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Capital Homes: Finance and delivery

Roundtable report - August 2019

Credit: Clifford Yeo

This paper summarises key points made in discussion at the fourth and final Capital Homes expert roundtable on London's housing crisis. Held under the Chatham House rule in July 2019 this roundtable explored financing and delivering the homes that London needs. Previous roundtables covered trust, design and community, land and planning and affordability and tenure.

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Context

Housebuilding in London is dominated by the private sector, who build around three quarters of new homes in the capital. Alongside private developers (of whom a small number lead development across London and the UK¹), housing associations account for around one fifth of homes, and local councils for smaller but growing numbers.

Most housing is built for the private market and is either bought by owner occupiers or by buy-to-let landlords. A combination of cross-subsidy and grant is used to build affordable and social rented housing, though grant levels have decreased sharply over the past decade. There has also been an increase in Build-to-Rent development, which is funded by long-term rental income, rather than by capital receipts from sales.

However, uncertainty is now rife and there has been a slowdown in London's housing market over the last couple of years, with average property prices dropping 2.6 per cent since 2017² and new build starts in London falling from 25,000 in 2015 to 17,000 in 2017.³

Against this backdrop, there are concerns that the current system is not working: that the dominant private developers will only build out as fast as the market will absorb homes, that relying on a market-led model to build affordable housing is inadequate, and that a wider variety of delivery and financing mechanisms will be needed to build the housing London needs. This roundtable discussed current and future financing and delivery mechanisms.

Issues and opportunities

Current models

Market housing is inaccessible for many buyers

Rises in house prices combined with a reduction in the amount that banks will lend have made it increasingly difficult for first time buyers to get into the housing market, even if mortgage rates are relatively low. On average, first time buyers in London are putting down a deposit of £110,656, compared to a UK average of £32,841.⁴ Some participants highlighted that the maximum loan-to-value ratio is still much lower than before the crash, creating an artificial barrier for many potential owner-occupiers. Help-to-Buy Equity Loans were intended to top up a five per cent deposit with a loan of up to 20 per cent of property value (40 per cent in London since 2016), but take up had been much lower in London than other regions, reflecting the challenges of even finding a five per cent deposit against London's current prices.⁵

This means that many Londoners now rent properties from private landlords. In turn the number of private landlords has boomed in recent years, boosted by small investors seeing buy-to-let housing as a one-way bet (though recent tax changes have dampened the sector). Renters in turn face much higher monthly costs than they would as owner-occupiers (diminishing their ability to save for a deposit), albeit without the potential capital loss – or gain – of home ownership. Moreover, while costs for renters have been rising (despite stagnant wages in the capital), their ability to challenge unfair rent rises has been limited to date (though may be boosted by proposed abolition of 'Section 21' evictions).

Build-to-Rent has potential but is currently limited in its reaches

When thinking about the private rental market, Build-to-Rent (BtR) offers the potential to improve standards and security for tenants. BtR works on a different financial model to the build-for-sale market, using institutional investment (which seeks predictable long-term income streams) to deliver homes at scale. At its best, BtR operators can offer a more professionalized service than private landlords, with an emphasis on long-term returns and stewardship.

While this growing tenure offers potential, participants at the roundtable acknowledged that, at present, BtR is aimed at the middle to upper end of the private market. Research has shown that BtR rents are, on average, 11 per cent higher than the local market rent.⁶ As such, participants discussed whether BtR could be expanded and how it could work at different price points, in order to bring benefits to a broader cross-section of Londoners.

More public and third sector delivery could meet need, but financing is a challenge

Some roundtable participants felt that increased public investment in social and affordable housing was the best way to address London's acute housing needs at the scale required. Participants argued that public bodies must take the lead alongside housing associations, building on the expansion of borough programmes reviewed in Centre for London's 2018 *Borough Builders* report.⁷

Cuts to grant funding (which has reduced by 60 per cent in real terms compared to the five years preceding the financial crash⁸), right-to-buy and caps on local authority borrowing (although now lifted) have contributed to the historically declining role of the public sector in the house building market. Lower grant rates have also pushed housing associations to behave increasingly like private developers, building more private market housing and increasing their exposure to the same risks that face private developers.⁹

There was a strong consensus that higher levels of grant would help deliver more affordable housing, as argued by the Mayor of London¹⁰, though some participants suggested that there could also be a shift from grant funding to shared equity investments.

Similarly, Centre for London's 2016 *In No Uncertain Terms* report, discussed ways to convert housing benefit payments to private landlords into productive investment in new homes, based on long term, binding guarantees that housing benefits would keep pace with inflation, thereby enabling councils and other developers to borrow in order to build social housing against a guaranteed income stream.¹¹ Innovative ways of public sector delivery should be explored to ensure maximum return to the public purse.

Some participants also argued that existing social stock should be better protected (which would also increase the confidence of local authorities seeking to build new homes). Since 1980, Right to Buy (RTB) policies have allowed council tenants to buy their homes at a discount of up to £108,000 a home. Participants pointed out that RTB has led to many former council properties being sold and subsequently returned to the rental market. In 2018, councils in London spent approximately £22 million renting back homes that they previously owned¹², and 42 per cent of former RTB homes are owned by private landlords (up from 36 per cent in 2014).¹³

While some argued that RTB should be stopped or at least suspended in London, others pointed to its continuing value as a way of, in the words of the London Assembly Conservative Group, ‘giving aspirational and hardworking people a stake in their society.’¹⁴ Others pointed to the government’s consultation on allowing a higher proportion of RTB receipts to be reinvested, which would both enable more council housebuilding.

Public private partnership tensions persist

Councils have explored a number of delivery models, including public private partnerships and joint ventures. These have taken many different forms over the years – from land disposals, and simple development agreements, to more complex special purpose vehicles. In many cases, public bodies’ land and built assets are pooled with developers’ finance and expertise to bring forward new development, with risks and rewards shared between the partners.¹⁵

Such joint ventures have been controversial in recent years, and several participants highlighted concerns about them. In theory, risk is transferred to the private sector, but as one participant put it, the public sector has a duty of care and will ‘pick up the pieces’ if problems arise. Furthermore, some participants had negative experiences of these partnerships, citing incidents where private sector partners had failed to address issues within a scheme, meaning a public body was forced to intervene.

Additionally, institutional investors raised concerns about the risks inherent in development, particularly given the time taken to get through planning and construction before achieving a return. Such investors preferred not to take on risk at this stage, but to buy into schemes later, seeking consistent yields of two to

five per cent. Perhaps this was the stage at which public bodies were best equipped to take on risk, and use the rewards generated to reinvest.

There was also a broader concern – about the hierarchy of objectives. We should be seeing housing primarily as a right for local people, not as an asset class for investors. There was a role for private investment and partnership, but it is needed to service the public interest, not vice versa.

Generally, participants felt that a more honest conversation about financing, responsibility and risk was crucial to addressing some of these challenges with collaboration between the public and private sector.

Diversifying the sector and incentivising development

A more standardised planning system

It is widely acknowledged that the planning system can be complex and difficult to navigate. Participants noted that the system carries a number of uncertainties with it. This was seen as deterring new entrants and SMEs, as they are less able to absorb these risks. A housing market delivered by volume builders (as we have now), was viewed as a constraint on delivering the diversity of housing that Londoners need.

Fostering long term partnerships

Participants working in the development industry highlighted the value of fostering long term relationships with contractors, as a way of cutting costs and achieve economies of scale. One participant who works for a London borough noted that many outer London boroughs have portfolios of smaller sites: while running procurements for whole packages might achieve economies of scale; smaller packages might do more to attract smaller developers, particularly SMEs – if returns were phased to match cashflows.

Similarly, research conducted by the Local Government Information Unit found that resource and capacity pressures within local authority planning departments served as the main barrier to the allocation of small sites.¹⁶ Planning departments have been severely hit by funding cuts since 2009/10,¹⁷ and participants at the roundtable agreed that building long term relationships could help to overcome some of these resource constraints.

Modern methods of construction

Participants also discussed the potential of modern methods of construction (MMC) to deliver more homes in the capital. Some participants claimed that MMC are not a ‘silver bullet’ for London’s housing crisis, highlighting that costs, at present are in line with other forms of building. Additionally, others explained that the initial capital required can be prohibitive as costs have to be met up front (compared to bricks and mortar where supplies are bought as you go along).

Yet participants working with MMC agreed that while costs were currently similar, they had found that the main advantage was quicker build out times. Despite some skepticism, others noted that MMC is still in its infancy, and with greater growth, costs are likely to fall. As we outlined in our 2018 [*Made for London*](#) report, there is limited data on uptake, but 2013 estimations suggest only seven per cent of construction output was off-site.¹⁸ As the sector matures, one participant noted that it could offer ‘great potential’ for the delivery of homes in London.

Tax reform

Aside from increasing delivery across tenures, some participants described land value capture as the ‘real key’ to addressing London’s housing crisis. Some suggested that new tax mechanisms could create greater incentives to deliver homes at pace in the capital, by taxing undeveloped land on the basis of its permitted end use. Land Value Tax (LVT) was discussed, with some concern that, unless different types of land were valued in different ways, a LVT would encourage the most profitable use of space. To protect a ‘low value’ land uses (like parks and museums), it would be essential to have a tax rate linked to value of land use.

Others pointed to specific technical issues such as VAT. Neither build-for-sale nor Build-to-Rent (BtR) were subject to VAT, but the former allowed reclamation of input tax, but the latter doesn’t. On-sale of BtR is also subject the Stamp Duty surcharge intended to hit second-home owners.

The financial emphasis of valuation models fails to capture other metrics of value

Some participants raised concerns about current valuation models. At present, valuation is based on Red Book standards, but some felt that we should also be considering a broader set of metrics along the lines of HM Treasury’s Green Book. On top of this, participants also commented that traditional valuation methods fail to capture social or community value. These participants suggested that there could be a place for evaluating development value in a more holistic way.

Summary

Our current housing delivery model is not producing enough homes, and the homes that are produced are too often unaffordable. Ultimately, the private sector cannot meet the housing needs of all Londoners. With growing uncertainty and a slowdown in the market, this is an important moment to consider the way we finance and deliver homes in the capital.

The revitalisation of the public sector is crucial to providing the diversity of housing that London needs. Alongside greater public sector involvement, we must also look at new methods of delivering affordable, good quality homes for Londoners, as well as new ways to capture the value of land.

With this in mind, here are some headline considerations:

- 1. Have honest conversations about risk sharing between public and private sector**
- 2. Develop long-term relationships between local authorities, contractors and partners**
- 3. Limit Right to Buy sales to protect diminishing social stock**
- 4. Increase public sector delivery**
- 5. Explore potential for a more standardized planning system**
- 6. Secure housing benefit guarantees to enable preferential financing for public housing**
- 7. Rethink the way we capture land value**
- 8. Level the playing field in terms of tax treatment, and consider more radical tax reforms**

This is a brief overview of our discussion on finance and delivery of housing in the capital. We will use these initial thoughts to form more detailed policy recommendations as part of Centre for London's Housing Manifesto (due for publication in Autumn 2019).

Endnotes

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