

Institutional Investment in Social Rental Housing – France, the Netherlands and the United Kingdom explored

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Abstract In the United Kingdom, social landlords are facing decreasing governmental financial support for them to fulfil their role in the provision of social housing, which has led to increasing pressure on them to rely on private capital. Traditionally, bank loans were the main source of private capital, but after the Global Financial Crisis (GFC) and the credit crunch, social landlords have had to identify alternative sources of capital funding. At the same time, institutional investors have the strong intention to diversify their investment portfolios. This paper aims to explore whether institutional investors might be interested in diversifying their investment into social rental housing in France, the Netherlands and the United Kingdom. The paper considers broadly why social landlords want institutional investors, why institutional investors have been investing in social rental housing, the returns, risks and barriers associated with institutional investment in social rental housing, and finally how the GFC and government regulatory policies potentially influence future institutional investment in the sector. The research was based on interviews with a small number of social housing providers and institutional investors in these three countries.

Keywords Bond finance, equity investment, intermediate renting, social housing

1. Introduction

In the United Kingdom, institutional investors have started to take an interest in social rented housing, finding the investment profile of potentially long-term, index-linked income an attractive proposition to match against their annuity/pension liabilities. However, to date, there have been few examples of institutions investing directly into this sector. To understand why, the Investment Property Forum (IPF) commissioned a project in 2014 to investigate how institutional investment might expand the social housing sector in the UK, as well as in selected European countries.ⁱ

Prior to the 2008 Global Financial Crisis (GFC), the 'traditional' source of private finance for social landlords was bank loans. But nowadays, banks, not only in the UK, have been less able to lend cheaply or for long periods particularly after the new Basel III regulation that forces them to hold extra capital for long-term debts (Milligan et al., 2013). As a result, social landlords have sought alternative sources of private finance. This paper explores the possible expansion of institutional investment in social housing by reporting results from the IPF-study on prospects for institutional investment in social housing. This study aimed to uncover a) the reasons why social landlords need institutional investment; b) the reasons for institutional investors to invest in social housing; and c)

the returns, risks and barriers associated with institutional investment in social housing. The United Kingdom, the Netherlands and France are compared, as the governments in the three countries have explicit policies aimed to achieve a bigger involvement of the institutional investor in the social rental market.

The research, therefore, evaluates which elements of existing models work, why they work and whether possibly the models could work better, if certain barriers were removed. In order to achieve this objective, Section 2 presents a framework for the analysis, followed by a summary of the methodology in Section 3. Section 4 focuses on our definitions of social housing in the three countries. Sections 5 to 7 discuss the extent of institutional investment in social housing in France, the Netherlands and the UK, including how the GFC and governments' regulation of social housing affect the forms of institutional investment in social housing. Before the conclusions in Section 9, Section 8 compares the barriers and constraints to institutional investment in social housing in the three countries, as well as the role of the three governments.

2. The comparative framework

The comparative framework in Figure 1 shows the three key actors who are involved in institutional investment in social rental housing. The institutional investors and the providers of social rental housing (social landlords) make a deal with each other about the form of the investment. At the same time, the government sets the 'rules of the game' which may be changed in response to the changing economic and political environments of the country. The three actors will be elaborated on more closely in this section.

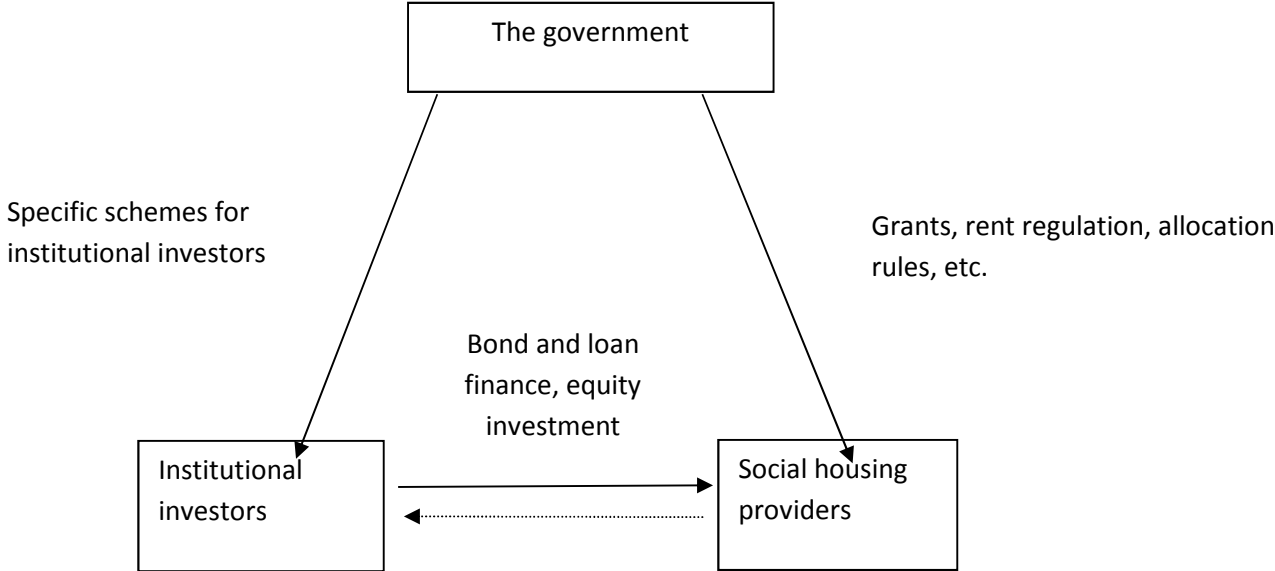
To begin the discussion, it is important to define "social housing" in Europe. In the rental sector, the distinction social versus private is often defined in terms of who owns the housing. The social landlord often is a public body or a non-profit organisation which is obliged to perform a public task: to provide social housing (Oxley, 1995; Haffner et al., 2009, 2010). However, in Germany and the United Kingdom, for example, private landlords are involved in the provision of social housing (see also, Oxley et al., 2010). Harloe's (1988) definition is therefore more broad, as he introduces affordable rents, administrative allocation according to a socially desired level and a political (governance) framework. The primary purpose of social renting is therefore to meet housing needs (see also Maclennan & More 1997). Haffner et al. (2009 and 2010) argue that in theory, there is only one defining characteristic of social housing: allocation according to needs rather than according to market conditions (demand and supply). In this view, certain dwellings are set apart and are allocated according to administratively defined needs. This treatment is not only reserved for rental dwellings, but can also be applicable to owner-occupied dwellings. It must be noted again, in practice, the definition of social renting may have to be adapted by using another criterion than only allocation. In Section 4, we elaborate in more detail on the way in which we define social rental housing in France, the Netherlands and the UK.

Institutional investors are defined as large organisations (such as finance companies, insurance companies, labour union funds, mutual funds or unit trusts, and pension funds) which have considerable cash reserves that need to be invested. These organisations may operate in groups or in an umbrella type of organisation to use scale advantages. Institutional investment may take two main forms: equity investment (e.g. joint ventures, sale and leaseback agreements) and debt finance (loan or bond finance). The latter involves no sharing or transfer of ownership, while the former may be seen as more similar to direct property investment. Sections 5-7 show the variety of institutional investors and the types of institutional investment involved in the three countries studied.

Finally, the government most often sets rules to ensure social housing is allocated to people in housing need as defined by Harloe (1988). It may also regulate rents and/or provide government finance or subsidies. Such rules and regulations may impact on the extent of institutional investment

in social rental housing, which are described in detail in Sections 5-7 for the three countries under study.

Figure 1 Three key actors – social housing providers, institutional investors and the government (the regulation and government policies)



Source: own elaboration based on Oxley et al. (2015)

3. Approach

The research was carried out in four stages. The first stage was a desk-based literature review, which in the UK informed the selection of a sample of social housing providers and institutional investors for the primary research. The second stage was a series of semi-structured telephone interviews in the UK with firstly the Finance Director/Head of Corporate Finance in the selected social landlords (nine) and with institutional investors (11) to explore their funding needs and what they think about attracting institutional investment, and secondly with investors to explore their experience and interest in investing in the sector. These interviews aimed to identify the key characteristics of the existing financial models that are used as well as barriers to investment in the sector and issues to be addressed in new models.

Similarly, in France and the Netherlands a small number of social housing and institutional investment professionals or experts (four in France and six in the Netherlands were interviewed by phone. The aim was to identify the main factors (e.g. government policies, specific financial models) that help to attract institutional investment into social housing.

The final stage was a half-day round table discussion with UK participants and the researchers to discuss the preliminary findings of the research. It aimed to address issues on the mismatched expectations between the social housing suppliers and fund providers and how to resolve these barriers.

4. What is social rental housing and who are the social housing providers?

As we mentioned in Section 2, because of the differences in the ownerships and allocation rules of social housing in different countries, different definitions of social housing are applied to the three countries we studied. In the United Kingdom, social housing is low-rent housing for people on low incomes. There are approximately four million social housing units in the United Kingdom, which

equates to about 18% of total housing stock. These are split between 2.4 million units with registered providers (housing associations (HAs) or private developers using government grants: 10% of total housing stock) and 1.7 million units that are still retained by local authorities (8% of total stock). Almost half (46%) of HAs' units were once in local authority ownership. Much of the rent in the social rented sector, 62%, is paid by the state in the form of housing benefit (British Property Federation, 2013).

In France, the combination of ownership and allocation results in the choice for the dwellings with a rent level below market rent owned by social housing providers called *Habitations à Loyer Modéré* organisations (HLMs). However, as it turned out, these dwellings are not a candidate for institutional investment, since HLMs have a long-term commitment to build and manage social rental housing under specific rules in which there is no place for institutional investment. Therefore, the focus here is on the so-called intermediate rental sector which offers affordable rents which are 'in-between' social rents and market rents and which are subsidised. Suppliers can be the HLMs, but also institutional investors or individual households. The selection criterion applied therefore is administrative allocation, as income limits are relevant, but they are higher than in the social sector. The aim of the French government is to enhance investment in the intermediate rental sector by offering attractive investment conditions. The aim is to achieve new construction of 8,000 to 10,000 dwellings per annum financed by institutional investors.

For the Netherlands, the ownership criterion in combination with the allocation criterion also targets the social housing providers which we will call social landlords. They are non-profit organisations with a public task. However, it was known beforehand that the social landlords mostly finance their investment with loans from two special circuit banks (Haffner et al., 2009; see Section 6); therefore, another selection criterion could be applied – the criterion of governance, specifically rent control. It increased the research population in principle to 92% of rental dwellings in 2009, as rent control applies to any rental dwelling with a monthly rent of up to 700 Euros (2014), regardless of the ownership of a dwelling. The regulated (rent controlled) rental stock includes about 96% of the stock of social landlords and about 70% of stock of private landlords (Haffner, 2014). The stock with a regulated rent must be considered as affordable under the assumption that these so-called regulated rents are lower than market rents (no detailed data available).

With the definition clarified that is used for the 'social rental' stock in each country, the next sections provide information for each country on institutional investment in 'social rental' housing.

5. Institutional investment in France

a. Policy and crisis context

As stated in Section 4, institutional investment in the French social rental sector is basically investment in the French intermediate rental sector. On many aspects, the French intermediate rental sector occupies a middle position between the social rental sector and the private rental sector. The rent levels in this sector are higher than in the social rental sector, but lower than in the market rental sector in which the rent setting is free. Just as in the social rental sector, tenants who want to live in the intermediate rental sector generally have to meet certain income criteria. However, the income limits that apply are higher than those in the social rental sector (Haffner et al., 2009).

The idea behind the French intermediate rental sector is that it fills the gap between the social rental sector and the market rental sector, by offering a good alternative to tenants from both these sectors. For social tenants, the intermediate sector might offer an opportunity to make a housing career within the rented sector; while private tenants, as well as newcomers on the housing market with a slightly higher income who are not entitled to enter the social rental sector, will be attracted

by the relatively good price-quality relationships in the intermediate rental sector. Intermediate rental dwellings are especially needed in regions with a relatively tight housing market, in which there are large price differences between relatively 'cheap' social rental dwellings and relatively expensive market rental dwellings (Hoekstra & Cornette, 2014). These price differences have remained large in recent years despite the influence of the GFC.

Intermediate rental dwellings are mainly provided by individual private rental landlords. Many of these landlords make use of the various tax incentives that are provided by the government. These incentives assure that in exchange for the financial support of the government, landlords have to meet certain criteria with regard to the rent level¹ and the income of the tenants (see Hoekstra, 2013, for a detailed description of these tax incentives). The financial arrangements between government and individual private rental landlords apply to a rather long (typically more than seven years) but fixed period of time. When this time period has passed, the dwellings concerned will be part of the free rental market.

b. Institutional investment in the intermediate rental sector

The French government has been trying to stimulate investment in the intermediate rental sector for several decades because of a continuing shortage of affordable rental dwellings for middle-income groups, especially in areas with a strong population growth such as the Paris region and cities like Bordeaux and Toulouse. Investment in the intermediate rental sector is supported for all types of investors: HLM organisations, market parties (including institutional investors) and individual households. For HLM organisations and market parties, special loans are available: The *Prêt Locatif Social* (PLS) and the *Prêt Locatif Intermédiaire* (PLI). However, institutional investors are generally not interested in taking up PLS and PLI loans as they are accompanied with rather strict conditions with regard to the rent setting, the income of the tenants and the duration of the arrangement. Consequently, almost all PLI and PLS loans are taken out by social rental landlords. However, in terms of financed dwellings, most of the investment in the French intermediate rental sector takes place by individual private rental landlords, stimulated by the fiscal incentives that the French central government provides (see Hoekstra, 2013).

Recently, however, two important new developments have taken place in the intermediate rental sector that aim to further enhance investments by social rental landlords and institutional investors in this sector. First, a new legal and taxation framework that gives the intermediate sector a more formal position has been introduced. This legal framework gives HLM-organisations the opportunity, albeit under strict conditions, to set up a branch organisation that provides intermediate rental housing. Furthermore, the new framework provides some tax advantages to institutional investors that choose to invest in the intermediate rental sector; these investors pay a lower VAT rate (10%) and are exempt from paying local property taxes for a period of 20 years. Finally, a new initiative has been developed that aims to attract institutional investors to the intermediate rental sector: *The Fonds Logement Intermédiaire* (FLI).

The Fonds Logement Intermédiaire (FLI)

The *Fonds Logement Intermédiaire*, formerly called Argos, has been initiated by the *Caisse de Dépôts*² and its branch *Société Nationale Immobilière* (SNI). SNI is one of the largest landlords in France and manages more than 185,000 social rental and almost 90,000 intermediate rental dwellings. The FLI was officially launched on July 24, 2014. Apart from SNI, the fund consists of seven institutional

¹ The maximum rent levels of the *Duflot* tax incentive run from 16.72 €/m² in the most expensive region of Paris to 8.96 €/m² for middle-sized metropolitan areas (www.anil.org). For other territories there is no norm set.

² The *Caisse de Dépôts* is a public investment fund. Among other things, the *Caisse de Dépôts* provides low-interest loans to social rental landlords. A substantial part of the money that *Caisse de Dépôts* invests comes from tax-free saving accounts for French households (the so-called Livret A scheme).

investors, mainly active in the field of insurances and pensions. These investors already have affinity with investments in residential property. The aim of the fund is to create 10,000 new intermediate rental dwellings (in 2014) in areas with a tight housing market. The fund will have an investment capacity of 1.7 billion Euros. Half of this amount of money comes from own equity of the fund participants, whereas special bank loans are available for the financing of the remaining half. The fund expects to have a yearly net rental yield of 3.5% per year, and a total yield (including the future sale of the dwellings) of 7% (IRR). The fund will run for a period of 20 years after which all the dwellings will have been sold.

The new intermediate rental dwellings will be integrated in so-called mixed programmes with at least 25% social rental housing. These dwellings will generally have two or three rooms, a floor area of an average 54 square meters, and a rental price that is about 15% below the market price. The fund takes the form of a *Société Civile Immobilière* (a French variant of the Real Estate Investment Trust) and will be managed by the company *Ampere Gestion* (HSBC, 2014).

In 2015, the FLI is attempting to attract additional investors, including institutional investors from abroad. For this purpose, they have scheduled meetings with two big Dutch pension funds (APG and PGGM) as well as with some German institutional investors. For 2015, the FLI plans to provide 8,000 new intermediate rental dwellings. FLI does not construct the new intermediate rental dwellings itself but buys them from construction companies and project developers. Interested property developers can submit their plans to FLI, which will make the selection via a tender procedure.

c. Future prospects

On paper, the prospects for institutional investment in the intermediate rental are rather good. Although it is still too early to draw a firm conclusion, the FLI seems to have a considerable impact. Moreover, the yields in which these investments result can be attractive, particularly in areas with a tight housing market. However, there are also a number of impeding factors as a result of which many institutional investors are relatively reluctant to invest in (intermediate rental housing). First of all, the strong tenant protection, and the broad societal support for this, plays a role. Institutional investors are afraid of non-paying tenants. Not only because it is difficult to evict them but also because evicting non-paying tenants can lead to 'bad advertising' and give the institutional investors the image of a 'bad guy'. This is something that they want to prevent at all costs. Second, French housing policies and regulations (rent regulation, tenant protection and particularly the availability of fiscal advantages) are not very stable and often change once a new government has been installed. This leads to insecurity with regard to the yield that institutional investors can expect in the medium and longer term. Third, after the strong house price increases in the 1999-2006 period, many institutional investors expected a house price decline after 2007. In anticipation of this, they started to sell some of their residential properties. In reality, however, the post-2007 house price decline in France was fairly limited: after a house price decrease in 2008 and 2009 price levels recovered and in 2011 and 2012 the nominal house price index was already above the 2007 level (EMF, 2013). Finally, there has been a lack of investment products for investors that don't want to exploit and manage the residential property in which they invest themselves. Obviously, the newly created FLI attempts to fill this gap.

6. Institutional investment in the Netherlands

a. Policy and crisis context

In the Netherlands, both the effects of the GFC and policy changes impacted on investments in the rental market. The Dutch economy has been relatively hard hit in the aftermath of the GFC by moving into and out of three recessions since the start of the crisis resulting in a drop in house prices of approximately one fifth. In the interviews, the expectation was also launched that house prices in

the Netherlands are bottoming out, offering new opportunities for investment in the private rental market (Eichholtz et al., 2014). Also, the new policies for homeownership (decreasing tax advantages as of 2013 and 2014) are expected to improve the relative attractiveness of renting.

However, these generally 'good' investment conditions are expected for 'market' investments only. A move towards 'more market' and a 'more marginal' social rental sector is underlying (expected) policy changes since 2010. In short, a better balance on the rental market was aimed at curtailing social renting and allowing for better yields for investors in rental housing with more market-conforming rents (Donner, 2011). Along with budget cuts lowering the tax advantages for homeowners in response to the budget problems following the GFC, a landlord tax was introduced, as of 2013. The aim of the levy is to have (originally social landlords, but broadened to) owner-landlords who own more than ten dwellings with a regulated rent pay this tax³.

The newest proposals that government was putting before parliament (amendment bill) made the private deregulated rental segment a more attractive investment option: temporary rent agreements instead of mostly permanent rent contracts in certain situations and a freeze of the threshold deregulation rent level at the 2014 level of almost 700 Euros per month. The combination of these measures is expected to allow (for the longer term) the deregulated rental segment (rent of more than about 700 Euros per month) to grow.

b. Institutional investment – social housing: debt finance

As explained in Section 4, traditionally social landlords finance their investments with private sector borrowing, e.g. loans from the so-called "sector banks", the BNG Bank and the Dutch Water Board Bank (NWB Bank). The shares of both banks are in hands of different government and/or statutory bodies. Their aim is to provide financing for the public sector and/or for socially beneficial purposes.

Social landlords in search for the 'cheapest' loan offered increasingly seem to be serviced by other organisations than the sector banks. The share of sector banks in the amount of newly-guaranteed loans has slowly been decreasing from 90% in 2009 to 88.5% in 2013, while the share in the annual new loan volume from institutional investors has increased from 1.2% to 7.9%. Loan volume in 2013 amounted to 5.5 billion Euros (*Waarborgfonds Sociale Woningbouw*, 2014). The increased interest from institutional investors can roughly be explained by two factors. First, with the low interest in especially Dutch and German government bonds, the search for yield causes institutional investors to consider alternative attractive investments. In particular, insurance companies, also from Germany, were said to discover the finance of social rental housing as a way of asset-liability matching in the longer term. Second, *Waarborgfonds Sociale Woningbouw* (WSW), the guarantee fund for loans for social housing to social landlords with government backing, has actively searched to stimulate new, supply of finance. And the government backed guarantee for the financing of the social rental dwellings, makes the sector a relatively attractive investment opportunity for financiers as risks of non-payment are taken away. Additional security is provided by the Central Housing Fund (CFV) which is responsible for the financial health, and also the financial reorganisation of social landlords in financial trouble.

c. Institutional investment – regulated rental housing other than social: equity finance

There are no residential real estate companies that are quoted on the stock market; instead the legal form is a holding company. The fact that there are only these types of holding companies operating on the Dutch rental market is regarded as a barrier for the entrance of non-Dutch investors: Dutch institutional investors of any significance all had been investing indirectly in the rental market

³ The Landlord Levy (verhuurderheffing) is calculated on the sum of the taxable house value. An exemption exists for the value of the first 10 houses of each owner. For 2013, the tariff was 0.0014%; for 2014 0.381%, and 2015 0.449%. It will be increased to 0.491% in 2016 and 0.536% in 2017.

including the regulated part for some decades. Together they invested about 2.7 billion Euro in residential real estate in 2013. The interviewees explained that the portfolio of institutional parties on average contained about 20% to 40% of rental dwellings with a regulated rent. However, in the past few years, little investment in new stock with a regulated rent has taken place because of the impact of the GFC, but also because of the new (proposed) policies that are expected to make investment in the regulated sector less attractive and returns unsure (see above). Rent control as such was also mentioned to invade entrepreneurial freedom. An attractive element in the regulated rental stock used to be the longer tenancies than in the stock with a deregulated rent with higher turnover costs (competition with owner-occupation).

If the risk-return profile were found attractive, stock acquisitions with dwellings with a regulated rent would have taken place. Talks were taking place between the property companies (holding companies) and the social landlords, but without any resulting deals between Dutch actors. The restrictions that are connected to the acquisition of a portfolio with a regulated rent (Blok, 2013) were mentioned as a barrier. These are national rules in relation to rent increases and profit sharing at the point of sale of the dwellings by the institutional investor who is said to buy the total risk, but not the total benefits. However, the largest sale of dwellings of a social landlord to a German fund manager representing a number of large foreign pension funds belied this claim, as around 70% of dwellings sold were in the regulated segment. This sale of about 5,500 dwellings was needed by the social landlord in order to solve its financial problems (speculation gone wrong with derivatives).

Investment in the regulated stock more generally may be something of the past, once the landlord tax is considered. Since it has been introduced (2013), it has been affecting investment decisions as an extra cost implying a lower acquisition price than the investor is willing to pay. The strategy may become to deregulate rents (after adding value) of the existing stock, if the market will bear the rent, when a new tenant moves in.

d. Future prospects

The stock of social landlords comprised mainly rental stock with a regulated rent that has been financed with loans from the sector banks (guaranteed by government in the last instance). Since 2009 the share of loans from institutional investors has increased, because the guarantee fund and the social landlords have actively diversified their supply of finance. Insurance companies have been discovering the finance of social rental housing as source of acceptable alternative returns.

The sale of portfolios by social landlords is considered unsure. New policies such as the landlord tax may or may not cause increasing sales of stock by social landlords. If institutional investors wish to buy dwellings with potential for the rent to be deregulated relatively easily (when a new tenant moves in) or which are already deregulated, from social landlords, central government has set up rules to facilitate such transfers. Whether the rules will indeed facilitate stock transfers from social landlords to commercial actors remains to be seen. The sale of regulated rental stock from social landlords to institutional investors or institutional investment in new construction will only take place if rates of return turn out to be satisfactory for the buyers, taking into account all the costs, including the landlord tax. The share of up to 40% of regulated rental stock owned by institutional investors is expected to decline, and traded in for more attractive business in the deregulated segment.

7. Institutional investment in the United Kingdom

a. Policy and crisis context

Prior to the 2008 GFC, the 'traditional' source of funding for HAs was a mixture of government grants from the Homes and Communities Agency (HCA) and bank debt to allow the sustainability of low-cost housing construction. Since 2008/2009, the HCA grant has been significantly reduced. The proportion

of HCA grants in HA gross investment expenditure was around 40% throughout the period from 2008/2009 to 2011/2012 (Pawson and Wilcox, 2013). Between 2011 and 2015, the HCA invested £4.5 billion in affordable housing through the Affordable Homes Programme (HCA, 2011). Despite that, the amount of public funding available for the construction of new social homes has been cut by 60% as a result of the Coalition Government's austerity agenda⁴. With regard to bank debt, HAs have traditionally been able to borrow long term at very low margins from banks. As of March 2014, 78% of the HA sector's debt was attributable to bank loans, reflecting the historical significance of bank finance to the sector (Moody's, 2014). However, since the GFC, banks have no longer been able to lend cheaply or for long periods, now typically set at five years (rather than the traditionally offered 20 years). Because of the reduced bank lending, HAs have begun to shift towards capital market bond financing.

b. Institutional investment

Multiple attempts have been made by successive governments to stimulate investment from institutional investors (insurance corporations and pension funds) in the residential sector. Notable government measures include the 1988 Business Expansion Scheme, the Housing Investment Trust Scheme (Crook et al., 1998; Crook and Kemp, 2002), Real Estate Investment Trusts and more recently the Build to Rent Fund (Alakeson et al., 2013). Despite these efforts, the scale of institutional investment in the residential market is very small. The 2014 Investment Property Forum's (IPF, 2014) survey of institutional investors' attitudes regarding residential real estate investment in the United Kingdom showed that only 4.2 per cent (£200 billion out of £4.8 trillion) was invested in real estate, of which only £12.8 billion was in residential property. Of this £12.8 billion, £4.4 billion was in private renting (market rent/assured shorthold tenancies) with only £0.4 billion in social housing.

Institutional investment in HA housing includes HA bonds, development partnerships/joint ventures and sale and leaseback agreements. Of these, HA bonds have been the main mechanism by which institutions have invested in the social housing sector. HAs have issued bonds since 1996 but it is only after the GFC that bond issuance has accelerated. Today, HAs can raise funds with retail and wholesale bonds with 'own name' issues or bonds issued by an aggregator, such as The Housing Finance Corporation (THFC). For example, from 2011–12 to 2013–14, £7.9 billion was raised from the bond market, equivalent to 63% of total external finance raised over the period (Moody's, 2014, Exhibit 1). In 2012–13 alone, HAs raised £3.6 billion debt in which £3.2 billion was from the bond market, representing over two thirds of all new debt facilities arranged (HCA, 2013). The main bond investors are insurance corporations and pension funds such as Aviva, Legal and General, M&G Investments (Prudential) and Standard Life.

To encourage more institutional investment in social housing, the UK government in September 2012 launched the Affordable Housing Guarantee scheme whereby the Department for Communities and Local Government (DCLG) provides a guarantee to support debt raised by borrowers (HAs and other private registered social landlords) to develop additional new affordable homes. The guarantee scheme (£3.5 billion initially, with £3.0 billion held in reserve) was complemented in England by grant funding, although the guarantees themselves are UK wide (DCLG, 2013b). On 20 June 2013, DCLG appointed the THFC through a newly formed subsidiary, Affordable Housing Finance, as the delivery partner for the Affordable Housing Guarantee scheme. In May 2014, under the Affordable Housing Guarantee scheme, 13 HAs secured £208.4 million of funding through AAA-rated 28-year bonds, which was believed to be the HA sector's cheapest ever bond finance. It is estimated the guaranteed-

⁴ "European Investment Bank to fund UK social housing", *Financial Times*, 18 July 2014.

bond will support the delivery of 5,800 additional homes, with over 4,100 homes to be delivered outside London⁵.

In the research, eight of the nine HAs interviewed had used institutional investment to fund their new developments in the last five years (2009–2014). Within this group, bond issuance was the main form of institutional investment. Bonds were typically structured with fixed coupon rates for 20 to 40 years. Most often, there was no amortisation prior to final maturity date. Larger HAs, defined as those owning more than 20,000 units or were credit rated, issued ‘own name’ bonds through public issuance. The most common financial covenant was asset cover, in which at least 105% of the value of the bonds is secured on property. The amount of capital raised through private placement could be quite small. One HA raised as little as £10 million through an overseas investor within the last five years. For smaller HAs (i.e. those owning fewer than 10,000 units) and some medium-sized HAs, bond issuance was usually via an aggregator, such as THFC or GB Social Housing. One HA obtained institutional investment through the subsidiary of THFC, Affordable Housing Finance, under the government’s Affordable Housing Guarantee Scheme. Aggregated bonds were usually required to meet both asset cover and interest cover covenants (i.e. ratio of net rental income/interest). The minimum property security value had to be 115% of the loan. Most often, the bonds issued were senior debt.

While bond issuance and development partnership/joint venture have been used to fund new development, sale and leaseback arrangements were solely for the acquisition of existing stock. Amongst the sample, development partnerships/joint ventures had rarely been used for the development of social rented units. Only one HA interviewed had entered into a sale and leaseback arrangement with an institutional investor in the last five years. The HA used the proceeds to acquire existing stock from another HA. Lease payments were based on the Retail Price Index (RPI), but the HA will seek to change to Consumer Price Index (CPI) when the annual rate of rent increase changes after 2015/16 to CPI plus 1%. The length of the lease was 50 years, but in effect, 45 years as, for the last five years, rental payments will be notional. At the end of the term, the HA will pay £1 and the ownership of the leased stock will transfer back to the HA.

Overall, the interviews revealed that there was no barrier to prevent institutional investment in social housing, particularly in the case of bond issuances. In the past, medium- and smaller-sized HAs used to think that institutional investors would not invest in their HAs because of their small size and, hence, smaller amounts of capital required. Today, HAs believe they can access the bond market through many routes, and transaction size is no longer seen as an issue, although some medium- and smaller-sized HAs found that substantial conditions were required to be met in order to issue bonds via an aggregator. Even though they had no problem in issuing bonds, many medium- and smaller-sized HAs still thought that institutional investors needed to understand their distinctness from larger HAs. However, there were barriers for HAs to accept index-linked finance (i.e., sale and leaseback). A number of HAs expressed concerns at potential cash flow problems if rental income failed to keep pace with inflation, either due to policy changes or a growth in arrears or vacancy rates. One HA that had entered into a sale and leaseback stated that it had to cap the extent of such index-linked arrangements at not more than 25% of the HA’s whole loan portfolio.

Within the sample of institutional investors, four investors had successfully invested in either traditional social housing or shared ownership, while a further three had deals in the pipeline. Notably, there was little evidence of investor participation in equity-type investment in traditional social housing beyond sale and leasebacks. Investor responses indicated that HAs played a key role in managing the number of tenant relationships – some respondents also specified the HA’s role in mitigating reputational risk. Other investors interviewed were either looking at the sector or have

⁵ “Government-backed bond prices at 37 bps to mark sector’s ‘cheapest issuance’”, *Social Housing*, 22 May 2014.

tried and failed to invest. Reasons given for not investing included: internal priorities and resources, the lack of attractive investment opportunities, pricing and generally being unready to invest. In relation to this lack of readiness, a number of respondents mentioned that the sector is new and the route of entry would need to be a simple investment as a first step, such as a straightforward refinancing of existing stock. This highlights that new investors have a hurdle to overcome, before taking more risk and participating further in the sector – successful transactions were required before the sector becomes recognised as a natural area of investment for a number of prospective investors.

Institutional investor respondents listed a number of motivations for investing, relating to specific characteristics of social housing. These reasons can be categorised into three groups: (1) cash flow and return prospects; (2) ethical and moral preferences of HAs; and (3) regulatory environment (the role of HCA) and macroeconomic conditions. Social housing and infrastructure were seen as growth opportunities, driven by underlying demographics and the need for housing. In general, it was believed that there were diversification benefits from exposure to social housing relative to other commercial real estate sectors, given the stability of its cash flow from the rental incomes. The current low interest rate environment has also driven down expectations, making social housing more palatable.

c. Expected development

When asked what will be the main funding source for new development, all surveyed HAs stated that bonds would increasingly become the main (or only) source of funding. While there was an increasing appetite for bond finance, HAs continued to have very limited or no interest in using equity finance (joint venture and sale and leaseback arrangements).

Institutional investors, on the other hand, were keen to expand their equity investment in social housing. The reasons offered for the dominance of bond finance, as given by both surveyed HAs and institutional investors, were stemmed from inertia amongst HAs and how they considered advice and the stance and approval process of the HCA, as well as the attitude of treasury advisors consulted by HAs. In practice, HCA has urged HAs to exercise caution when entering into sale and leaseback deals because linking debt to the RPI over 30 years or longer can cause problems when the rent regime, which is currently also RPI-linked, will change after 2015/2016 to CPI plus 1% each year for the following 10 years (Wilson, 2014). Also, there are possibilities that there will be further changes on rent regimes for the next 15, 25 or 30 years. It is evident that the ability to raise debt cheaply has a significant impact on HA choices. While interest rates remain low, the greater interest in fixed-rate debt is likely to continue.

8. Barriers and constraints

In the United Kingdom and France, large scale direct institutional investment in social housing is not the norm and growing institutional investment is a relatively new development. A significant barrier is thus the lack of understanding and experience with this form of investment on the part of both social housing providers and investors, even though in the Netherlands there has been a long term indirect institutional investment in regulated-rented dwellings. Drivers of expansion in institutional investment in all countries have included, in varying degrees, a reduction in direct support for social housing from government and constraints on the cost and availability of “traditional” lending from banks as a consequence of the GFC and tighter regulatory requirements in the financial sector, as well as sinking alternative returns.

The form that institutional investment takes is driven by the circumstances of individual countries, the variations in the forms of social housing provision and the stance of governments with respect to regulation and financial incentives to promote institutional investment. The net costs to providers of

alternative forms of new funding are of great importance. In the United Kingdom, for example, whereas pension funds and insurance companies have shown some interests in equity investment in social housing organisations, many HAs are content with what they see as the lower costs of funds raised through the issuance of bonds.

In France, government has been trying to expand the intermediate rental sector to meet a growing need from households who are not poor enough for the most “social” of social housing but cannot afford market rents or home ownership. However, initially most of the government incentives focused on individual investors rather than on institutional investors. In an attempt to change this, special tax incentives and a new funding vehicle have recently been established to specifically promote institutional investment. In France, as in other countries, reputational risk for investors is an issue. They do not want to be associated, for example, with the eviction of tenants in rent arrears. They are also concerned about the impact of rent regulations and tenant protection. A further lesson from the French experience is that fluctuations in government policy and changes in the fiscal advantages of involvement can be problematic for institutional investors looking for long term secure yields.

The Dutch situation is characterised by the differences in the attractiveness, from an investor’s perspective, between the regulated and unregulated parts of the rental market. Unregulated dwellings are clearly more attractive, and regulated tenancies have been made less attractive by the imposition of a new tax on the landlords having (more than ten) regulated rental properties. However, as explained in Section 6, the volume of loans to social housing providers is shifting in favour of institutional investors and away from banks as insurance companies, in particular, take advantage of secure long term yields backed by a guarantee fund.

The overall level of direct institutional investment in the residential sector in the United Kingdom is small despite various government initiatives that have tried to boost such involvement. In the social housing sector, housing association bonds have been the main form of investment despite an appetite for more equity investment on the part of the institutions. Once established, the process of bond issue is seen by HAs to be a straightforward way to fund new development. Bond finance is expected to grow as both other sources of finance become more difficult and familiarity with bonds increases.

9. Conclusions

Institutional investment in housing takes different forms in different countries. In the Netherlands mainly social landlords finance their investment mainly with loans, also from institutional investors also own regulated rental stock. The French intermediate sector is also in the hands of institutional investors, while in the UK bond finance has become popular. In this contribution, it is shown that Institutional investment takes the form that the structure and the governance of the rental market allows for.

Reticence associated with a lack of experience by both social housing providers and institutional investors may well decline as more deals are struck and learning increases. However, the French experience in particular suggests that governments have a crucial role in developing fiscal incentives and institutional arrangements that promote institutional investment in social housing or, more precisely, in the French case, intermediate housing. As explained in Section 5, a dedicated fund was established in 2014 that aims to fund the development of several thousand new intermediate dwellings with support from seven institutional investors who are mainly active in insurance and pensions. Further institutional involvement in the fund, including from Dutch and German investors is being sought. The fund, underpinned by fiscal support, will run for 20 years with the dwellings then being sold.

Governments can, in several ways, increase the rate of return and decrease the risks from institutional investment in social housing. The French case provided the clearest example of tax reductions which increase rates of return. The Dutch have a clear example of how a government backed guarantee and a housing fund that ensures the financial security of social housing providers can reduce the risk associated with residential investment. The UK Affordable Housing Guarantee scheme is a further example of how government can reduce risk for investors.

Social housing investment is seen as a potential growth opportunity by some UK investors given the underlying housing shortage and the perceived diversification benefits from social housing. Low interest rates have had an important impact on expectations increasing the advantages of this alternative form of investment. This type of reasoning has also been expressed in the Netherlands for insurance companies' finance for social landlords.

Not all institutional investment in social housing expands the stock. There is an explanation in Section 6 of how a German fund manager representing foreign pension funds has acquired Dutch social housing stock. The sale has provided funding for the landlord that has decreased its stock but eased its financial position.

Institutional investment in social housing is ultimately a function of the costs and availability of alternative forms of finance from the social housing providers' perspective and the relative returns and risks from the investors' perspective. Governments can exercise a good deal of influence on the extent and specific form of institutional investment. If governments want more of such investment, as they appear to, they can exercise this influence mainly through fiscal and regulatory changes. It might be said that large scale changes require bespoke investment vehicles, as in France, such changes can be encouraged through policy initiatives. To be successful, government initiatives have to be seen as long term and contributing positively to investors' perspective.

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ⁱ The full study examined the institutional investors' appetite for investment in social housing as well as social housing providers' appetite for new sources of finance. More information about the study findings can be found in the main report on which this article draws (Oxley et al., 2015).