Global Counsel

Firm foundations? UK residential property investment and the Housing and Planning Act

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Summary

Following a slow but ultimately successful passage through Parliament, the centrepiece of the UK government's housing reform agenda has received Royal Assent. Through its explicit prioritisation of ownership over rental, the Housing and Planning Act legislates for the government's ambition to drive up home ownership rates and to build one million new homes by 2020. Its complex, centralising and tenure-biased approach will change the calculus for residential investors and developers alike, across tenures and across the UK – with many details yet to be decided.

The UK Housing and Planning Act is an explicitly political creation in both function and form. Understanding this is key to understanding its likely impact on the investment environment for UK residential property.

Its function is to re-engineer the notion and funding of affordable housing towards ownership and away from rental. The political logic is neatly summarised by Brandon Lewis MP, Minister for Housing: "We are going to correct the fact that, at the moment, affordable housing in government language is technically a home that you rent, but affordable housing for 86% of our population who want to own their own home should be a house that they can afford to buy."

This political imperative explains much of the Act's form. The policy mechanism that it creates is clunky, rests on mutual interdependencies, has little margin for error and is centralising in nature. In essence, the political tail wags the policy dog, with the inelegance of the policy justified by the electoral importance of appealing to the "86%".

Having subsidised demand for first home purchases through the Help to Buy scheme, the Act is a flanking policy on the supply-side, via its creation of new "starter homes".

These homes will be sold to first time buyers at a discount which is funded by the removal of existing affordable homes requirements (primarily, 'Section 106'). Meanwhile local authorities and housing associations will be required to dispose of high-value social housing (those in the 70th percentile of value and above) in order to fund discounts for renters purchasing under the extended 'Right to Buy' policy.

The cannibalisation of existing for-rent provision for the purposes of discounted ownership reflects the tenure bias of the government's approach. It also reflects the political reality of the UK housing market, which is based on the financialisation of UK residential property. Homes have become a crucial source of equity for households and are treated as a welfare asset, to fund retirement and forms of mid-life consumption such as healthcare spending.

The more dependent people become on housing assets for welfare provision, the greater the political pressure to preserve values. It is therefore politically acceptable to subsidise the purchase of otherwise unaffordable homes, but not to address affordability by reducing prices.

Fundamental market dynamics will persist

The Act is therefore not intended to address the fundamentals of pricing or affordability in the market. Even at the aspirational rate of 200,000 homes per year, the level of building targeted by the government would be well short of the level needed to stabilise affordability, given projections for growth in household formation. UK Treasury officials made this clear when giving evidence in Parliament during the legislative progress of the Act.

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This means that the Act will not change the overall dynamics of UK residential property as an asset class, insofar as it is predicated on over-demand and under-supply. This is important for investors making judgments about UK housing in the medium and longer term. Where the Act will change the investment calculus is around the funding of developments in the nearer term, both in terms of for-ownership and for-rental provision.

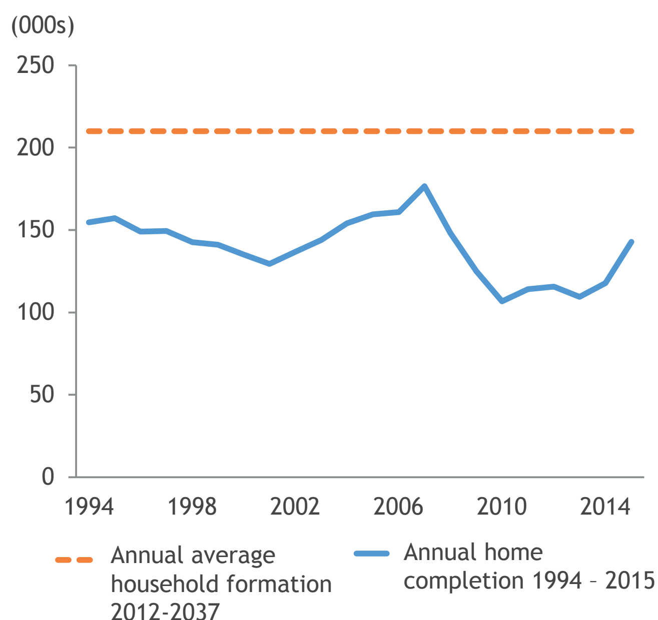

Figure 1: Future demand for new homes compared to recent home building rate.
Source: DCLG, Global Counsel analysis

A new take on affordable housing

The Act introduces 'starter homes', a new form of discounted for-ownership homes for first time buyers. The homes will be sold at a 20% discount against market value to first time buyers, capped at £450,000 in London and £250,000 elsewhere. The discount is funded by offsets against 'Section 106' affordable housing contributions, which are the traditional mechanism through which local authorities secure contributions from developers.

However, the majority of the specific rules around starter homes are not decided in the Act - instead, a series of statutory instruments (secondary legislation) will, over the coming months, put more definition around them. This makes an analysis of their impact difficult, but the key question for investors and developers is whether the transition to a starter-home based model of affordable provision is more or less attractive than the current approach based on 'Section 106'

At a maximum of £450,000 in London and £250,000 elsewhere, less 20%, initial feedback suggests that the framework looks viable and possibly even attractive from a developer perspective. However, the lack of detail to date puts a premium on scrutiny of the secondary legislation yet to be brought forward.

A key concern is whether starter homes are viable from a mortgage lending perspective. Lenders are concerned about how the open market value of the homes will be determined and how the 'discount period' - which governs the sale of the property in the 5 years after purchase - may distort valuation or consumer behaviour. Resolving this is central to the success of the starter homes policy.

Replacing social stock

The Act puts a number of duties on local authorities and housing associations which are necessary to the functioning of its central mechanism around starter homes, high value asset sales, Right to Buy and 'pay to stay', whereby council tenants on higher incomes will be moved onto market-based rents.

The ability of local authorities and housing associations to replace stock lost through the requirement to sell high value units has been a key source of contention. One for one replacement - rising to two for one in London - is already problematic in some areas and the planned proliferation of starter homes may squeeze available stock further. One potential implication is that housing associations are forced to price their land and unit bidding more aggressively. There is some evidence of this beginning to happen in London where stock replacement is likely to be most acute.

Another unknown, but central to the impact of the Act on the economics of investment and development, is the interaction between the Act and the 'devolution deals' being agreed across England. Some local authorities - for example in Cambridge - have sought greater flexibility to determine the types of affordable home that are built on new developments, including the proportion of starter homes. Should local actors win this kind of flexibility within deals, the emergence of a patchwork of differing requirements will complicate the analysis and decision-making of investors and developers.
Build-for-rent: feeling the squeeze

In terms of for-rental provision, the Act is a reminder that housing tenure is a rivalrous concept: a household which rents is not a household which owns, and vice versa. So, in promoting home ownership, the Act has substantial implications for the investment calculus around build-for-rent, in particular.

The blend of incentives and compulsion within the Act means that starter homes are expected to dominate the future provision of affordable housing in the UK. The key question is what the policy means for the viability of build-for-rent: in November 2015 the British Housing Federation told MPs that it expected the starter homes proposal to effectively eliminate BFR collaboration with Local Authorities and Housing Associations.

A quota or obligation to provide starter homes in any residential development proposal receiving planning permission would fragment development blocks and force developers to mix for-sale and BFR components. Those with a preference for coherent, long tenure control of assets for rental yield may see the presence of for-sale assets over which they will lose control in a development block as changing the investment calculus. Mixed tenure also presents a challenge for site management.

Build-for-rent blocks could yet be exempt from the starter homes requirement, pending a government consultation. But even so, they would be required to make payments in lieu of the starter homes not built, so this kind of exemption would replace an operational challenge with a financial one. It is unclear how this contribution would be calculated, and how much discretion local authorities would have in setting it. But whether the starter homes requirement manifests as an operational or a financial challenge, BFR investors will feel the squeeze.

More generally, BFR developers and investors will take little encouragement from an Act which explicitly subordinates rental as a tenure. If political 'mood music' is a factor worthy of consideration, then the build-for-rent investment proposition has weakened.

Buy-to-let: weathering the storm

Though not part of the Act itself, the buy-to-let market (BTL) has seen substantial policy change in recent months and its fate is an important flanking consideration for investors and developers across the residential market.

Reform has been motivated by the twin ambitions of seeking to contain a perceived bubble in the market, while reducing the number of BTL investors competing with first-time-buyers for property, particularly in London.

The removal of interest relief on BTL mortgages and a 3% stamp duty surcharge on BTL transactions illustrate the willingness of HM Treasury to pull fiscal levers, and will immediately change the investment calculus around BTL. While the stamp duty change has generated more noise, and will act as a bigger short-term bump in the road, the change to mortgage interest relief fundamentally alters the attractiveness of BTL from a landlord's perspective and is undoubtedly the more significant of the two changes.

Meanwhile, the Bank of England has identified BTL, as well as for-ownership lending, as a financial stability concern. Recently revised underwriting standards published by the Prudential Regulation Authority represent the first move in an effort which may extend to more formal prudential controls, should HM Treasury award powers of direction over the BTL market to the Bank's Financial Policy Committee, which seems likely. The FPC has already imposed loan to income controls in the residential market, so investors can assume that if powers are granted, action is likely.

However, though the policy reform agenda feels powerful, its transmission through to a materially changed investment case for BTL is unclear. The Bank of England estimates circa 17% growth in BTL mortgage lending in the next two years, which suggest that the fundamentals underpinning the market remain strong.

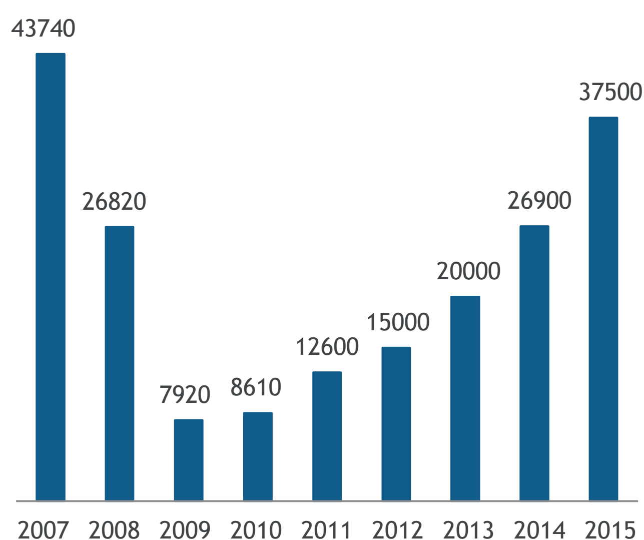

Figure 2: buy-to-let mortgages extended, £m
Source: CML, Global Counsel analysis

Moreover, the capital gain element of BTL investing remains tied to house prices, which in turn depend on housing supply and demand. As discussed above, neither the Housing Act nor the BTL policy changes will materially affect the fundamentals of supply and demand, and therefore affordability. In turn, they do not constitute a major threat to continued price growth, all else being equal.

An open question is whether this raft of reforms represents ‘job done’ from the perspective of government and regulators, or whether it merely heralds the beginning of a longer and more radical overhaul of for-rent provision. This depends on the evolution of the financial risks in the eyes of the Bank of England, and the success of policies to promote home ownership in the eyes of the UK government. In this sense, for-rent investors are likely to be buffeted by developments which are well beyond their control.

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