Financing Social Housing in Europe

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INTRODUCTION

Financing social housing in Europe was traditionally a matter for governments. Very large numbers of dwellings were provided under government guarantee and with public money. Over the last two decades the introduction of private funding into the provision of social housing has been an important development across many parts of Europe especially in countries with large social sectors (Papa, 1992; Turner and Whitehead, 1993; Boelhouwer 2000). This, in turn, generates large opportunities for private financial institutions.

From a policy point of view, the shift towards private finance has arisen as a result of two main pressures:

- the need to reduce public expenditure in the face of macro-economic pressures, including in particular EU borrowing constraints; and
- the growth of global finance markets which has made it possible and sometimes cost effective to raise funds through the private sector.

From the point of view of financial institutions social housing presents an opportunity to widen the base of their portfolios and to include a relatively low risk stream of revenue which can be expected to rise in real terms and which is subject to a rather different pattern of those risks than other categories of debt.

In order to assess the quality of these instruments and their value to different types of institution it is necessary to understand the nature of the underlying security and revenue streams and the different ways in which the debt is structured. These elements differ between countries as does the scale of the funding required and therefore the extent of longer term opportunities available.

This special issue examines some of these questions in the context of four European countries with somewhat different approaches to both the role of the social housing sector and to funding that social housing. This introductory article sets out some of the principles which lie behind the introduction of private housing finance, indicates some of the attributes of what is provided, and draws lessons for other countries.

THE DEVELOPMENT OF SOCIAL HOUSING IN EUROPE

The rationale for and mechanisms by which social housing has been provided have differed greatly between different European countries. In some, such as the UK, social housing has generally been restricted to the provision of rented housing for lower income households by public landlords; in others notably in Scandinavia, the Netherlands and Germany; it has included assistance across tenures and has been available to all types of household; in most Southern European countries, on the other hand, there has been very little social housing and accommodation has tended to be self-financed and often self-built (Boelhouwer and van der Hayden, 1992; Whitehead, 2003 forthcoming).

The methods of financing and subsidy have similarly differed, ranging from tenure specific public finance to restricted rents for rented housing to tenure neutral subsidy systems supporting private finance in both rented and owner-occupied sectors. Equally, how much households living in social housing have been required to pay has been determined by very different principles and has varied from nothing up to market rents and prices (Gibb, 2002; Stephens *et al*, 2002).

While the starting point for government involvement and the specifics of housing provision have differed greatly across countries, the economic environments in which these policies have operated have tended to converge over the last decades. Special circuits of housing finance have, in the main, declined in importance, as have the subsidies relating to general housing investment. Housing financing arrangements have been integrated into wider finance markets, which have become global as they have been deregulated. Controls on rents and security of tenure in private rented sectors have also tended to be reduced as absolute shortages of housing have declined. Government funding for housing has become more limited, especially in Europe, where as part of the development of the European Union, member governments have been required to restrict their public expenditure to meet centrally determined monetary criteria.

TWO APPROACHES TO SOCIAL HOUSING PROVISION

The common baseline for almost the whole of Europe after the Second World War was a massive shortage of housing arising from the destruction or major damage to significant proportions of the existing stock together with an almost complete lack of housing investment through the war years. Equally the labour force and other resources had to be redeployed from war to peace production. Housing was seen as an important element of social infrastructure and of political cohesion. It was therefore given high priority. The result was that large scale resources were mobilised for social sector production across Europe (Papa, 1992; Boelhouwer and van der Hayden, 1992).

There were however two distinct approaches. The unitarist approach, exemplified by Sweden and the Netherlands, and, with somewhat different parameters, Germany, was applied with more or less consistency across much of continental Europe (Lundqvist, 1992). It was predicated on tenure neutral subsidies for investment usually in the form of interest rate reductions and guarantees. Rents were generally cost based and often set in negotiation with unions and other stakeholders. Rents in the private sector were controlled and their determination at least partially linked to social sector rents. In some countries, notably the Netherlands, administrative allocation of the available stock continued for decades.

The wider financial framework however remained highly regulated and within this there were special circuits of housing finance. France was in many ways an extreme example of this model, with a complex range of financial intervention techniques linking dwelling types to particular income groups and therefore to available demand side subsidies (Turner and Whitehead, 1993).

As investment caught up to need over the years, rents across the private and social sectors tended to converge often at or near market levels. These rents were themselves significantly modified by the availability of social investment. Social housing often became open to all households and, in most countries, municipalities took a more strategic role allowing independent providers to develop the social rented stock.

At the same time, while subsidy systems remained broadly neutral, financial deregulation enabled greater choice in housing for many households leading to greater investment in private housing. The pressures for more targeted assistance grew in order to concentrate help on poorer households and areas in an environment where the vast majority of households were well-housed and other priorities, notably health but also macro-economic stability started to dominate (Turner and Whitehead, 1993).

During the 1990s problems of low demand and particularly of obsolescent stock particularly in the rented sectors began to dominate in many European countries - both in metropolitan and more rural areas as population followed employment change. At the same time, notably in France but now across most northern European countries, the idea of housing became more widely defined to include not just the attributes of shelter and security but also a range of neighbourhood, environmental and service attributes. This often results in a wider role for social suppliers as leaders in urban management (Boelhouwer, 2000; Housing Studies, 2002).

The second, dualist approach, exemplified particularly by the UK, concentrated on tenure specific subsidies to municipalities. These authorities were enabled to borrow at government interest rates and both developed and managed the resultant stock. Housing was allocated to those in poor housing conditions, who were mainly lower income households. Initially authorities had complete powers to build within individual cost limits. Later their borrowing powers became more limited and subsidies were reduced and directed at areas where the costs of managing and maintaining the stock at below market rents could not be covered by revenues (Department of Environment, 1977). The question of how the value of existing assets might be employed to fund new and improvement investment became paramount and led to significant changes in subsidy, ownership, rents and allocation principles. In particular social sector provision became more broadly based with housing associations taking the main role in provision (Whitehead, 1993).

Financial deregulation and a generous tax regime enabled the growth of owner-occupation, as did subsidies to transfer from social housing. This helped reduce the range of households accommodated in housing requiring supply subsidies. More recently assistance has become even more tightly targeted on lower income tenants (Stephens *et al*, 2002). Equally, many of the problems of obsolescent infrastructure and social exclusion can be found in areas dominated by social provision (Smith, 1999; Social Exclusion Unit, 2001). This has led to a growth in area and housing specific policies to improve neighbourhoods and individual opportunities.

Thus, each country's investment experience can be divided into three main stages. The first stage in almost all countries concentrated on new construction. As the stock of dwellings began to exceed the number of households, usually in the 1970s but much later in Germany, the emphasis moved towards management and maintenance of the existing stock and to questions about the appropriate form of subsidy (Hills *et al*, 1990). In this second stage the pressure was on reducing public expenditure and improving the use of existing assets including an emphasis on greater privatisation and a shift towards demand side subsidies. Finally, in part because of the very large scale post war building programme, the emphasis in the third stage has now moved on in most European countries to addressing problems of regenerating urban areas and restructuring housing within wider social infrastructures, again often within a framework of privatisation and reduced funding (Boelhouwer and van der Hayden, 1992; Papa, 1992; Boelhouwer, 2000).

From the point of view of private finance the countries with the greatest opportunities to be involved in social housing finance are those with the largest sectors and where deregulation of financing systems has been greatest. At the present time this tends to restrict involvement to the UK, the Netherlands and some Scandinavian countries. France has a large social sector, but to date the complexity of funding and subsidy arrangements tends to mitigate against the introduction of market based, as opposed to government sponsored, financing systems. The German system depends heavily on bonds providing a rather different private financing opportunity and has a much more fragmented approach to ownership and provision which makes it difficult to generate the scale of activity necessary for efficient financing. In the Southern European countries the emphasis is very much more on the effective provision of mortgage finance for owner-occupation and the potential for mortgage securitisation (see e.g. Karley and Whitehead, 2002).

IMPLICATIONS FOR THE PRIVATE FINANCING OF SOCIAL HOUSING

As a result of these very different paths of development the nature of the social housing debt on offer across Europe varies across a number of particularly important attributes.

Asset base

The asset base against which the funding is provided: There are in principle at least four different possibilities:

- the total existing stock owned by the social sector - this implicitly lay behind earlier versions of government based funding prior to the pressures for privatisation but does not allow those pressures to operate effectively - it is therefore becoming far less usual;
- the total stock owned by the individual providers - this version is most consistent with general debt financing in that the assets of the organisation lie behind the debt;
- the new investment being undertaken by the sector as a whole - identifying the rents associated with that new investment as the available revenues - this allows pooling but only across a vintage of investment - and raises particular difficulties in situations where the emphasis is on improvement and regeneration where rents are not necessarily particularly buoyant; and
- project funding based simply on the specific development -thus including no mechanism for rent pooling.

The mechanisms actually chosen in each country usually relate quite closely to the way in which the social sector has been developed within the public sector. Equally the possible range of instruments enable mixes between these four models, for instance splitting revenue streams from the asset base. Thus the UK approach concentrates on the second - clarifying ownership but allowing rent pooling across different vintages of property and relating the asset base to the rental stream. The Netherlands has tended to require the individual providers to support one another but has maintained separate funding, organisation by organisation. Funding each tranche of investment separately is the mechanism most consistent with the traditional ways in which social housing was funded within the public sector in much of Scandinavia. However it often separated the two being project based from the point of view of the rent stream and sector wide from the point of view of funding. This is the way in which it has operated for wholesale funding in Finland.

The revenue stream

The question of the revenue stream, and indeed the quality of the asset base, is related to two distinct issues: the extent of government guarantees and the restrictions on the individual providers to set their own rents. In terms of guarantees it is clear that the principle of privatisation excludes formal guarantees from government. Yet, historically funding had often been formally guaranteed by local government particularly in the case of project funding based systems and by national government in more centralised systems. A fundamental attribute of the changes over the last two decades has been to transfer risk to providers. However there has clearly been some continuation of implicit guarantees as well as the development of mechanisms for pooling and spreading risk. In England the grants (actually loans in that they are repayable to government in the event of sale) from government are subordinate to private funding and the regulatory framework provides a mechanism for restructuring ownership in the face of financial problems. In the Netherlands there are formal mechanisms for pooling between different groups of housing association - as well as a long tradition of municipal involvement in partnership which provides some comfort to lenders. Similarly in France the direct involvement of municipalities in what is anyway a very integrated system of funding with strong implicit guarantees ensures that very little risk is transferred to financial institutions.

A rather different way in which the sector is guaranteed is by the provision of housing allowances and other social security benefits. In all the countries included in this issue there are large scale housing specific benefits available to those on the lowest incomes and sometimes for those in low paid employment - which implicitly guarantee the revenue stream. In the UK this currently pays the full rent for those eligible for benefit in the social sector in part because of the very low levels of more general social security available. In the Netherlands, most of Scandinavia, Germany and France social security is itself more generous and housing specific assistance tends to be less than 100% of the rent - but still extremely generous for those on the lowest incomes or in particularly high cost housing. Such safety nets are inherently subject to political risk but have been core elements in the provision of the welfare systems which exist across Northern Europe (Stephens *et al*, 2002).

Partly linked to the provision of household specific assistance is the question of how much freedom social housing providers have to set their own rents - a fundamental factor in assessing the risks involved in long term funding. To the extent that governments pay for the housing - whether by supply subsidies or through assistance to relevant households - there is an incentive for those governments to intervene in setting rents. This is particularly true in countries where the more general regulatory frameworks are based on controlling prices - e.g. through an RPI (i.e. the inflation rate) plus/minus x formula - i.e. the UK and countries that have followed their example with respect to privatisation. Equally it tends to be more relevant where social housing is equated with rents below market levels. This approach formally distinguishes those countries where social housing is seen as an integral part of the housing system and therefore investment is expected to be adequate to lower rents in general and to allocate social housing in relation to demand with those countries where demand tends to outstrip supply because rents are subsidised or controlled in one sector more than in others.

In practice the distinction is nowhere near so clear cut - in part because of the different traditions about how markets in general should be managed. In Sweden for instance -while investment does ensure adequate supply in many areas - there is still a mirror system of rent determination in which the trades unions and other stakeholders play a part which link private and social rents directly but where it is the costs in the social sector that help to determine the outcomes. In the Netherlands rents are cost related with market rents as the limiting possibility. In England the initial legislation to enable the introduction of private finance was based on the same principles - but now rents in the social sector will be determined by formulae relating to incomes and capital values in the locality and wider labour market area. This aims to introduce pressures to restrict cost increases - in line with the wider privatisation principles - but it equally impacts on the risks faced by financial institutions.

These examples show how important it is for the private sector to understand both the current situation in relation to government safety nets for the sector and the extent to which what is on offer is truly open to the usual risks of changing costs and demand. The other side of this story must be the extent to which it is political risk rather than market risk which determines the value of the instrument.

More fundamental concerns relate to the nature of the assets in terms of both the existing housing stock and of new investment and who demands social housing and therefore the security of the revenue stream.

Costs

The costs associated with social housing have been falling sharply over the last few years in countries where variable interest rates predominate. This has helped to provide quite a benign environment for introducing private finance - and has meant that there has often been little pressure for increased efficiency in provision.

On the other hand labour costs and in particular the costs of management and maintenance have risen more rapidly than inflation and can be expected to do so - so rent regimes unrelated to costs bring with them significant risks.

Management costs vary widely across countries - notably with respect to the range of services included in the provision of social housing and the extent to which neighbourhood management comes within the same remit. One of the most important aspects of privatisation in England for instance was intended to be to increase the incentive to managerial efficiency. However the evidence so far is that costs per unit have actually risen - in part in order to provide a better service, in part because the types of tenants are changing increasing the need for additional inputs to maintain the same level of services and in part, because of sales to tenants which result in greater fragmentation of ownership. This pattern has been less obvious in countries where the social sector covers a wider proportion of the population - but is of growing concern across Europe. In Finland for instance it is recognised that it is no longer possible to manage the housing without significant investment in the neighbourhood, financed through a range of housing and other social infrastructure subsidies as well as through rents. In the Netherlands there is a strong movement towards selling property to established tenants.

Equally much of the existing stock in many European countries that had large scale building programmes in the 1950s and 1960s are looking to undertake comprehensive rehabilitation and redevelopment of their social sector stock. While this may be entirely necessary in order to ensure adequate provision it is not at all obvious that increased rental streams will necessarily meet the increased costs. It is in this context that large scale voluntary transfers have been introduced in the UK with at least three major objectives - to enable investment to bring property up to standard paid for by implicit subsidies in the price; to allow the restructuring of the stock to provide higher densities and mixed development and therefore a larger stream of revenue; and to introduce private finance and private incentive and management structures into social housing provision. Other countries tend to be looking more to partnership relationships but the general principles - and the associated higher costs - are similar.

Overall it is likely that interest rate costs will stabilise or perhaps even decline slightly in some countries. However both annual management and maintenance and improvement investment costs will rise - implying that rents will need to rise faster than inflation. There is thus both interest rate risk and concern about real increases in total costs.

The demand for social housing

The demand for social housing depends heavily on the attractiveness of other sectors, on the mechanisms for administrative allocation and on rent setting and subsidy arrangements. In many of the countries which have had unitary systems of subsidy, rents are close or equal to market rents, except in areas of very high market pressures. This is true for instance in most of Scandinavia outside the capitals and some university towns. It is also true in some parts of the Netherlands and in areas of low demand in the UK. In these areas social housing has to complete with both private renting - which can be better located if not better managed, and with low cost home ownership which is still often the subject of government subsidies. To the extent that the social sector provides for those worst off in society it can face problems of residualisation. Good management including regeneration investment and neighbourhood services can help to maintain and indeed increase popularity - but this has associated costs. Alternatively social housing can be used to meet other government requirements e.g., providing for refugees and asylum seekers - but these carry with them their own problems as well as more certain streams of revenue.

In the UK and other dualist countries there tend to be many areas where demand is high and where the problems are more of ensuring that housing needs are met than of lack of suitable tenants. In these areas the stream of revenue - and the popularity of most of the social housing - is secure, although there will always be some localities with problems. These are tending to be addressed through greater emphasis on joined up provision of services, in particular mechanisms to control anti-social behaviour.

The ultimate security for all private financing lies with government preparedness to guarantee demand or with the right to sell the property in the market place. Again each country has different approaches and each country has concentrations of different types of dwelling. Outside the UK and Ireland the majority of social housing tends to be in the form of apartments - so the capacity to sell depends on the nature of the leasehold and condominium relationships. What is fairly clear however is that in a world where the majority of households aspire to home ownership (true across the whole of Europe for traditional types of household) and long term provision must include mechanisms for enabling these aspirations to be met.

OVERVIEW

The potential for private financing of social housing across many parts of Europe is significant. Mature markets exist in most of Scandinavia, the Netherlands and the UK and there is growing interest in other countries, notably France and Germany.

The mechanisms used have so far mainly been in the form of retail funding even when large packages of funds are being put together to purchase existing assets. Securitisation has not generally been attempted, except in Finland, even though in many ways the scale and standardisation aspects of the debt fit the requirements for efficient securitisation more than some of the owner-occupied mortgage based issues which are of growing importance in parts of Europe. What is perhaps even more surprising is that, up to now, there is little or no evidence of private equity involvement in the provision of social housing. The ownership of social housing assets remains firmly with the housing associations or other social landlord. However the UK government, in particular, is beginning to look at new approaches to the possibility of ownership including partnership between developers/institutional owners and housing associations (ODPM, 2003).

The nature of social housing must inherently be that it is provided for those who need some element of assistance to be properly housed at affordable rents. Depending on the country social housing may or may not be available to more mainstream households able to pay their own way. The implication is that government policy will always be of importance in determining the risks and returns involved - and political risk may well be as difficult to assess than the more normal set of risks associated with property. In the majority of countries the extent to which government is providing explicit or implicit guarantees is declining. This means that social housing has to stand more on its own risks and returns - increasing the relative benefits of diversification both geographic and by asset type.

Some of the factors affecting costs and revenues are similar across countries - notably those to do with funding. Others, e.g., the likely client base, the nature of the stock and the extent of potential cross subsidy between schemes differ greatly depending on the specifics of development in each country. Equally important are the terms and conditions under which housing can be transferred between tenures and the nature of property rights involved in redevelopment programmes. What is clear across Europe is that aspirations are rising and only housing which meets those aspirations will be acceptable into the longer term.

What is clear is that social housing can provide a significant market for some types of private financial institutions - but that those thinking of being involved need to understand the specifics of the markets in a way which is not true of more traditional asset categories. The other papers in this special issue aim to provide some insight into the particular countries - including three, England, the Netherlands and Finland where mature finance markets already exist and France where the relationship between funding and subsidy is more closely intertwined.

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