How two wrongs can make a right: How *A Local Housing Fund could help savers and fund new house building*

Kathleen Dunmore of Three Dragons (writing on behalf of the Highbury Group) proposes a Local Housing Fund to generate funding to support the delivery of housing and accompanying infrastructure , while at the same time offering savers a secure return on their investment.

'This is a crisis unlike any other. It's a total collapse of the financial system with tremendous implications for everyday life. On previous occasions when you had a crisis that was threatening the system the authorities intervened and did what was necessary to protect the system. This time they failed.' George Soros, *Times*, 28 March 2009.

So what does 'a total collapse of the financial system' mean for housing? Housing starts are down to just over 100,000 a year, the lowest level since 1946. House prices have fallen, but this has brought little relief to first-time buyers. In many areas, particularly rural districts, the fall in house prices has been insufficient to make market housing affordable, while the increased deposit that mortgage lenders are demanding has in effect pushed buying a home even further from the reach of people on modest incomes. Local authorities have been finding it increasingly difficult to finance infrastructure provision through section 106 contributions from private developers, and virtually impossible when looking at major sites. Housebuilders and RSLs seeking to secure finance for their developments are also reporting difficulties.

The impact of the financial crisis is also being felt beyond the world of housing. Private savers and investors have seen a fall in the value of shares (down by a third in 2008[1]) and the return on investments has fallen below the rate of inflation for the first time since the 1980s.[2] Banks and building societies currently offer savers interest rates ranging from 0.15% to 3%, compared with an average of 5% a year ago. This hits people saving for retirement, living on interest from savings or buying an annuity. Both savers and borrowers have been hit by the turbulence in the banking system, which looks set to continue for some time to come.

[1] FTSE Top 100 Index

[2] Brooke, M, Clare, A and Lekkos, I, 'A comparison of long bond yields in the United Kingdom, the United States, and Germany', *Quarterly Bulletin*, Bank of England, 2000: www.bankofengland.co.uk/publications/quarterlybulletin/qb000201.pdf

With the financial sector in disarray, the time is right for local authorities or local delivery vehicles (LDVs) to explore other mechanisms for accessing funds to kickstart housebuilding and development. One obvious solution would be to tap the resources of individual private investors who are currently searching in vain for somewhere to put their funds. If it is a shortage of capital that is hindering housebuilding, and the lack of secure investment opportunities is a problem for savers, could local authorities not reinvent the role of the early building societies and find one solution for two problems? There are precedents for using private finance to fund major new housing developments. The early Garden Cities were funded using private finance[3] and large parts of Georgian London, Bath and Edinburgh were financed on precisely this basis.

What would a modern version of such an initiative look like? One possibility would be for a local authority or LDV working either on its own or in partnership with a friendly funding institution to set up a Local Housing Fund .

How would a Local Housing Fund work?

The Fund would have two components: a Local Housing Bond and a Local Housing Mortgage:.

- The Local Housing Bond would provide gap-funding to finance the physical and social infrastructure required to enable development to take place, as well as development finance for affordable housing including housing for both social and intermediate rent. It offers a way for the affordable housing sector to market its product to private investors in the same way that RSLs have been issuing bonds to the institutional market.

- The Local Housing Mortgage would provide mortgages for first-time buyers and low-cost homeowners. Local authorities would be able to choose whether to offer both options in their area or just one.

. Savers could choose whether to invest in the Local Housing Mortgage or the Local Housing Bond, or both. The Local Housing Mortgage would provide a monthly income

[3] Ebenezer Howard proposed that the original Garden Cities should be financed by a mortgage at four per cent.

funded by mortgage payments. It would offer an alternative to buying an annuity, which would be of particular benefit at the present time when annuity rates have been depressed by the operation of quantitative easing. The Local Housing Bond would provide a specified payment after a fixed term, either 10, 15 or 20 years and would be aimed at people saving for retirement. Both products would also be attractive to ethical investors looking to invest while helping to support their local community.

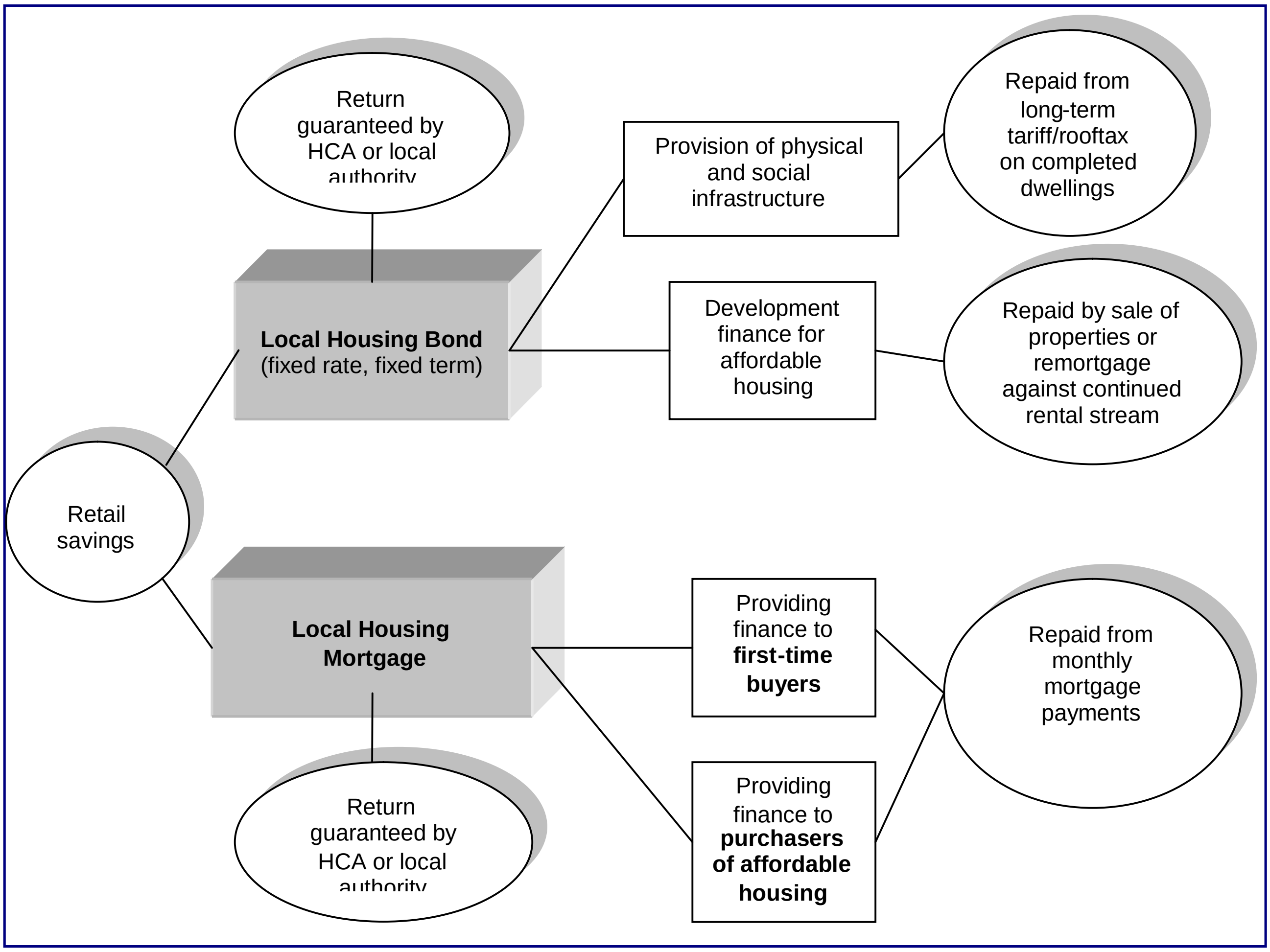
The Local Housing Fund would aim to provide a risk-free investment, offering a secure return that would be guaranteed by the local authority or Homes and Communities Agency (HCA). That return would need to be higher than returns currently available to savers on the open market, but not so high that repayment costs become prohibitive. A five or six per cent return from a Local Housing Bond or Mortgage would seem an attractive option to savers currently being offered a maximum of three per cent on an ISA. .

Because the Local Housing Bond would need to be held for a considerable period of time (upto ten years) savers would need to take a view on longterm interest rates. Yhis is not an easy task. Interest rates have fallen over the past three decades, from an average of twelve per cent in the 1980s to eight per cent in the 1990s and four per cent in the 2000s. However, it would not be unreasonable to assume that both inflation and interest rates will have to rise to help the Government finance the recent massive fiscal stimulus. On this basis a long-term investment yielding five per cent offers a reasonable return for at least part of an individual’s investment portfolio . In the current context of financial upheaval, the secure and guaranteed return offered by Local Housing products would be attractive to savers and provide a better return than they can currently get from a building society or bank or through investment in the stock market..

Although Local Housing products would primarily be targeted at the retail market, they could also be of potential interest to pension and investment funds looking to broaden their property portfolio.

Figure 1 below illustrates how the Local Housing Fund could work

Figure 1: The Local Housing Fund model



Funding infrastructure and development

The Local Housing Bond would be used to fund infrastructure projects and to provide development and long-term finance at competitive rates to RSLs and developers active in the local authority area. RSLS are already issuing bonds for sale to institutional investors: Affinity Sutton, Sanctuary, Places for People and Circle Anglia have all raised bonds at rates of six to seven per cent. The Local Housing Bond applies the same principles, but enables individual small scale private investors to invest in housing. The infrastructure element of the Bond would be financed from a roof-tax on development (and ultimately on land value) payable by developers on completed new homes and modelled on the Milton Keynes tariff (see Box 1 below),. Private finance raised through the Local Housing Bonds would take the place of public-sector gap-funding. Careful initial costing of infrastructure projects would be required to identify whether HCA gap-funding would also be also required because a realistic roof-tax would still not fully cover the costs of infrastructure provision.

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Box 1: The Milton Keynes tariff

The scale of development envisaged in Milton Keynes requires major investment to provide the necessary transport, educational, health and social infrastructure. In advance of development. Milton Keynes Partnership (MKP, the Local Delivery Vehicle) has agreed to forward fund some of the infrastructure required by borrowing from English Partnerships against future income from uplift in land value.

To achieve this MKP has secured a commitment to tariff-based section 106 contributions from landowners and developers within the expansion areas (where 15,000 dwellings will be accommodated). With approval from HM Treasury, MKP (through English Partnerships) is acting as a bank providing advance-funding for the construction of roads, education, health, and community services, and parks, which will attract inward investment alongside the new homes.

The developers' and landowners' tariff contributions are £18,500 per residential dwelling and £260,000 per hectare of employment space. The contributions will be pooled and used to reimburse English Partnerships in the future once much of the infrastructure is in place.

Financing homeownership

The Local Housing Mortgage would be available to people buying a home in the local authority area, either in the open market or as low-cost home ownership. Local authorities could restrict access to the mortgage to particular types of property or borrower – ie first-time buyers and low-cost homes – or decide to offer it to all home buyers. The idea of local authorities providing mortgages is not new: in the 1980s local authority mortgages represented 16 per cent of the overall mortgage market and a considerably higher share of the first-time buyer market. The Local Housing Mortgage builds on the success of this model and provides a alternative, independent source of funding to reliance on the public purse.

A tried-and-tested variant to financing purely through a Local Housing Mortgage would be a top-up mortgage. A high-street lender would provide a first-charge mortgage for, say, 70 per cent of the loan required and the Local Housing Mortgage would provide the remaining 30 per cent secured by a second charge, thereby taking on the risk. To maintain affordability, the borrower would provide a minimal (five percent) deposit. Such schemes operated successfully in the 1980s,helping many young people onto the housing ladder and contributing to the regeneration of inner-city neighbourhoods. This approach would spread the available finance further, enabling more people to be helped into home ownership through the Local Housing Mortgage.

Guarantees for investors and lenders

The expectation is that both the Local Housing Bond and the Local Housing Mortgage would be self-financing, but both products would be more attractive to investors if the loan were to be guaranteed either by the local authority or the HCA. The loan could either be fully guaranteed against a specified rate of return or partially guaranteed to a minimum rate of return with provision for a higher rate of return to investors if house-price inflation is higher than forecast.

One purpose of the Local Housing Fund is to offer investors a secure return from a clearly specified product. If loans are not guaranteed, the private investor would have to take on the risk that the proceeds of a development are insufficient to cover the roof-tax or that house prices fall and mortgagors default on loans against properties that can only be sold at a loss. More risk to the investor would force up the cost of borrowing and reduce the attractiveness of the Fund.

Local authorities and the HCA already have powers to guarantee loans and have used them. The HCA is understood to be currently exploring the prospect of using funding guarantees to attract institutional investors into investment in rented housing. The Local Housing Fund is based on the same principle and provides a vehicle for investment by private investors.

Affordable housing in rural areas

A Local Housing Fund is obviously applicable in the Growth Areas and Growth Points but could also be used in rural areas to provide finance for affordable housing provision. Small local rural affordable housing providers have found finance very difficult to obtain at competitive rates from conventional sources and individual borrowers have also had difficulty in obtaining mortgages for low cost home ownership because of restrictions on subsequent resale[4]. The Local Housing Fund could provide finance for both these activities either wholly or in part through the top-up mechanism referred to above,

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[4] To maintain a supply of affordable homes, homes built in settlements with a population of fewer than 3,000 are subject to a restriction that they cannot be sold into the open

Next steps

Local authorities (or LDVs) could set up their own bank to handle Local Housing products (as Essex County Council is proposing to do to aid local businesses). Alternatively, they could work with a local building society or an appropriate bank, such as the proposed Post Office 'People's Bank', Virgin Group, Tesco, the Co-op Bank, Charity Bank or one of the ethical investment funds. The Charity sector is already moving in the direction of local funds earmarked for specific purposes. The Charity Bank, together with Yorkshire First, offers a Yorkshire Deposit Bond which lends money for charitable projects in the region including the provision of affordable housing and Tomorrow's People, working in conjunction with CityLife, has pioneered a locally based Employment Bond which combines lending to RSLs with support for local employment initiatives. To date such schemes have been targeted at philanthropic investors looking to ensure that their money is safe but not necessarily to receive a commercial return. The Local Housing Fund would offer a logical next step which took advantage of the current large gap between rates available to savers and those charged to commercial borrowers to offer a product which met both their needs.

The Local Housing Fund could operate at local, regional or subregional level: a Regional Development Agency or the Greater London Authority would be natural bodies to spearhead such an initiative. Yorkshire First has shown that such initiatives are possible, Other RDAs could follow suit.

Conclusions

Activities to remedy the credit crunch to date have been centralised and involved directing huge sums of money at institutions. Individual savers and investors have seen interest rates fall and to date this policy has not resolved the problems of mortgage availability or stemmed the fall in housebuilding. Centralised solutions have conspicuously failed to meet local needs. A Local Housing Fund would be targeted at the local level, allowing people to receive a real rate of return in exchange for funds that would be specifically targeted at meeting local housing needs.

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market. This is achieved by restricting the amount of equity that can be owned, usually up to a maximum of 80 per cent. This restriction is seen by conventional lenders as presenting additional risk and in consequence has led to the withdrawal of residential mortgages from such properties.