Focus on affordable housing

With the cost-of-living crisis front of mind, the combined need for the LGPS to deliver positive social impact alongside generating an inflation-linked income stream has rarely been more pressing. Could investing in new energy-efficient affordable housing be the solution?

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Access to a safe, warm and affordable home is a fundamental building block of all societies. By global standards the UK housing market is unaffordable, resulting in an elevated need for subsidised housing to support those who cannot afford to purchase or rent on the open market.

Building and operating affordable housing has historically been the responsibility of councils and not-for-profit organisations. However, since 2010 legislation has allowed profit-distributing organisations to directly own and operate affordable housing, allowing investors – including the Local Government Pension Scheme (LGPS) – an opportunity to share in the potential success of the asset class directly.

Of course, the devil is in the detail, with questions often asked about how best to access this market, the reasons for investing in affordable housing, the potential benefits that pension fund investors can bring, regulatory requirements and the opportunity across the varying tenures.

An ever-growing need

In March 2022 Legal & General and the British Property Federation authored a white paper Delivering a Step Change in Affordable Housing Supply outlining the lack of financial capacity of housing associations to build more affordable homes. It identified the deep need to bring in new sources of capital through long-term and aligned investors into the sector given that, due to deep financial capacity constraints, housing associations alone do not have the capacity to build more than around 65,000[1] homes a year.

This is against the backdrop of a long-term need for a net addition of 145,000[2] affordable homes a year to provide much needed long-term housing for the 1.4 million[3] households on social housing waiting lists across the UK. Sadly, since then, the market within which social housing providers operate has become much more challenging. Significantly higher debt servicing costs, capped rents, escalating management and maintenance costs, and larger programmes of ongoing capital works have all resulted in the position becoming significantly worse.

1. Source: Legal and General, March 2022 Delivering a Step Change in Affordable Housing Supply
2. Source: National Housing Federation & Crisis estimate: crisis_housing_supply_requirements_across_great_britain_2018.pdf
3. Source: DLUHC: Department for Levelling Up, Housing and Communities, 2022

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Importance of affordable housing in a falling market

History has shown that when the mainstream for-sale market slows down, activity in the construction sector falls with knock-on effects on housing supply and employment in local areas. The longer time is left to encourage intervention through other tenures, the greater the ‘shrinkage’ of the construction sector and the longer the build-back time is to get to pre-downturn levels.

Affordable housing is the vital tenure in this scenario to act as a counter-cyclical catalyst just as it was in 2007-09. It provides housebuilders and developers with alternative purchasers to keep building through the downturn given the guarantee of sales to affordable housing providers. This helps to underpin housing markets and mitigate against what would otherwise lead to shrinkage of the sector and overall housing supply.

What benefits can for-profit housing providers bring?

Given this context, the need for new entrants with new funding has rapidly increased. Institutional investors have already shown themselves to be highly reliable partners in the provision of affordable housing with multiple new entrants in recent years. We believe that wider investment from institutional investors, including the LGPS, could unlock more homes and improve the quality and sustainability of existing and new affordable homes.

New institutional investors have fundamentally strengthened the sector as they bring an additional financing route into the sector that was previously not available, therefore increasing the total capacity in the sector.

However most importantly of all, we believe that the only way to significantly increase the level of new housing development is via a partnership between institutional investors (bringing additional long-term funding to the sector), housing associations (with decades of affordable housing expertise) and a supportive policy environment from the government.

Navigating regulatory challenges

There are some key challenges for new players entering the market, as there are with the wider housing association sector. Specifically, the sector enjoys and requires close regulation. This, in our view, is an absolute imperative to ensure that no entities (housing association or new investors) take excessive risk and to ensure entities operating in the sector remain well governed.

As new models are used across the sector, the Regulator of Social Housing needs to (and is) continuously evolve its approach, to ensure social housing is protected and the residents are well served by their landlord.

This includes remaining vigilant to others with less-aligned, short-term objectives with models transferring undue risk to lessee counterparties that can, in extremis, put individual entities and customer homes at risk.

We believe it is vital to make use of fair and equitable investment models to share risk and reward between institutional investors and housing associations partners. For example, Legal & General Affordable Homes directly leases properties to households, with a risk-sharing management agreement with our management partners.

Legal & General Affordable Homes (LGAH) – Focusing on efficient new builds

LGAH was launched in 2018 to increase the supply of affordable housing and now operates over 2,500 homes across the country, with a further 6,500 in its pipeline. As part of our inclusive capital vision, our goal is to focus on high quality, energy-efficient (i.e. with high EPC ratings), new-build affordable homes across the country and across tenures. Over the last 12 months we have developed and sold nearly 550 shared ownership homes and handed over nearly 1,500 affordable homes. LGAH’s mission is to significantly increase the supply, sustainability, and quality of affordable homes, aiming to deliver best-in-class customer service. Its aim is for the provision of its services to help reduce inequalities, improve people’s health and well-being, making a positive contribution to the communities it serves.

Two main forms of affordable housing: shared ownership and rented

Shared Ownership is a product that allows a household to gain access to home ownership at lower deposit levels than open market purchases and has undoubtably been a huge success in the 40+ years it has been running.

Shared Ownership housing development is an important cornerstone of affordable housing delivery and should, in our view, be significantly expanded as a programme. Institutional investors including the LGPS could be well placed to drive that growth. The explicit inflation-linkage and long-dated cashflows make Shared Ownership a very compelling asset class for investors in our view.

House prices have historically outpaced wage inflation, and this is not likely to stop whilst new build levels remain significantly below long-term need. In turn, homes have become progressively less affordable. When households cannot afford to buy, they typically have to rent.

This leads on to the second form of affordable housing: rented. 90% of the affordable rented housing units are let as 'social rent' with secure lifetime leases and CPI-linked rental uplifts, with rents typically set between 40% (London) and 70% (lower-value areas) of open market levels. However, this sector has largely been replaced in recent years by 'Affordable Rent.'

Affordable Rent is a small but rapidly growing class of stock that was introduced in 2011 as part of a government move from a capital to a revenue-based funding model. The rent level is capped at the lower of 80% if open market rent, or Local Housing Allowance, with CPI-linked uplifts and is typically for a fixed term of five years, although these typically expect to roll over.

Affordable housing – Closely aligned with LGPS objectives

All in all, there are a number of reasons why we believe that affordable housing is a close match for the needs of LGPS investors. It offers opportunities for a long-term income stream, with the potential for inflation linkage, all from an asset that is in great demand. Given the strong supply / demand dynamic, we believe that a competitive financial return is potentially available from the asset class. In addition, the creation of more affordable housing offers a positive social impact by helping to address the critical need for more affordable housing in the UK.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

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