Pinsent Masons

Housing Guarantees

Introduction

In September the Government announced the introduction of the Housing Guarantees scheme aimed at increasing the supply of affordable and market rented housing. The announcement came hard on the heels of a similar announcement in July this time relating to Infrastructure Guarantees. Both of these initiatives required Parliament to vote the monies for the schemes. This was achieved by the Infrastructure (Financial Assistance) Act 2012 which was enacted on 31 October 2012 and came into effect immediately.

The 2012 Act allows for the Treasury or relevant Secretary of State (with the consent of the Treasury) to give guarantees in relation to the provision of infrastructure. Infrastructure includes housing. There is a limit upon the quantum of guarantees fixed at £50bn. As a matter of policy this will be divided as to £40bn for infrastructure and £10bn for housing. The use of guarantees will also minimise the Government's fiscal position.

The housing guarantees scheme will be split into two separate schemes. This is because the EU State Aid rules will apply to affordable and market rented housing differently. Whereas affordable housing will be covered by the "exemption" under the Services of General Economic Interest (SGEI), market rented housing will not. The latter therefore will need to conform fully with the EU State Aid rules particularly the market economy investor principle.

The Housing Guarantee Scheme Rules were published by CLG on 1 February 2013. CLG has also issued an invitation to tender seeking applications from the market from those interested in becoming the "aggregator" for each of the two schemes (ie organisations interested in raising debt and on-lending to borrowers). It is anticipated that the aggregator(s) will be in place by the end of April 2013.

Affordable Housing Guarantees

The Government is seeking to use the affordable housing guarantees to provide up to an additional 15 000 affordable homes. On the assumption that the rents under the scheme will be affordable rents (i.e 80% of market) and assuming investment by way of subsidy of £300m then depending upon the out turn financing costs it is anticipated that the affordable homes scheme will take up around £1.5bn – £2.0bn of the £10bn allocated to housing.

The purposes of the affordable housing guarantees scheme are threefold to (1) attract new sources of fixed income investors and (2) reduce the cost of funding and thereby to reduce the levels of subsidy required to achieve affordable rent and (3) enable smaller registered providers to access the capital markets.

The guarantee will be available for fixed income (institutional) investors, and as such will be used to guarantee bonds (public or private) issued by registered providers. The form of guarantee will be a straightforward debt guarantee covering the repayment of interest and principal.

As indicated previously, the scheme will involve the use of an “aggregator” to enable smaller and medium sized registered providers access to the institutional investment market.

Again, as mentioned previously as affordable housing is covered by the EU State Aid SGEI “exemption” there will be no need to make a commercial charge for the guarantee. However, borrowers will pay a pro rata administration fee to cover costs of managing and monitoring the guarantee loan scheme as a whole.

There will be a bidding process to join the scheme, which will be undertaken by the CLG. Eligibility will obviously be restricted to registered providers (including newly registered “for profit” providers). However the borrowing must be classified to the private sector. Applicants will need to commit to deliver an agreed number of affordable homes (although these may be a mix of affordable rent and home ownership). Support will only be for additional homes meaning that support will not be available for schemes where funding is already committed or for the refinancing of existing debt. All bids will be subject to the HCA’s usual investment appraisal process.

There will be a minimum size for a project, requiring at least £5m total debt (although a project may comprise more than one development site). The homes must be used for affordable rent or affordable home ownership for the period of guarantee.

The likely structure for the affordable housing guarantee is set out below at Figure 1. An aggregator will be established, probably an independent “not for profit” special purpose vehicle. The aggregator will issue bonds to institutional investors on behalf of registered provider participants in the scheme. The aggregator will on lend the proceeds of the issue (and any further taps of the issue) to the registered providers. The debt will be available for up to 30 years.

This is little or no different to the bond issues arranged currently by or on behalf of The Housing Finance Corporation. However the difference in this structure will be that the Government (either through the Treasury or relevant Secretary of State) agrees to guarantee the principal and coupon on the bonds.

The debt (as guaranteed) will be available for drawdown in one amount (ie by definition it cannot be a facility) on completion of the loan and security documentation. Borrowers must commence construction of the affordable homes within 12 months of drawdown.

As a consequence of the guarantee the Government will be the primary creditor. Therefore the Government technically will be subrogated in the rights of the guaranteed lenders. A Security Trustee will be appointed to hold and manage the security on behalf of the aggregator (and the Government) for the loans advanced from the proceeds of the bonds (and the Guarantee). This will comprise the assets provided by the registered providers as security for the loans. The Government will therefore have the right to direct the Security Trustee to enforce the security should the guarantee be called by or on behalf of the institutional investors (subject to the usual conditions for registered providers in the Housing and Regeneration Act 2008).

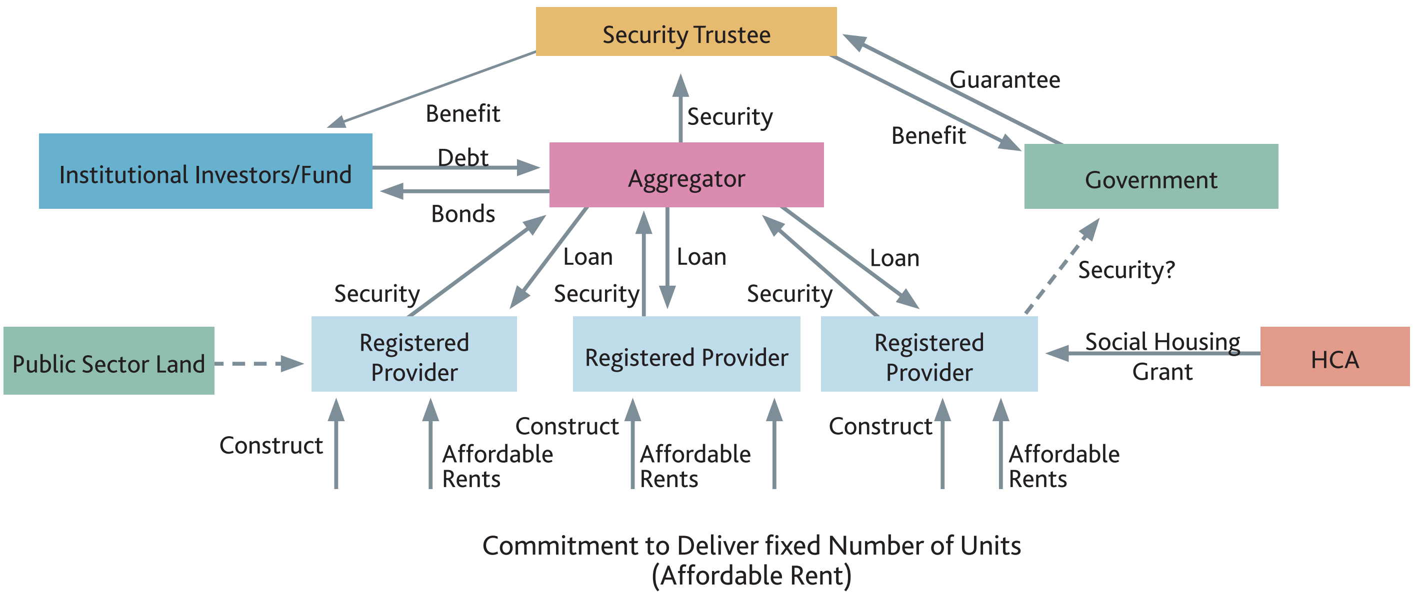
Asset and interest cover ratios are not unusual. The assets within the security must meet the required loan to value and interest cover ratios. The former must be not less than 115% (on an Existing Use Value – Social Housing basis) of the loan and the latter Net – 1:1. Security may be released when asset cover exceeds 150% and revaluations will be on a 5 yearly cycle.

The structure also contemplates there may be HCA funding albeit reduced to take into account (1) the rents are affordable and not social and (2) the anticipated reduction of the cost of private finance.

As large registered providers are already able to access institutional finance through the bond markets the principal question is the extent to which the guarantees scheme will (1) increase access to smaller or medium sized registered providers, (2) increase the supply of fixed income institutional investors seeking to enter the affordable housing market and (3) give rise to a reduction in the cost of funds from that currently available to registered providers in the market. The latter in particular will be dependent upon investors willing to reduce their coupon (due to any perceived credit enhancement effect of the Government guarantee).

One of the significant issues facing registered providers is security capacity for loans, meaning by this the unsecured assets available to be given as security and the capacity taken up by Social Housing Grant as unsecured debt. The latter effectively rules out registered providers taking out unsecured corporate loans which are available to similar sized businesses in other sectors. Registered providers may have hoped for assistance from the Government to ease this problem through a relaxation on security requirements in the guarantees scheme. However, this seems unlikely.

Fig 1: Affordable Rent Guarantee Scheme



Market Rental Guarantees

Along with guarantees for affordable housing the Government is also looking to generate growth in the housing industry more generally by offering guarantees to kick start the private rental market. On the assumption that the affordable housing guarantees takes up £1.5bn to £2bn of the available £10bn guarantee limit for housing the balance available for market rental guarantees is pretty significant and signals the Government's intention to stimulate the private rental market in a big way.

As with the affordable housing guarantee the market rent guarantee is specifically designed to attract fixed income institutional investors and will take the form of a debt guarantee (covering principal and interest) for a period of up to 30 years. The purposes of the guarantee are again similar to (1) lower the cost of borrowing (2) attract new investors and (3) help smaller organisations to access the capital markets through the use of an "aggregator".

There will, however, be one important difference from the affordable housing guarantees in that to comply with EU State Aid rules the guarantees will need to be on a commercial basis attracting a commercial fee which reflects the Market Economy Investor Principle. How this may work is discussed below.

There will be a bidding process to join the scheme, to be undertaken by CLG. There will be no restriction on the nature of the properties to be covered by the scheme, all standard new build residential properties will be permitted (as will conversions to residential but specific use residential eg student lets will not be). As the guarantees will only be available from practical completion or purchase of the dwellings and bearing in mind the scheme only runs until the end of March 2015, the properties will need to be capable of early delivery. Applicants will also need to demonstrate availability of equity funding.

Applicants will need to commit to provide an agreed number of market rental homes. There will be a minimum size for a project of £10m although the project can comprise one or more development sites. The homes must be retained for private rent for the period of the guarantee (and borrowers will be required to use their "best endeavours" to ensure that the homes are actively marketed for rent). Borrowers must be classified to the private sector which means for example local authority or other public sector SPVs will be excluded but joint ventures may not be.

There will almost certainly be an appraisal process including an investment appraisal to demonstrate, amongst other things, good value for money for the guarantee (although there is no suggestion that there will be any pre-condition around projects being dependent upon a guarantee to proceed).

The finance will therefore not cover the development period although the Government may offer a letter of confirmation of the finance to help secure development finance. The debt may be drawn down before practical completion but only if security is provided to cover lettings risk.

The likely structure for the market rental guarantee is set out below in Fig 2. As with the affordable housing guarantee structure the aggregator will issue bonds to institutional investors. The aggregator will then lend the proceeds of the issue (and any further taps on the issue) to approved applicants for the scheme (landlords) to enable those landlords to purchase homes for letting. The debt will be available for up to 30 years although a shorter term may be possible subject to the Government being satisfied with the refinancing risk.

The individual homes will be let probably on assured shorthold tenancies at a market rent. The rental income will repay the principal and coupon on the loans. The Government (either through the Treasury or relevant Secretary of State) will agree to guarantee the principal and coupon on the bonds.

The maxium loan to equity ratio will be 80:20. Landlords will need to detail how the properties will be managed and maintained. The landlords will either manage the market rental homes themselves (if they have the requisite in-house management expertise) or otherwise outsource the management to a management agent (which could include a registered provider). The management contract is likely to be performance related.

As a consequence of the guarantee the Government will be the primary creditor. Therefore the Government technically will be subrogated in the rights of the guaranteed lenders. A Security Trustee will be appointed to hold and manage the security on behalf of the aggregator (and the Government) for the loans advanced from the proceeds of the bonds (and the guarantee). This will comprise the assets provided by the landlords as security for the loans (which will include a floating charge over all of the company's assets of a SPV is the landlord). Recourse will be limited to project assets and equity capital.

In addition to securing the property there will also be security over the rents from the dwellings. There may also be right in favour of the Security Trustee to step-in to the management of the homes should standards drop below a certain defined level. As a consequence the Government will therefore have the right to direct the Security Trustee to enforce the security should the guarantee be called by or on behalf of the institutional investors.

The assets within the security must match the required loan to value and interest cover ratios. The former must be no more than 80% of the loan and the latter net – 1.2:1. A landlord can offer other approved assets to meet the ratios. Security may be released when asset cover exceeds 200% and revaluations will be on a 5 year cycle.

The Government is also setting aside £200m by way of funding for market rental. This is likely to be bridging development finance, equity or debt. It is not yet clear whether the two will run together.

As a consequence of EU State Aid rules guarantees will need to be issued on a commercial basis, both as to price and commercial terms. The proposed method of pricing is unknown although the scheme rules point to fixing the price by reference to risk covering any expected losses, administrative costs and the cost of capital associated with providing the guarantee. We also know that pricing on the Infrastructure Guarantees will be by reference to the Treasury's view of the risk of the project and its structure. As a consequence pricing on Infrastructure Guarantees reflects credit spread in the market with adjustments for liquidity. A pricing grid is therefore proposed with a different percentage fee (reflecting credit spread) depending on credit rating between A/A2 and BB + /Ba1. Approved borrowers/landlords will be required to meet the cost of arranging the guarantee together with a pro rata share of management and monitoring costs.

The extent of the market for large scale acquisition, ownership and market renting of dwellings has not as yet been quantified. No doubt the new CLG PRS Taskforce will want to undertake some market testing.

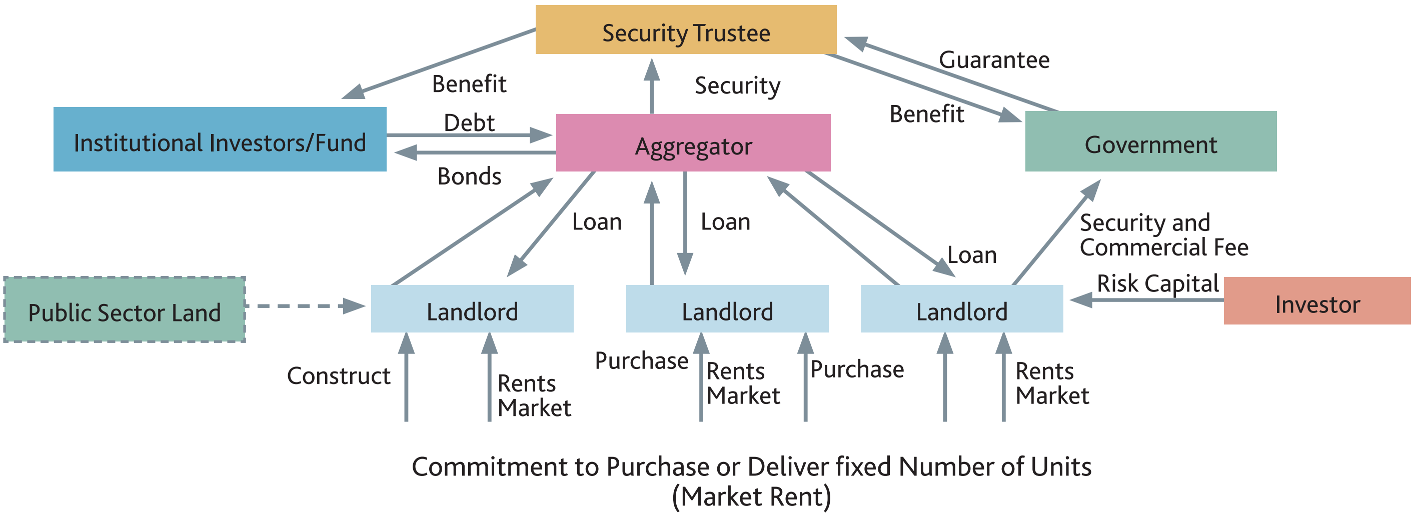
The current version of the scheme is predicated upon the use of an aggregator. A competition is being held for an aggregator for both the affordable and market rent guarantee scheme and it could conceivably be the same organisation(s). It appears to be assumed that the appointed aggregator must be used and therefore a landlord who is sufficiently large cannot raise its own finance and/or act as an aggregator raising finance for itself and others.

To what extent will there be a requirement to retain the dwellings as market rent dwellings whatever happens to the housing market? Will there be an ability for landlords to sell voids should demand shift away from market rent? The scheme rules clearly state that the dwellings must be used for private rent for the period of the guarantee.

What role can public sector land play in this initiative? Clearly the simplest and most likely model is for landlords to raise finance (through the aggregator), to use the finance to purchase homes and then let them to tenants. Another approach would be for the public sector to make available surplus sites. This may involve a sale or joint venture (with the public sector land transferring into the joint venture company in return for shares). If a joint venture the public sector will share in the returns from the rents and it will need to be classified to the private sector.

The extent to which the EU procurement rules will apply will depend upon the extent there is a contract for works with the public sector body as a Contracting Authority (i.e control by the public sector over the content of the works). The public sector could consider working in partnership with institutional funders (through the aggregator) and subsequently seeking a landlord (or indeed creating a landlord). Public sector bodies will need to consider EU procurement law carefully before introducing the guarantees scheme into an existing procurement.

Fig 2: Market Rent Guarantee Structure



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