in areas which match greatest needs.

Foundation three: utilising the full capacity of social landlords

Local authority landlords

Council housing makes a surplus. Until the reforms introduced in April 2012, councils were paying their surpluses to the Treasury. The reforms have meant that, where councils own housing, they are now self-financing and are in a much stronger position to invest in new homes. As a result the number of homes built by English councils has risen, as the table below demonstrates:

Financial year	Number of homes built
2011/12	1,450
2012/13	1,610
2013/14	1,920

However, the landlord role of local authorities remains under pressure and constraints include:

- Borrowing caps – which have varying impacts on the ability of councils to invest
- Right to buy – continued loss of stock and insufficient funding for replacement homes
- Cuts in General Fund spending by councils – which has led councils to look to transfer more of the costs of services to their landlord accounts
- Rents policy changes – affecting future income streams

Nevertheless, surveys by both the Local Government Association and the Association of Retained Council Housing suggest output could increase to more than 5,000 a year for the next five years, under current rules[41].

estimate of the amount it would receive for each asset if the investment was settled on that date. In contrast, grants are included in the statement of comprehensive net expenditure as an in-year cost to the Department

[40] http://www.insidehousing.co.uk/home/blogs/the-way-forward/7003212.article

[41] LGA (2014) *Housing self-financing survey: a survey of councils and ALMOs* (see www.local.gov.uk/research-housing). ARCH (2013) *Innovation and Ambition: The impact of self-financing on council housing.*

Authorities do have untapped capacity which, if unlocked, could produce yet more homes. There is the potential for their development capacity to be significantly increased if the financial framework were to be further reformed. The key would be lifting the current caps on borrowing or significantly raising them. This would mean that councils could potentially borrow as much as an additional £20 billion under prudential rules.[42]

Savills has estimated that removing or substantially lifting the borrowing caps on local authorities would lead to them having the capacity to build 15,000 extra homes per annum. The figure could be enhanced still further if authorities were to be supported in these new freedoms with higher levels of government grant.

A key issue here is giving local authorities the ability to deploy their capital resources as flexibly as possible, while incentivising them to build homes to be let at Living Rents. This could see local authorities receiving grant on the assumption they would match it using their other capital resources (borrowing, receipts, revenue and reserves). As part of this approach, the payment of grant could then be linked to the streamlined release of the debt cap – thus reducing the current barriers.

Housing associations

It is clear that English local authorities could increase the number of homes they develop. There are also a small number of private registered housing providers who are likely to be able to build more homes to be let at Living Rents, with higher grant rates. However, the bulk of new homes let at Living Rents would need to be built by housing associations.

The level of government investment required is inextricably linked to the decisions individual associations make on maximising the use of their resources to fund new housing development. Following the decline in grant funding in recent years, many housing associations have been innovative in utilising internal resources for the development of new homes.

Currently landlords are producing mixed programmes with variations in terms of:

- Differing ways of 'cross-subsidising' new development with funding generated from general surpluses, asset management strategies, open market sales and other profitable products
- Being able to access cheap land and section 106 deals
- Differing ambitions in terms of boosting house building, relative to size and financial capacity

The higher capital investment modelling above assumes that government subsidy represents around 30% of the total cost of production, with the landlords providing the remainder of the cost through a mixture of debt and internal subsidy.

In meeting around 70% of the development cost themselves, it will be important for housing associations to extract the best economic and social value from their existing assets, improve value for money and unlock latent, under-used capacity in their businesses. This will mean combining sound business principles - driving efficiency, taking measured commercial risks, delivering the best possible service at the lowest possible cost and investing in homes and communities – with driving up quality and standards, and delivering on their social mission.

It will be important for the HCA's regulatory framework to continue protecting public investment in social housing, while accurately reflecting the level of ongoing government support. At the same time, social landlords and the regulator should consider how they might continue to develop mechanisms and a narrative for ensuring and explaining how associations keep moving forward to ensure that their business is making best use of their resources and investing in building and improving homes.

[42] See *Let's Get Building* (2014) *Treating Council Housing Fairly.* (2011): NFA.

<u>Foundation four</u>: Political leadership

It is important that moves to develop more Living Rent homes are not just seen in terms of debates around government grant and landlord contributions. Other measures are important in ensuring a continuing supply of genuinely affordable housing.

If we are to increase the supply of Living Rent and intermediate homes then we need to see increasing land release more generally generating extra market supply as well. Given the current approach in England to building homes, with the use of the planning gain process and a presumption of building mixed communities, this is important. Details of how this could be done are beyond the scope of this report.

The vital role of local government and land assembly have, however, been particularly highlighted by participants in the work we have undertaken.

Planning gain – via the use of section 106 agreements – has been important in the delivery of housing for those on low incomes. In the period 2002/03 to 2008/09 more than half of affordable housing completions included section 106 contributions. It has also played a crucial part in ensuring the development of mixed-income communities, which are generally seen to have had a beneficial impact.

However the recession, followed by changes to the planning and funding systems, has meant that a significantly lower proportion of overall housing supply is being delivered as section 106 affordable housing. As recently as 2007/08, planning gain from private developers – mainly via section 106 agreements – was worth almost £5 billion and contributed to the provision of 48,000 new homes. By 2012/13 this had fallen by half and today's figure is likely to be much lower still because of changed government rules.[43]

Clearly section 106 housing does still form an important mechanism in delivering for those on lowest incomes in some areas at some times. However, this is more limited and complicated than in the past. Therefore there is a growing need for changes to reinforce the benefits of planning gain. A recent report for JRF[44] has called for strengthening the operation of the section 106 process by promoting good practice where local planning policies prioritise the provision of affordable housing accessible to those on the lowest incomes and re-aligning definitions of affordability in planning legislation to the ability of households to pay. The report recommends that:

"Key to strengthening the operation of section 106 will be introducing greater transparency into the viability process, clarifying the viability parameters used to ensure appropriate capture of land value uplift and making changes to the definition of affordability in planning legislation."

In addition, a more proactive role for local authorities in land assembly and more creative use of public land holdings such as proposed in the recent Elphicke-House Report [45] could make a significant contribution.

These approaches might be enhanced if local authorities were given clearer powers to take more proactive approaches, such as:

- Enhanced powers in terms of fiscal measures, land assembly and compulsory purchase orders
- Focusing more clearly on affordability and markets in terms of planning definitions, particularly in terms of returning to a definition of affordable housing to "meet the needs of eligible households at a cost low enough for them to afford, determined with regard to local incomes and house prices".

[43] DCLG (2014) *Section 106 Planning Obligations in England, 2011-12*

[44] Brownhill et al: Rethinking planning Obligations. JRF, 2015

[45] Elphicke-House: From statutory provider to Housing Delivery Enabler: CLG, 2015

- A fund aimed at unlocking sites to incentivise the market. This would be used when lower-value areas are not being developed, despite a buoyant market. One possibility here is to develop housing zones - along the lines that the GLA and HCA are currently pioneering

There is a clear role for local government to create the vision and provide leadership and strategy to deliver new approaches in this area. One aspect is that authorities could use any additional powers in the development of more robust partnerships between themselves, housing associations and other developers to maximise the use of land value and partners' expertise and financial capacity.

5. Housing investment works for the economy

We have seen that the extra cost of government providing capital investment to produce genuinely affordable rents has advantages in terms of:

- Being more cost-efficient in the long run for public funds
- Providing robust incentives to providers to increase house building
- Stretching the capacity of housing associations and local authority landlords to do more

There has been a lot of emphasis in economic policy in recent years on the importance of infrastructure spending in terms of improving economic performance, particularly at a time when low interest rates mean the cost of debt is relatively cheap. Housing needs to be seen in this light, particularly given that - unlike roads for instance - it does provide an income stream and, as we have seen above, would reduce the need for revenue spending in future years.

Directly driving increased housing investment helps provide the well-known additional benefits of house building, beyond those accrued by the occupiers of the new homes. Impact analysis that Savills has undertaken with Oxford Economics shows that the lag between investment and impact of housing development expenditure is short - less than a year. This also found that for every 50,000 new homes built, 114,000 full-time equivalent 'real' jobs are created. Importantly many of them are provided by small businesses[46].

Moreover, sustained government investment in low-cost housing can provide a counter cyclical balance to the volatile and cyclical English housing market. This helps keep skills in the construction industry and the economic contribution of this important sector of the UK economy flowing during market downturns. The OECD has said that: "Greater provision of social housing could enhance housing supply where private sector activity is insufficient." [47]

So increased capital spending to build homes let at Living Rents, using the cheap borrowing available to government at the present time, has positive short-term economic benefits and provides longer-term savings to the public purse in terms of reduced benefit subsidies.

Wider economic benefits

A Living Rents framework, such as has been outlined above, would also move away from providing homes at rents that poorer people cannot afford. This has wider economic and social benefits in terms of helping to tackle particular issues:

Improving employability	Work by Frontier Economics[48] suggests that affordable housing may improve employability for new tenants. They say that this could be particularly the case given that – compared to housing in the private sector – many housing associations run programmes to help their tenants find work.
Increasing purchasing power	People on low incomes tend to spend what money they have in the local economy, while people on larger incomes spend more on higher-value goods that are often imported. Therefore, putting more money in the pockets of people on low incomes is likely to be beneficial to the UK economy.

[46] The case for housing, Savills, 2010
[47] OECD UK overview 2015
[48] Assessing the social and economic input of affordable housing investment: Frontier Economics, 2014

Increasing social mobility	The Social Mobility and Child Poverty Commission[49] emphasised how "changes in the housing market are already increasing poverty and are threatening to become a major impediment to social mobility". The Commission also reported that the number of children unable to afford a basic standard of living after housing costs has risen by 450,000 since 2009/10. Therefore, addressing the effect of housing costs on living standards is not just about the life chances of working adults today, but the opportunities for social mobility that will be available to their children.
Decreasing household debt	There is considerable evidence now that poorer families are increasingly relying on short-term debt. The Centre for Social Justice has reported that: • Almost half of households in the lowest 10% of income bracket were spending more than a quarter of their income on debt repayments • Payday lenders, pawnbrokers and home-collected credit providers lent out £4.8 billion in high-cost credit in 2012, rising sharply from an estimated £2.9 billion in 2009/10[50] A JRF report in 2013 on debt has emphasised the importance of social housing providers having genuinely affordable rents, alongside wider measures to combat poverty and problematic debt[51]
Incentivising work	Higher rents also affect work incentives. Work by The University of Cambridge for Affinity Sutton has shown that "in higher-cost areas the prospects of escaping benefit dependency are greatest when rents are set at or close to social rent levels"[52]. This is reinforced by JRF research which finds that low-cost housing "makes it easier to 'make work pay"[53] . Lower rents can make it more worthwhile for people to work by increasing their take-home pay.
Increased labour mobility	A report by the IPPR[54] has said "it would appear that housing factors may be a significant inhibitor for those with low skills to move for work". Providing genuinely affordable housing for those who wish to move to improve their labour market prospects would help with this.

The ongoing management and maintenance of low-income rented housing also has a positive ongoing effect on the local economy, providing work for building contractors, cleaning firms, accountants, etc. In addition, social housing providers are becoming more skilled at ensuring that in commissioning services they capture positive economic benefits for their areas, particularly in terms of wages and apprenticeships.

[49] State of the Nation 2014: Social Mobility and Child Poverty in Great Britain (2014): The Social Mobility & Child Poverty Commission
[50] MAXED OUT: Serious personal debt in Britain. CSJ, 2013
[51] Grahame Whitfield: Poverty and problematic debt: what can social housing providers do? JRF, 2013
[52] Exford, K. (2014) What role for social renting in the new world? Coventry: CIH (see www.cih.org/policyessays).
[53] Tunstall, R. *et al:* (2013) *The links between housing and poverty*. York: JRF
[54] Cox: Home economics: IPPR 2014

6. A Living Rent framework

As we outlined in chapter 1, without a change in direction, in 25 years' time poverty rates in England are likely to be higher and the relationship between poverty and housing deprivation stronger. We are arguing that there is another choice: the development of a Living Rent framework that is committed to building more homes and providing decent, affordable homes for low-income households.

This would be based on:

- A partnership between housing providers, developers, local authorities and the government around how to maximise the use of resources to build 80,000 homes each year to be available at below-market prices, at least half of which would be let at Living Rents
- A commitment by the government to provide the capital investment required to deliver the 80,000 homes
- A commitment by housing providers to combine a commercial approach to development and management with the mission of providing homes that are the basis for poorer people to build a life and offer housing options for the most vulnerable

Living Rents – underpinning affordability

A vital part of this framework is the way in which Living Rents are utilised to underpin affordability, given the dual aims of:

- Building more homes that are genuinely affordable for those that cannot access the housing market
- Re-establishing the crucial link between housing and the labour market and between rents and the ability of people in poverty to afford them

It is vital to build at least 40,000 homes each year to let at Living Rents. The real issue of affordability for tenants is the level at which rents are set for the 290,000 new lettings by social landlords each year.

Our work on the proposal for Living Rents as set out in chapter 2 suggests it would be possible to introduce Living Rents as a national product focusing on all new and relet social housing tenancies. There is, however, an opportunity to use the introduction of Living Rents to help develop a more sophisticated and flexible approach to enhancing housing affordability.

Over the past decade, social landlords have generally not had to develop a detailed rent-setting policy, given that rents have been set on the basis of a national formula. This has begun to change as landlords have introduced Affordable Rents. These rents are expressed as a proportion of the market rental value of the property and in response to the effects of the wage levels of tenants and the impacts of welfare reforms. In doing so landlords are focusing more clearly on the affordability of rents and in many cases are using different price points (see examples in the boxes below).

80% of Southern Housing Group's tenancies are social rented. This is a higher proportion than most other associations in London, who have a more diverse portfolio. SHG therefore sees using intermediate tenancies to provide a more varied offer to the range of people requiring its housing.

It offers three types of tenancies:

- social rented - where rents are linked to the current regulatory formula
- intermediate rents - which are set at 80% of market rates
- affordable rents - which are set somewhere between social and intermediate rents, generally based on the views of the borough in which they are located

Yorkshire Housing is letting its Affordable Rent homes on a different basis to its homes let at social rent. AR homes are managed by its non-charitable arm. The aim is to let these properties to people who have market affordability difficulties, as opposed to people with specific housing needs.

As circumstances can vary dramatically in individual localities, it would seem appropriate for landlords to be encouraged – and given the flexibility – to develop their own rent-setting policies, based on assessing affordability at a local level. At present, landlords are constrained in their ability to do this effectively by the current rent framework and the requirement to charge Affordable Rents, rather than focussing on affordability.

Given the mission of social landlords, their rent-setting would be expected to clearly focus on prioritising affordability for those on the lowest incomes. However, this would also allow them to set rents based on local circumstances aimed at those on higher incomes than those at whom Living Rents are primarily aimed, but who have significant affordability problems

Landlords would need to have to have a published rents policy based on a robust assessment of needs and affordability at the local level. This would include being very clear about how their rents were meeting the housing needs of those in poverty.

Assessing localised affordability is however a complex task for individual landlords. This can be seen from the approach of Affinity Sutton (see box below).

Affinity Sutton had concerns that the households being nominated by local authority partners for Affordable Rent housing were largely the same as those nominated to the social housing product. As a consequence, Affinity Sutton became concerned about the affordability of its housing and commissioned research from Cambridge University to better understand how affordable rent levels interplayed with earnings and the welfare benefit system.

The research found that, due to the household size and income level in most of Affinity Sutton's larger homes, housing benefit needed to be claimed to make the tenancy sustainable. However, for smaller homes there was an opportunity for tenants to not be reliant on housing benefit, provided they were paid a living wage. There was, therefore, a real impact that rent levels could make on household affordability for these properties, which also accounted for the majority of Affinity Sutton lettings.

Affinity Sutton did consider a more granular rent policy by considering property values and incomes at a more local level but decided that such an approach would be complex to administer. They also investigated the use of existing or amended social rents but these produced a compressed range of rents that did not adequately value the increased amenity of larger accommodation.

Affinity Sutton therefore developed a rent-setting policy that was easy to understand and straightforward to operate based on:

- Abandoning a link to market rent and concentrating on affordability
- Increasing the differential between properties of different size
- Reducing the rents of 1 and 2-bedroom homes
- Creating two levels of affordable rent – inside and outside London[55]

The clear formula based on local earnings that Living Rents provides could help focus a landlord in developing its own tailored approach to rent-setting. It could be used as a mechanism to help social landlords develop a clear, flexible way to set rents and/or a point of reference against which to benchmark their approach to housing affordability. This could be done by:

- ***Core development product***

Living Rents being the core outcome for new homes for those on very low incomes built as part of the government's housing investment programme for rented homes for households in poverty. At least 40,000 homes would be built to be let at Living Rents each year.

[55] For further information on Affinity Suttons rents see Ellis, K. and Whitehead, C. Affordability: A step forward Affinity Sutton (2015)

- ***Living Rent Landlords***

For their existing properties landlords would have the freedom to become Living Rent Landlords, committed to making rents locally affordable. Given that there is a 10-year rents strategy in place which is designed to annually increase rents by CPI plus 1%, we would propose that:

- A landlord's current rent income should act as a ceiling or 'envelope' for its rent-setting policies. This rent envelope can be increased by a maximum of CPI plus 1% each year
- Landlords would have the flexibility to determine sub-market rents that were responsive to local needs. They could develop their own methodologies or use Living Rents as the core basis of their rent-setting, possibly alongside other homes at a range of rents to meet different housing needs
- Landlords would publish their rental policy annually

Such an approach would help landlords focus on delivering resilient and sustainable communities, responsive to local labour market conditions, for people with a variety of affordability problems and over a range of incomes.

How this approach might be dealt with in terms of landlords themselves spreading good practice on rent policy throughout the sector and/or the regulator having a role in supporting the wider use of such policies, would be a matter for wider discussion.

For those in poverty, a Living Rent framework significantly helps address the shortage of affordable, decent housing. Linking rents to local incomes tackles the current housing affordability gap, while the provision of high-quality and stable housing ensures that tenants can thrive and contribute, whatever their employment circumstances.

Such a Living Rent framework could be part of a more coherent strategy on renting, as a crucial part of a comprehensive, long-term plan to build the homes we need in the right places and avoid locking low-income households out of affordable homes.

Detailed papers on the research work which form the background to this report can be found on Savills website.