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## A National Housing Bank



*by Stephen Merrett and  
Ross Cranston*



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# A national housing bank

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# Introduction

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Housing is rising up the political agenda again, thanks to a steep increase in homelessness and in home repossessions amongst owner occupiers.

**F**rom the end of the Second World War through into the 1970s, successive governments were able to bring about a clear quantitative improvement in the conditions of life, whether measured by the ratio of the total dwelling stock to the number of households or by the decrease in slum housing or by the increase in homes with a full range of internal amenities such as a bath-room and central heating.

But in the last 10-15 years these advances have slowed down almost to a halt. In June 1991 the Duke of Edinburgh's second *Inquiry into British Housing* demonstrated that homelessness for families had doubled between 1980 and 1990 and that the numbers placed by local authorities in temporary - often appalling - accommodation increased by 200 per cent, with about two-thirds of the homeless found outside the capital. Whilst there has been a welcome and continuing contraction in the number of houses and flats lacking amenities, the number of homes which are unfit or in serious disrepair has remained well above one million units since 1976.

And a new threat has emerged to family security: heavy mortgage debt, mortgage arrears and repossessions by mortgage lenders. Between 1970 and 1990 in the UK, net mortgage outgoings rose from about 19 per cent to 41 per cent of net income. Between 1980 and 1990 mortgages which were 6-12 months in arrears soared from some 16,000 to 123,000 cases and repossessions by mortgage lenders rose from 3,480 to 43,890 and they may have doubled again in 1991.

The origins of housing poverty are complex but, as the *Inquiry into British Housing* confirms, the most powerful proximate cause is the decline in the year-on-year supply of lettings of good quality accommodation. The fall in this supply is due primarily to cuts in the number of homes for rent built each year and to a loss of the total stock of existing rental accommodation from which re-lets are continually made.

The council sector has seen a huge contraction in new construction since the mid-1970s as well as the loss of stock resulting from the sale of council houses at discounted prices. The level of building by housing associations in the 1980s veered first down and then up again around only a modest annual

level. As the *Inquiry* comments:

The total house-building for rent in Britain - which had halved between 1979 and 1984 - was halved again from 1984 to 1989, from a combined total for housing associations and the public sector of 51,000 homes in 1984 to 26,000 homes in 1989.

Finally, the private rental sector's stock continued to decline through the 1980s by an estimated average of 80,000 homes each year.

The policy changes which are needed to resume the long march against housing poverty are wide-ranging. They include measures to stimulate the supply of residential land for affordable housing, an expansion in the skills base of the construction industry, and the more effective use of government subsidies and tax reliefs available to housing developers and users. However, the most important single advance would be to staunch the haemorrhage from the existing rental stock in the council and private sectors and to increase the flow of new rental units produced from local authorities, housing associations, private landlords and mixed-tenure schemes including shared ownership. Such a sustained expansion of the rental sectors in its turn requires a considerable growth in finance to fund the associated capital programmes. The Institute for Housing has suggested a minimum requirement of 100,000 new rented homes per year.

In our view, the present funding framework for the local authorities, whereby their capital programmes are financed either from their own capital receipts or from Treasury money channelled through the Public Works Loan Board, is basically satisfactory. Here the key advance must be a planned expansion in the availability of such funds.

However, the current capital financing arrangements for housing associations and private landlords are inadequate and unreliable. Too few institutions maintain a commitment to these sectors; the insurance companies and pension funds, for example, are virtually absent.

We propose that this deficiency in financing rental housing outside the public sector be reduced by the creation of a National Housing Bank (NHB). The Labour Party is committed to the creation of such a bank. There are a number of ways in which this commitment could be implemented; this pamphlet outlines one.

The bank would be a public limited company (plc) and therefore fall within the private sector of the economy. Its principal shareholders would be the Bank of England and some of the major insurance companies, pension funds, building societies and banks. The NHB would borrow short-, medium- and long-term money in bulk from institutional sources and lend this money to housing associations, private landlords and for mixed-tenure schemes. The funds would be used for new building for rent, including shared ownership, conversions and major rehabilitation works on the existing rented stock.

Finance would also be available for landlords to purchase houses and flats on the open market on a modest scale and then, after any necessary refurbishment and/or conversion, to make them available for rent. Such programmes could provide a means to overcome the current slump in the owner occupied market as well as reducing the scale of homelessness.

The NHB could also finance the launch of local housing companies, on the very successful Swedish model, where their creation was sought by tenants as a means for their empowerment and where such a company offered more effective management than the existing local authority, housing association or private landlord.

The initial capital of the NHB could be set at £125 million, with a Bank of England equity holding of £25 million. If the NHB's capital was increased to £500 million by the fifth full year of its operation, then a feasible scale of lending during those first five years would be £10 billion.

The bank itself, as a private sector institution, would provide no subsidies to the rental sectors. These would continue to be the responsibility of central government. On capital account the direct impact of the bank's borrowing and lending would be to reduce public expenditure rather than to raise it, for funds borrowed by the bank from the private sector and on-lent to the voluntary and private sectors do not fall within Treasury definitions of public expenditure.

The fundamental rationale for a National Housing Bank would be its ability to make a net addition to the flow of loans available to voluntary and private sector landlords as well as an improvement in the terms on which such loans are offered. In essence, the bank would be constituted as a specialist financial institution borrowing in bulk from a wide range of national and international financial sources and lending that money to housing associations and private landlords.

# 1

## Establishing the Bank

Institutions performing the functions we envisage for the NHB exist in other countries, in a variety of forms.

**T**he spectrum runs from the statutory corporation, such as the New Zealand Housing Corporation, to the mortgage credit institution - found in Sweden and Denmark. Our plans for the NHB are closer to the Danish than to the New Zealand model. As set out below, we see the NHB as a public limited company, established under the Companies Act, rather than as a statutory corporation. A plc can be established quickly, whereas a statutory corporation may take months or even years in the struggle for legislative time.

A plc also has the advantage of an established framework of law relating to its operations, whereas this must be spelt out for a statutory corporation, a process which can give rise to unproductive debate. A plc has flexibility, within the law, to vary its organisation and operations, whereas a statutory corporation has the straight-jacket of its legislation. Whereas all the funds loaned by an NHB in the guise of a statutory corporation would form part of the public expenditure totals, this would not be the case with our NHB plc. This is because a statutory corporation falls within the Treasury definition of the public sector. In contrast, the NHB would be a private sector company, outside the public sector definition, and as a result its spending would not contribute to the public sector borrowing requirement.

If the NHB should not be a statutory corporation, what should its exact status be? It could be incorporated under the Industrial and Provident Societies Act. An advantage which a body incorporated under that Act has is that there is no need for the heavy capitalisation required of a plc. Another is that holders of bonds in the body have interest paid gross. The disadvantages, however, are considerable. The Act is designed for non-profit making bodies, although under the Act it is possible for them to have surpluses. Moreover, the market perception of a body incorporated under the Industrial and Provident Societies Act is likely to be less favourable than that of a public limited company, not least because the market is not familiar with that type of body. Market perception is crucial since the NHB will be seeking to raise considerable sums in the capital markets.

The NHB should therefore be a plc registered under the Companies Act. (It

could be a private company under that Act, since it will be placing its bonds with institutions, not issuing them to the public generally, but for the reasons of market perception and if it wishes to be listed on the London Stock Exchange it should be a plc. Once it is established, the NHB could well incorporate subsidiaries which are private companies.) A plc must have at least two shareholders and a minimum capital of £50,000. For reasons which we set out below such requirements will be met.

We propose that the Bank of England should have a minority shareholding in the National Housing Bank. In addition, and at the pre-launch stage, the merchant bank handling the creation of the NHB should seek to bring in a range of institutional investors to take-up between them a substantial proportion of the equity not held by the Bank of England. This would make the public flotation easier. Moreover the NHB would need the long-term commitment which the insurance companies, the pension funds and the banks can provide to equity capital which offers solid but unspectacular income yield and capital growth. With institutional equity in place, it would prove much easier to borrow from the capital markets in its first year. The government should also consider giving the institutions a tax break incentive to take-up a defined minimum number of shares. Thereafter, the initial share offer should be launched in the ordinary way, with the preparation of a prospectus, and with professional City advice and assistance.

Government involvement in the NHB should be restricted to its initial minority shareholding, so it will not be subject in any way to political direction. The chief executive of the NHB should be a member of the board and the non-executive directors should include several people with a background in housing and related areas. However, the board should run the organisation in a commercial manner, and be concerned with maximising rental housing construction, as financial circumstances permit.

### *A Bank of England shareholding*

An initial government shareholding is necessary to act as a catalyst for the NHB's successful launch and to set its policy firmly in place. However, once the NHB is operating smoothly, there can be no objection to some eventual reduction in the government shareholding, although we would wish to see at least two government appointees continue on the board, given that it is the public subsidy of landlords and tenants which is critical to the bank's borrowers' ability to repay their loans. (In any event the example of government directors on boards of non-government Danish mortgage credit institutions is a helpful indication of its desirability.) Who should hold the government shares? An obvious candidate is the Department of the Environment (DoE), which is responsible for the government's housing policy. But in our view DoE involvement would be seen as too political and as subjecting the NHB to

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non-commercial influences. We propose that the government shareholding be held by the Bank of England.

Generally speaking, it is undesirable for a central bank like the Bank of England to have direct interests in commercial banking activities, since this may divert it from its main functions of preserving the domestic and external value of the currency, fostering sound financial conditions and promoting the sound functioning of the financial system and payment mechanisms. There are also problems of conflict of interest if the shareholding bank has central banking and other functions. However, Bank of England involvement in the NHB would not be likely to divert its attention from its main functions or lead to such conflicts, since its activities in this regard would be small relative to those of the Bank as a whole. The advantages of Bank involvement are great in terms of the guidance it would be able to give to the fledgling NHB, and the stability that would ensue. The shareholding would enable the Bank to appoint directors and we propose that it nominate at least one director from its own number and at least one from the Department of the Environment, to ensure that the DoE's views on housing policy are taken into account in NHB decision-making and vice-versa.

There are at least two precedents for Bank of England involvement in commercial banking activities. It is worth spending a little time on them, since the parallels between them and the proposed NHB will be apparent. The Agricultural Mortgage Corporation was established in 1928 to provide business loans for the farming industry as efficiently and competitively as possible. It is a plc and its shares are held by the Bank of England (27.4%) and five major clearing banks. In 1991 its board of directors comprised an independent chair and deputy-chair, the managing director, three independent non-executive directors (all of whom had farming connections) and three government nominees, two from the Ministry of Agriculture, Fisheries and Food and one from the Treasury. (The system of nominated directors will, however, shortly cease.) The Corporation has recently raised money on the financial markets: in 1991 it made a Eurosterling note issue of £100 million, which it subsequently swapped into floating rate sterling.

The second precedent is Investors In Industry (3i), which was incorporated in 1945 as a private company but subsequently became a public company and then a plc. Its principal activity is investing, both directly and through subsidiaries, in small and medium-sized industrial and commercial enterprises in Britain, by subscribing for or purchasing shares in them, or by making loans, which are mainly secured on the businesses' assets. It also offers a range of financial services, including management consultancy. Like the Agricultural Mortgage Corporation, its shareholders have been the Bank of England and major clearing banks. For many years 3i has raised money on the financial markets. At the time of writing, the Bank of England and the other owners of 3is are planning to sell their shares to the public.



The Bank of England should therefore have a shareholding in the NHB; initially this should be of the order of 25%. Choosing the level of the Bank's initial shareholding is somewhat arbitrary. It should be large enough to give the Bank a powerful interest in the early years so that the NHB is successfully launched. It should not be so great, however, that it detracts from the orientation which we wish the NHB to have - a substantially private sector, commercially oriented body. Nor should Bank involvement in the NHB be such that the funds it raises commercially in the market by the issue of bonds be regarded as part of the public sector borrowing requirement.

To assist in the successful launch of the NHB, and to provide capital, we would want consideration to be given to start-up financial support for the bank from central government. Part could be a grant for start-up administration costs, and part for a longer period in the form of special bonds. The special bonds could be subordinated to the ordinary bonds which the NHB will issue, so as not to subtract from, indeed positively to improve, the latter's attractiveness. The special bonds could still be counted as capital for the purposes of the NHB's capital adequacy. It is of interest that when the Agricultural Mortgage Corporation was established by the Baldwin government in 1928, it received both interest free advances from the government and payments for ten years to cover administrative costs. Only in 1991 were government loans repaid.

### *Banking regulation*

The NHB would be subject to control by the Bank of England under the Banking Act. This is because it would accept deposits in the course of carrying on a deposit-taking business. Although the NHB would raise its finance primarily by the issue of bonds, it would also, to use the terms of the Act, be holding itself out as accepting deposits on a day-to-day basis from local authorities, building societies and other institutions. The fact that the NHB had authorization under the Banking Act would give investors an assurance of its soundness. Authorization would also enable the NHB to use the word 'bank' in its name, which otherwise would require special statutory provision. To be authorized under this Act, and to use the description 'bank', the NHB must meet certain requirements. First it must have a minimum capital and undistributable reserves of £5 million. Then it must meet the 8% solvency ratio of capital to assets introduced as a result of European Community directives. On the asset side, the overall risk weighting attached to its lending would be of the order of 50%. On the capital side, there is obviously the NHB's share capital. Any special bonds to be issued to the government would also count as part of the NHB's capital, as will the reserves which it would quickly build up. The mortgage credit institutions in Denmark have had no difficulty in meeting the 8% solvency ratio.

## *Borrowing from the financial markets*

The salient financial characteristic of housing landlords is the long-term nature of their assets, the stable flow of their rental income and its slow trend rate of growth. From this it follows that the bulk of the borrowing by landlords should take the form of long-term debt at fixed rates of interest or in an index-linked form. Consequently, the core funds which the NHB must raise must ultimately also be of this nature.

How would it do this? Primarily, the NHB would raise funds from the private sector by the issue of medium- to long-term debt instruments. The Bank's activity would not be restricted to sterling; debt instruments could take the form primarily of domestic debentures or internationally traded Euro-bonds. They would be readily saleable in the secondary market. It should also be possible for the NHB to issue some shorter term paper, although for the reasons we have given, this would not be the main source of private sector funding.

One possible source of wholesale long-term funds for NHB bonds, in addition to local authorities, will be the domestic and foreign insurance companies and pension funds. These institutions seek high quality, liquid placements and the NHB should be able to offer these. The return the institutions would seek on such bonds would be set above a bench-mark equal to the redemption yield on gilt-edged stock. A number of factors should ensure that the NHB would attract funds from these institutions at favourable rates of interest and in the volume it requires. These factors are the prestige of the NHB's shareholders, the range of its assets across the voluntary housing sector and the private rental institutions, central government's commitment to financial support for rental accommodation and the economies of scale of the NHB's borrowing. At present the funding by the insurance companies and pension funds of the housing sector is at a modest level, so the success of the NHB as a financial intermediary would, for the first time, bring 'new money' from these sources into the expansion of rental accommodation.

Then we come to the building societies. Their roots in the finance of housing stretch back to the first half of the nineteenth century. Of course, the bulk of their lending is in a retail form, to individual owner occupiers. But 15-20 per cent of their assets are in liquid form. Their activities are overseen by the Building Societies Commission. The moneys the NHB could expect to win from the societies would range from the short to the long term, at variable or fixed rates. Perhaps the bulk would be as short- to medium-term funds (for example in the form of Certificates of Deposit). No change would be required in their authorised investment regulations to make this feasible.

Of course in so far as the NHB is in a position to issue prime commercial paper with an A1P1 rating, the top rating for short-term paper, it would be able to access the whole pool of short-term liquid asset provision, including

the building societies, the banks and industrial and commercial companies, at very favourable rates.

The principal source of public lending to the NHB would be through the local authorities themselves. Particularly since the passage of the 1980 Housing Act, they have amassed a considerable volume of capital receipts, whether from the sale of dwellings or other real property.

In spite of the debt redemption provisions of recent legislation, the value of these receipts is very high. Central government's estimate of accumulated usable capital receipts at 1 April 1991 is £1.167 billion. By 'usable' is meant the accumulated value of receipts net of those used to finance expenditure, to cover for credit arrangements, and to provide for credit liabilities in 1990-91. In contrast, other commentators, using a less restrictive definition of capital receipts, have suggested they have a current value of at least £5 billion, an estimate never formally repudiated by government.

Whatever the precise value of receipts available at the time of the NHB's launch, the bank should certainly seek to attract a share of this money for its own work by offering the municipalities a variety of short, medium and long-dated debt instruments at competitive rates. Real success on the part of the NHB in rapidly tapping into capital receipts could give it a kick-start in the field of funding rental housing.

## *Securitisation*

In recent years, especially in North America, securitisation has become an important financing technique for financial institutions providing housing finance. Basically, securitisation in this area involves the sale of housing loans to a special purpose vehicle, which finances their acquisition by raising funds against the security of these loans. The funds may be raised by the issue of bonds or under a syndicated loan arrangement. The security for their providing the funds is the income from, and principal value of, the underlying assets.

The NHB should be able to securitise its lending to private landlords and the housing associations. The reason it may wish to do this is that the sale of debts owed to the bank simultaneously reduces the NHB's assets and increases its capital, with a consequent improvement in its capital:asset ratio. A rise in this ratio permits the bank to engage in additional lending, while at the same time still meeting the solvency ratio required of banks.

Securitisation is unlikely to be important in the NHB's early years, and will benefit from the development by the bank of standard loan products. It also has implications for borrowers, for it means that a borrower's lender effectively becomes the special purpose vehicle, not the original lender. Borrowers need protection. In the case of the NHB, landlord borrowers will need to be assured that on securitisation of their loans, the NHB will continue to set the mortgage interest rate (if it is variable).

# 2

## Relations with other institutions

In Britain there are at present three dominant rental sectors: the local authorities, the housing associations, and private landlords.

**I**t is essential, therefore, that we address the relationship between the NHB and two organisations in the public sector which play a major role in financing the provision of rental accommodation in two of these sectors: the Public Works Loan Board [PWLB], a department of central government; and the Housing Corporation, a public corporation.

At present local authorities obtain most of their capital borrowings from the Public Works Loan Board. In fact in March 1990, of the total outstanding advances to local authorities in Great Britain, 75% was sourced by the Board and 18% from internal funds, according to information from the Chartered Institute for Public Finance and Accountancy. The PWLB is a statutory body which dates back to the late eighteenth century. It receives money from the Treasury's National Loans Fund (NLF) account at the Bank of England, and then lends to local authorities and other public bodies on the security of their charges and revenues. Local authorities pay a fee to the Board for each loan. In line with government policy, the Treasury limits by statutory order the amount lent by the PWLB, which lends both at fixed rate and at variable rates.

There have been suggestions that the NHB should take over the PWLB's responsibilities, so that the NHB would be engaged in lending to all three rental sectors. This would provide the institutional basis for an integrated approach to the financing of rental housing, a move towards 'a level playing field'. Moreover, if the NHB was lending to all three tenures, it would actively work for the interests of all three types of landlord and thus local authority housing departments would have a powerful private financial ally in the corridors of power of Whitehall and the City.

But there is a powerful case against takeover. In the first place, the PWLB services a very much wider range of bodies than local housing authorities, and a far wider range of infrastructural works than the building and rehabilitation of the housing stock. If the NHB were to take over all these functions it would no longer be a financial institution dedicated to rental housing. If, on the other

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hand, it restricted itself to the local authorities' housing programmes, the PWLB would have to continue in existence alongside the bank. When a district or borough council wanted money for a swimming pool it would have to go to the Board, but for the refurbishment of a housing estate it would have to go to the bank. For decades local authorities have raised all their capital finance needs across departments in a co-ordinated way without limiting specific funds raised to particular types of capital project. This practice would have to cease. Particular confusion could arise where an authority is planning developments which are part-funded by the PWLB and part by the NHB.

In the second place, the PWLB already provides a very effective and inexpensive service and there is no reason to imagine that the bank could do any better. Indeed, the NHB is likely to be in an unfavourable position in comparison with the Board. If it did not have full access to Treasury lending through the National Loans Fund, it could not hope to provide funds at a price competitive with that of the Board. Even if it did gain access to NLF money, its fee per £1000 loaned would have to provide for a return on shareholders' capital. In contrast, the PWLB has no shareholders. The NHB would have to commit a substantial part of its capital as backing for its local authority lending, yet could not seriously offer the councils a better deal than they already receive.

We conclude that if the machine is not broken there is no need to mend it. The PWLB should continue to handle the bulk of the local housing authorities' financial requirements for their capital programmes, whilst the NHB should focus its energies on the housing associations and the private rental sector. However, in order to strengthen the NHB's ability to think through policy across all three tenures, the board of directors should include at least one person with a strong background in local authority finance.

### *The Housing Corporation*

The Housing Corporation, created in 1964, funds housing associations and polices their operation. In the early years it obtained its moneys from the NLF and at least half from the building societies, which it then lent to housing associations at a margin above the going Building Societies Association rate to cover its costs. The Housing Act 1974 introduced a new capital subsidy for housing associations, called housing association grant (HAG), administered by the Housing Corporation, to meet the difference between the cost of approved fair rent schemes and the likely yield from rent income. From 1980 there was some private funding for improvement for sale and self-build schemes. The Housing Act 1988 set the HAG available to mixed funded schemes at levels varying around 75% of costs. Nowadays, some housing associations raise money direct from the private sector - banks and building societies mainly, rather than pension funds and insurance companies.

2

The Housing Corporation sponsored the formation in 1987 of the Housing Finance Corporation. This raises money by issuing debentures and through bank loans, which it then lends to registered housing associations.

We propose a revolution in the debt financing of the registered housing associations. Under our proposals the NHB would be responsible for:

1. Raising finance to on-lend to the associations, over and above the money which they themselves raise directly from the capital markets.

2. Purchasing from the Housing Corporation all its outstanding loans to the associations. (Similarly the NHB could buy from the local authorities their outstanding loans to housing associations, where the municipalities seek this.) This would immediately give the bank substance and a customer base.

3. Assessing credit risk and financially monitoring the associations to which it lends money, as well as providing financial appraisals of other associations where requested and paid for by the Housing Corporation.

4. Advising the Department of the Environment and the Housing Corporation on the appropriate mix of HAG and debt finance for the associations' programmes of new dwelling construction, rehabilitation and open market purchases, whether for full rental or shared ownership.

5. Administering the provision of HAG on behalf of central government on an agency basis.

6. Setting up a formal liaison role with the DoE and the Housing Corporation to advise and assist in the formulation of housing policy in respect of the voluntary and private rental sectors and to act as a voice for all lenders to landlords outside the public sector.

Under this changed situation, the valuable work of the THFC would no longer be required: its liabilities and assets could be transferred to the NHB. The Housing Corporation's functions would become the legal oversight of the registered housing associations, their financial regulation, the monitoring of their management performance and the provision of appropriate advisory services and training programmes. The role of the Housing Corporation in the funding of housing would cease. Indeed the Corporation itself could be abolished and the legal, regulatory, managerial and training roles described above could be placed with an agency outside of central government, as the Institute of Housing has proposed.

In order to carry out the six functions listed above, the NHB's board from the outset would seek to create within the institution a formidable range of the financial skills appropriate to the funding of landlords providing rental accommodation. These financial skills, experience and databases would, in the course of time, become its hallmark. In addition, the bank would build up a fine appreciation of policy developments in the housing field as well as strengths in the costing, evaluation and financial monitoring of the development process.

# The bank and the landlords

# 3

We now turn to consider the principal purpose of the National Housing Bank, its activity as a lender of capital funds to the housing associations and the private rental sector.

**B**ut before we begin that discussion, some clarification is needed. The first is that the NHB will not from its own resources subsidise its borrowers in any way, either through 'cheap loans' or cash grants. The costs of subsidising housing, through housing benefit, mortgage interest subsidy, HAG and general assistance subsidy to local authority housing revenue accounts should be borne by the state from its taxation revenues or from public borrowing.

Secondly, it was argued in chapter two that the local authorities' present reliance on the PWLB for the bulk of their borrowing should continue. However, if they did seek to borrow from the NHB, for whatever reason, the NHB should welcome this. This might happen where the authorities seek short-term finance, because PWLB loans have a minimum term of 12 months. Or it might happen where PWLB funding fell short of 100% cover for the councils' borrowing requirements for their approved development programmes.

In the past the creditworthiness of the local authorities has been very good, and since the Second World War no council has reneged on its debt repayments. The view from the City may be less cheerful as a result of the interest rate swaps experience, the use of loan guarantees and off-balance sheet borrowing from the mid-1980s. However, we believe local authorities will continue to be attractive customers because of their very restricted ability to borrow for revenue purposes and the fact that debt charges are statutorily the first claim on local tax income and the supportive role of central government.

## *The housing associations*

The capital funding of the housing associations has been the subject of an intense debate recently. The 1988 Housing Act introduced a new regime in capital funding arrangements: housing associations are typically expected to work within a mixed funding framework, whereby some 75% of their needs are met from housing association grant (HAG) and 25% from private loans. At the same time, the Conservative government expects an expansion in the

annual total of dwellings completed, which have been 17% lower in 1980-90 than was the case under Labour in 1974-79.

The housing association movement has worked admirably to adapt to the shift away from 100% HAG funding, but major contingent and structural weaknesses exist in the current system. The core problem is that the financial markets see housing associations not as commercial companies but as social institutions which are sensitive to changes in government policy, which are not resilient in the face of loan default and which offer as collateral tenanted property for which no market exists. As a result, access to loan finance from the markets, particularly from the insurance companies and pension funds, has been very problematic.

At the same time, the more the housing associations adjust to the market environment, the faster they cut loose from their social function in providing good quality accommodation to tenants on modest or low incomes. An unwelcome side-effect of the drive for commercial status has been the amalgamation of smaller associations within larger ones so that the link between an association and its local community has been weakened.

These difficulties have already led to calls for the launch of a social housing bank dedicated to the housing associations or, alternatively, the incorporation of a dedicated credit enhancement agency. This adds to the case for creating a National Housing Bank.

The price at which the NHB would offer to lend to the housing associations would vary with the term and profile of the loan. The benchmarks would be the London interbank offer rate (LIBOR) for short-term rates and the redemption yield on gilts for long money, just as with the NHB's own borrowing from the private capital markets. The rate of interest would also reflect, of course, the credit rating of the housing association in question. Collateral on the debt should be a floating charge over tangible assets. In the event of the collapse of a housing association and where no take-over of the indebted institution by another proved feasible, the NHB would sell these properties on to other landlords.

Particular arrangements are likely to be required for small and for specialist associations as well as for housing co-operatives. Their credit rating is likely to be less favourable because some financial institutions will assume that smaller associations have committee members and staff who are less qualified and experienced in management, and because total loan administration costs vary little with the size of the loan, so for each £1000 lent out, small loans bear a heavier administrative cost burden. Moreover, smaller and specialist associations are likely to have a stock of housing which is less diverse in its geographical location, age, type and in its tenant body. Less diversity means higher risk.

In these cases the NHB as a general rule is likely to be driven by its commercial imperative to set a higher price on its lending. Yet a widespread



view exists in the housing world, which we share, that such associations have an important place in the range of services provided by social landlords.

How can this difficulty be overcome? The simplest solution is for the public sector to provide very substantial HAG cover for the schemes of smaller and specialist associations, thereby reducing both the size of the loan required as well as its price, for greater HAG commitment reduces the perceived risk on the loan. Second, if the NHB sets up a separate budgetary unit for all loans below a defined threshold, and if pooled insurance were purchased for these loans, the DoE could provide grant-in-aid for the running costs of this operation. In both cases the cost of shielding small and specialist associations from strictly market criteria would be borne by the public sector in recognition of the variety in service provision which such social landlords bring.

A second source of borrowing deserving special attention are the developers and owners of mixed-use schemes, which combine local authority or housing association or private rental housing with shared ownership or owner occupation. Provided that the combined rental and shared ownership content exceeds a low minimum threshold, the NHB should welcome such projects to provide development finance as well as long-term core funding.

The advantage to the housing associations of the creation of a National Housing Bank would be material improvement in terms of the volume, price and availability of long-term money. The NHB, a powerful financial institution with an elite listing of principal equity holders, and with a balance sheet containing a portfolio of assets across a variety of housing associations, private rental companies, mixed-use developments and some local authority debt secured against tax incomes, would access debt funding on far better terms than could any single housing association.

First, the bank's assets would be far more diverse than that of any single association. Second, lending to the NHB would not be categorised by commercial banks and other institutions as 'Commercial Property', with all its volatility in value, as housing association debts are today. Third, the costs of monitoring each separate housing association to which loans are made would not be borne by institutions which place money with the NHB. Fourth, the NHB, unlike individual housing associations, would not be perceived by the market as a non-commercial body engaged in a quasi-social enterprise. Fifth, the repeated issue of large blocks of bonds by the bank would provide assets of far greater liquidity than could possibly be the case with loans to individual associations.

In particular, the NHB will be far better placed than individual housing associations to mobilise funds from the insurance companies and pension funds, which would not otherwise be available. These could be added to the current funding originating from organisations such as the National Westminster Bank and the Halifax Building Society, with the prospect of syndication between the NHB and these financial institutions.

The scale and expertise of the NHB would enable these advantages in access to capital to be passed on to the housing associations. Each of them, instead of facing a diffident and uncertain climate in raising finance, would deal with a new institution which would be committed by its very nature to the expansion of rental housing and which would understand intimately the capital needs of the landlord.

But why should the NHB be willing to provide finance on better terms than the general market? The core reason is that its understanding of the market in residential lettings across all three tenures and its close contact with the Housing Corporation and the DoE would free it from the excessive risk loading imposed on social landlords by private capital markets which do not specialize in this form of debt.

We believe that these price and non-price advantages, as the Credit Local de France has found, would be of significant advantage to an expanding housing association capital programme. In a nutshell there would be a perceived risk differential, a 'risk gap', between the NHB's view of the associations and that of the general market and it would be this gap in the perception and therefore the pricing of risk which the NHB would exploit.

### *The private residential sector*

Expansion is needed not only in the provision of local authority and housing association accommodation, but also in the private rental sector - landlords which are companies or individuals but where the landlord does not live in the dwelling being rented.

The modest scale of private rental provision in the UK contrasts sharply with the situation of some of the best-housed populations in the world including western Germany, Sweden and Switzerland. In order to change this, the rate of return on residential lettings net of tax must be brought into line with market yields and the wasteful subsidy of home owners should be phased out.

If the yield question can be solved, landlords will require access to capital on attractive terms and here much of the argument coincides with our earlier consideration of the housing associations. Just one specific point needs to be made over and above that discussion. There has been some concern expressed that the NHB could find itself lending money to bad or even vicious landlords, new 'Rachmans'. This danger cannot be discounted and it is best avoided by making loans only to registered landlords, under the proposals of the Campaign for Bedsit Rights and Shelter in their *Private Tenants Manifesto*.

### *Costs and capital adequacy*

The specialist character of the NHB as a financial intermediary will offer it the potential to develop very considerable expertise in all aspects of the financing of rental housing. In time the NHB should seek to earn fee income

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in providing advice to landlords in project and programme evaluation, subsidy optimization, credit analysis, financial monitoring and control, asset management, accounting practice, and remedial action for landlords in financial difficulties. These activities could be promoted, both through consultancy and training programmes, perhaps through a private limited company subsidiary. With the passage of the 1988 Act and the introduction of private financing, there can be no doubt that both within the City and among the housing associations themselves, there has been a heightened awareness of the lack of financial skills amongst committee members and management staff.

The operating costs of the NHB in the main will consist of its staff costs and the costs of renting and servicing its headquarters in London. Consideration would also have to be given to the costs and benefits of establishing a limited number of branches in Scotland, Wales, Northern Ireland and the English regions, tapping into regional capital markets, particularly for local authority capital receipts, as well as assessing the creditworthiness of and maintaining contact with regionally based landlords. In particular, development characteristics vary considerably between geographical areas in respect of land values, development costs and local housing markets. This information needs to be fed systematically from the regions to the centre.

The nature of the NHB's business, in contrast with the clearing banks and building societies extensive retail operations, should permit it to operate as a lean machine. The staff's principal duties would be to raise money in bulk and on-lend it. As with the Credit Local de France, a most important function of the research division would be to assess the creditworthiness of potential borrowers.

The initial equity raised, and later additions, would be used to fund the start-up capital expenditures on equipment, and would also provide the NHB's necessary capital against potential losses and bad debts. Equity capital may be buttressed by once-for-all government loans, as we suggested earlier.

The capital adequacy ratio required of the National Housing Bank will have to conform to guide-lines laid down by the Bank of England. This stands at a *minimum* ratio of capital to risk-weighted assets of 8%. The risk weighting of local authority debt is 20%. The risk-weighting of most housing association debt is 50% as should be the case with the mortgaged property of the privately rented sector. City opinion is that in its first year the NHB's capital adequacy ratio in terms of risk-weighted assets should be of the order of 12-20%, with reductions in subsequent years as the bank proves itself to the markets.

This enables us to give a simple worked example of the NHB's capacity to lend. Suppose first that the initial capital of the NHB at its creation is £125 million; that the average risk-weighting of its loans to housing associations, local authorities, private landlords and mixed-tenure schemes is 50%; and that by the end of its first year of operations the NHB is working to a capital adequacy ratio of a conservative 16%. In terms of the non-risk weighted value

of its loans, this would permit borrowing by landlords of £1.56 billion by the end of the first year.

If by the end of the fifth full year of operation the NHB had increased its capital to £500 million and was working to a capital adequacy ratio of 10%, its loan portfolio accumulated over that five-year period could total £10 billion.

Putting this last figure another way, the capital servicing costs for the NHB of providing £10 billion of lending to the social and private rented housing sectors would be the dividends on the equity base and the return on subordinated bonds of £25 million.

# The NHB and public expenditure

# 4

In this chapter we examine the public expenditure implications of the creation and activities of the National Housing Bank over its first five years.

**T**he contextual assumption is a sustained expansion in the capital programmes of local authorities, housing associations and private landlords, both separately and through mixed tenure schemes, including the provision of dwellings in shared ownership. These programmes would embrace new building, conversions, major rehabilitation works and the purchase of empty dwellings from the owner occupier market.

The key to understanding the public expenditure implications is that where a public limited company (which would be the legal status of the NHB) borrows money from the private financial markets and lends that money to housing associations and to private landlords, the Treasury deems no public expenditure to have occurred. This is because, quite simply, neither the original source of the loans, nor the intermediary bank nor the recipients of the loans are institutions which are classified as within the public sector, which is defined as central government, local government and the statutory corporations.

However, some features of the bank's work would effect public expenditure. Whether or not the bank exists, a substantial expansion in local authority and housing association programmes would require a major growth in government capital spending because local authorities are, of course, classified as part of local government, and because housing association grant is a capital payment from central government.

Our proposals for the creation and operation of the NHB include two which would require public expenditure on capital account. These are:

- the initial 25% shareholding in the NHB of the Bank of England;
- (if proceeded with) the take-up by the Treasury of special subordinated bonds to contribute to the NHB's initial capital.

We shall again assume that by the end of the fifth year of the bank's

operation total capital equals £500 million, and that within this total the public sector's contribution remains stable at its original £25 million Bank of England shareholding and £25 million in Treasury bonds. The expansion in total capital could take various forms, including accumulating reserves or raising fresh equity.

It follows that, in this respect, the additions to public expenditure, and therefore the PSBR, as a result of the NHB's creation and activities would be only £50 million.

However, our proposals also included three which would bring a fall in public expenditure on capital account. These are:

- the purchase of the Housing Corporation's assets in the form of the outstanding debts to it of the registered housing associations;
- the purchase of all or part of the local authorities' assets in a similar form;
- the replacement of lending from the Housing Corporation to the associations by lending from the NHB.

From the Treasury's point of view, the first two generate capital receipts for the public sector and this constitutes negative public expenditure. The last item reduces public expenditure on new schemes to less than what it would have been without the bank's creation. We suggested earlier that the build-up of the NHB's assets over five years would amount to £10 billion. These reductions in expenditure, which constitute part of that £10 billion, would exceed the £50 million increase in expenditure. Therefore the work of the National Housing Bank would have a beneficial outcome on capital account of the PSBR.

On current account our proposals suggested grant assistance in the NHB's first year for start-up administrative costs, plus continuing grant assistance for the bank's Small Loans section. These outlays would be fairly modest, as would be any tax relief offered on institutional up-take of equity at the NHB's creation. To sum up, the direct outcome of the launch and activities of the bank over its first five years would reduce the PSBR on capital account and incur only modest current account outgoings.

A National Housing Bank will be a practical measure for facilitating the expansion of the rental housing stock in the ownership of housing associations and private landlords. If, after the general election of 1992, the new government finds these arguments persuasive, it should commission work on a business plan. If this work confirms the ideas set out here and if negotiations with potential equity holders prove fruitful, the NHB could open its doors as early as the Winter of 1992-93.

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## A National Housing Bank

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Housing is rising up the political agenda, thanks to the steep increase in homelessness and repossessions. The single most important measure needed to reverse these trends and resume the long march against housing poverty is an increase in good quality rented accommodation, from local authorities, housing associations and private landlords.

The authors argue that a National Housing Bank is required to overcome the current deficiency in financing housing for rental outside the public sector. The bank should operate as a commercial body, borrowing from institutional sources and lending to landlords, who could use the money to build new properties or renovate existing ones. The government, through the Bank of England, should have a minority shareholding.

As the bank would be a private sector body, its activities would not increase the Public Sector Borrowing Requirement. It is thus a policy which could be implemented rapidly after the general election, perhaps opening its doors as early as the winter of 1992-93.

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