CONSULTATION RESPONSE

CLG Select Committee Inquiry into Housing and the Credit Crunch 31 October 2008

Submission by the Home Builders Federation (HBF)

1. The Home Builders Federation is the principal trade association for private sector home builders in England and Wales. Our members build about 80% of the new homes in England and Wales each year and range from large national companies to smaller, locally based firms.

2. The credit crunch has particular relevance for a number of related aspects of Government housing policy which fall within the Communities and Local Government (CLG) remit: the numerical housing targets; the need to provide genuine housing choice for all sectors of the community (including, for example, older people) and not just first-time buyers; and a range of other policies related to new homes, most notably Affordable Housing, zero-carbon new homes, building regulation changes and infrastructure funding.

3. Following the summary, our submission sets the scene with a short discussion of the scale of the current housing market downturn. We ask whether the Government's housing targets are still valid. We examine the current market-based delivery model for new housing and the impact of the credit crunch, then ask whether there are feasible non market-based alternative delivery models. We examine the Government's financial and housing measures in response to the credit crunch. Finally we discuss our concerns about the cost impact of policy and regulation on housing delivery in the medium to longer term.

SUMMARY

- Our key message is that while we welcome the measures already announced by the Treasury, Bank and CLG, much more needs to be done to revive mortgage lending, arrest the steep decline in new home building and reduce the severe loss of home building industry capacity and skills. The more that can be done to sustain home building in 2009 and 2010, the narrower will be the gap between housing delivery and the Government's housing targets once the recovery begins. There is also a pressing need to review the cost burden of regulation which, combined with falling land prices, has made many sites unviable for housing development. This will act as a major brake on raising housing numbers unless these costs are lifted.

- The scale of the current downturn in prices and volumes is unprecedented in the post-war period. The fortunes of the new home sector, around 10% of the market, are determined by the wider housing market. Also Affordable Housing delivery, heavily reliant on the market, has been adversely hit.

- The Government's numerical housing targets, based primarily on demographic trends, remain just as valid. The anticipated falls in house building mean the timescale for achieving the 2016 and 2020 targets will have to be extended, and the target numbers adjusted accordingly. The planning system should continue to plan for the target numbers since these are based on projected household "needs".

- The current housing delivery model, for both market and Affordable housing, is heavily market based. In addition, many other policy aspirations, such as zero carbon or Lifetime Homes, depend for their delivery on residential land values, which are in turn determined by housing market values.

- The primary cause of the housing downturn was a sudden drastic reduction in the availability of mortgage finance and significantly tightened mortgage terms (especially loan-to-value ratios). However we are now in a downward spiral of continued falling mortgage finance, driving down volumes, driving down prices and damaging consumer confidence, etc.

- The absolute priority must be for the Government to intervene to arrest this downward spiral by restoring the mortgage finance. We eagerly await the findings of the Crosby Review of Mortgage Finance. Assuming the review identifies effective measures to revive mortgage lending, the Government must urgently implement its recommendations. Also the Treasury should consider how the required contraction in Northern Rock's mortgage book, and negative net lending by the building society sector in response to FSA requirements, is aggravating the mortgage famine. It is not at all clear how banks benefiting from the Government recapitalisation scheme are to restore lending to 2007 levels.

- HBF's survey evidence, and abnormally high new home cancellation rates, show that potential demand for new homes has fallen far less than new home reservations, which means many potential buyer are unable to proceed because they cannot obtain a mortgage on terms they can meet.

- While the policy focus is often on first-time buyers, we need liquidity in the whole housing market because measures just to help first-time buyers will not lead to movement throughout housing chains. There is a shortage of opportunities for families and older people to move into homes that better suit their needs and aspirations. Resolving mortgage finance across the board will, for example, enable older owner occupiers to move out of under-occupied family homes into smaller, more manageable and suitable homes, thus freeing up larger homes for more appropriate occupation. Although older home owners will usually downsize, and therefore not require a mortgage, most prospective purchasers of their existing homes, and buyers further down the chain, will require a mortgage.

- Home building numbers in England are set to fall steeply, possibly to well below 100,000 per year, over the next couple of years. Some in the industry are predicting house building could fall to as low as 60,000. Both private and Affordable Housing numbers will fall.

- The credit crunch and subsequent fall in house prices has severely damaged house builders' profit margins on already-owned land. It has also cut residential land prices, so that many residential development sites are no longer financially viable (i.e. land prices will be too low to persuade land owners to sell to residential developers).

- In addition, sharply reduced land values mean policy objectives such as Affordable Housing, zero carbon, infrastructure funding and Lifetime Homes will no longer be achievable because their delivery relied on being funded out of residential land values.

- We do not believe a new delivery model, based on much larger contributions of publicly funded housing, is feasible given likely future constraints on public spending and the fact that local authorities have no capacity to implement large-scale house building programmes at present. Also households' tenure aspirations do not suggest we need a major public house building programme.

- Therefore the Government must review the barriers to future private sector and Affordable Housing delivery if it is to achieve its housing targets.

- The recent Bank Rate cut must be followed quickly by further sharp reductions to help support economic growth and arrest the steep fall in the housing market, assuming lower rates are carried through into lower mortgage rates.

- The very significant measures taken by the Government and Bank to restore bank liquidity and help recapitalise the banks will not, by themselves, solve the mortgage famine, which is why the Crosby Review is so critical. In fact mortgage availability on reasonable terms seems to have worsened recently, with no sign of improvement. Other measures (below), while very welcome, are relatively small scale in relation to the housing crisis and likely fall in new home building.

- We welcome the £300+ million of CLG funding for RSLs to buy stock from house builders, and £300 million to fund some 10,000 shared-equity first-time buyer purchases of new homes over the next two years under the HomeBuy Direct scheme. This will help house builders maintain capacity and jobs, boost the supply of Affordable Housing and assist first-time buyers. We believe more funds from the CLG three-year programme should be brought forward to assist the industry, especially as its budget is likely to be under spent.

- Additional funds for RSLs are also welcome if they enable them to go ahead with Affordable Housing S106 agreements on private housing sites. However grant rates will have to be raised because RSLs have been hit by the fall in cross-subsidy from their open market and share-ownership sales and higher funding costs.

- The higher stamp duty threshold is a helpful contribution, as are measures to avoid large numbers of repossessions coming onto the market.

- Local authorities must be realistic about the impact of the credit crunch on land values and development viability when renegotiating existing, or negotiating new S106 agreements.

- The Government and local authorities must undertake a major reassessment of a range of policies involving new homes – Affordable Housing, zero-carbon, building regulation changes, funding infrastructure through S106 agreements or the CIL, Lifetime Homes, higher space standards, etc. – because the costs they impose on development have drastically reduced residential land values, in some cases making land values negative. Low or negative land values will make it impossible for the industry to lift production to meet the Government's housing targets. This was a serious problem before the credit crunch, but the subsequent fall in land values has made it even more acute.

AN UNPRECEDENTED HOUSING MARKET DOWNTURN

4. The current housing market downturn is without precedent in the post-war period:

- In the whole of the severe housing downturn of the late 1980s/early 1990s, mortgage approvals for house purchase fell by 57% over four and a half years. This time, in the seven quarters since approvals peaked, they have already fallen 74%.

- According to the Halifax index, house prices fell 13% in the whole of the last crash. Since their peak in August 2007, prices have fallen 14% and most commentators expect further substantial falls in the final months of 2008 and in 2009.

- A long-term house price series compiled by CLG shows that the previous record annual house price fall was 10% in 1932. Based on recent monthly declines in the Halifax and Nationwide indices, prices by the end of this year will be falling at an annual rate of around 16%.

5. New homes account for approximately 10% of total housing market transactions, so the fortunes of the new home sector are largely determined by the market as a whole.

6. RSLs are also heavily dependent on the fortunes of the housing and mortgage markets. Many rely on cross subsidy from open-market and shared-ownership sales to fund their social rented programmes. Both these categories of sales have been hard hit by the mortgage famine and market downturn. Also, a substantial majority of Affordable Housing is delivered through S106 agreements on private housing sites (discussed below), so the supply of Affordable Housing has been hit by the downturn in market house building.

THE GOVERNMENT'S HOUSING TARGETS: ARE THEY STILL VALID?

7. The Government's target for England is 240,000 net additions to the housing stock per year by 2016, 2 million additional homes between 2006 and 2016 and 3 million between 2006 and 2020.

8. The projections underlying these targets are largely demographic. And because demographic trends will not have been significantly changed by the credit crunch[1] – although net migration, and even household formation, could be altered if Britain

[1] Most of the people who will form the additional households over the next 10-15 years are already resident in England. It is noteworthy that almost half (48%) of the increase in households by 2023 will be older people.

experiences a prolonged and deep recession – there is no reason to doubt the continuing validity of the target numbers.

9. However the severe downturn in new house building expected over the next few years will require the Government to change the timing of the targets. 240,000 per year should still be our aspiration, but in practice it will not be achievable by 2016. Similarly we should still be aiming for 3 million additional homes, but realistically these will not be achieved by 2020. If the timescales are changed, as seems inevitable, then the target numbers will have to be amended accordingly[2].

10. Therefore we believe the planning system, through Regional Spatial Strategies (RSSs), Local Development Frameworks (LDFs) and strategic housing market and land availability assessments, should continue to plan for the housing targets. It would be quite wrong to assume that, because housing numbers are falling in the short-term, therefore we do not need to plan to meet housing need in the medium to longer term. To do so would be to risk the housing market being even more undersupplied in the future and exacerbating affordability.

HOUSING DELIVERY MODELS & THE CREDIT CRUNCH

The Current Market-based Delivery Model

11. The current housing delivery model in England is heavily market based. This applies to the delivery of new homes, as well as to other key policy objectives such as the funding and provision of Affordable Housing, achievement of zero carbon new homes and funding the infrastructure required to support additional development.

12. In recent years, total new housing completions have contributed around 90% of net additions[3]. CLG statistics also show that, in recent years, “private enterprise” has accounted for around 85% of total new housing completions. This covers open-market sales to owner occupiers and investors, as well as sales of ‘intermediate’ housing within Affordable Housing (shared-ownership and shared equity). Therefore roughly three quarters (85% of 90%) of the net additions target would, under normal circumstances, be housing for sale, dependent on the fortunes of the housing and mortgage markets.

[2] For example, if 2 million additional homes are not delivered by 2016, then the shortfall against the 2016 target will have to be reflected in even higher post-2016 targets.
[3] The Government’s targets are for ‘net additions’ to the housing stock. These are made up of new build plus conversions less demolitions.

13. In addition, official figures show that the majority of Affordable Housing (as defined in PPS3) is delivered through S106 planning obligations agreements on private housing sites. In 2006-07, 58% of all Affordable Housing was delivered through such agreements[4].

14. Therefore the net additions housing targets are very heavily dependent on market-based delivery. And within the target totals, new housing for all tenures – owner occupation, private rented, intermediate and social rented - is heavily dependent on market-based delivery. By contrast, in the 1960s and 1970s, between one third and one half of all housing completions annually were social housing, most of which were funded and built by local councils independently of the housing market or private new house building.

15. Therefore when considering how we might achieve the targets, a valid question is whether, given current circumstances, new housing supply can continue to be heavily market-based, as it has been for the last two decades, or whether we might see a significant change in the supply model towards a much greater contribution from social housing providers (councils, Local Housing Companies, RLS, etc.) operating independently of the market, more like the model of the 1960s and 1970s.

16. We noted above that, as well as housing provision, delivery of policy objectives such as the funding and provision of Affordable Housing, achievement of zero carbon homes and funding for the infrastructure required to support additional development are also heavily market based. In the cases of Affordable Housing and infrastructure, whereas these would have been funded directly out of public expenditure in past decades, funding now relies at least in part on subsidy out of development land values. The cost of other policy demands, such as zero-carbon homes, Lifetime Homes and higher space standards, will also have to be funded out of land values.

17. In a rising housing market, with rising land values[5], it was possible for house builders profitably to deliver new homes while at the same time meeting the escalating policy demands of central and local government. However, as discussed below, the financial impact of these policy demands was already approaching a crisis point, even before the credit crunch led to falling house and land prices. Post credit crunch, the residential land values that helped deliver these policies, and that are expected to delivery them in the future, are no longer available.

Market-based Delivery and the Credit Crunch

18. Private, or market-based housing delivery has two essential requirements:

[4] CLG statistics. Published 12 June 2008

[5] Residential land values in the last decade or more were pushed up by both rising house prices and, since 2001, by sharply higher housing densities.

- a competitive profit margin and return on capital from development, so that investors are willing to invest in house building companies;
- residual land values sufficient (a) to exceed any current or alternative use value, and (b) to persuade land owners to sell their land to residential developers.

19. (A simple description of residential development economics is attached as Appendix 1, outlining the links between sales prices, development costs, developer profit margin and land value.)

20. If these two factors are not met on a site, private residential development will not take place.

21. The credit crunch has seriously damaged both profit margins and land values.

22. The initial trigger for the downturn was a severe contraction in mortgage availability, caused by a collapse in the mortgage securitisation market, immediately followed by a tightening of lenders' terms as they rationed their limited funds. However we are now in a vicious downward spiral of restricted mortgage lending leading to falling housing volumes, driving down prices, undermining consumer confidence and housing and mortgage demand, further depressing volumes, which further undermines prices, etc. In addition, valuers are driving down new home prices by making extremely conservative assumptions, often on the instructions of lenders.

23. Some actions by the Government and FSA appear to be exacerbating the mortgage famine. Following nationalisation, Northern Rock has been required rapidly to reduce its mortgage book, thereby sucking funds out of the mortgage market. Bradford & Bingley seems likely to stop lending, and may even be required to shrink its mortgage book. In addition, the building societies sector has recorded negative net mortgage lending in recent months. We understand this is at least partly in response to stringent FSA regulatory requirements. If so, the FSA's actions are worsening the housing market downturn. With most specialist lenders closed for new mortgage business, the market is now reliant for net lending growth on the limited number of banks which have not been nationalised.

24. The absolute economic priority must be for the Government to intervene to arrest this vicious downward spiral. Because the mortgage famine, which lies at the root of the housing crisis, is being driven primarily by an unprecedented crisis of confidence among banks and investors, it can only be solved by Government intervention. Underlying housing need, driven by demographic pressures, remains unchanged by the credit crunch.

We also believe there remains strong underlying demand for owner occupied housing, if only potential buyers could secure mortgage finance. If funding could be restored, effective demand would stabilise and begin to lift housing transactions, which would in turn put a floor under prices, and so begin a virtuous spiral of recovery which would lift private house building and Affordable Housing provision.

25. As an aside, some have argued the current fall in prices is a “necessary correction” to restore affordability. While affordability was indeed extremely stretched, and some correction in the relationship between incomes and house prices was desirable, the current uncontrolled correction is likely to drive house prices down far further than would be needed for such an affordability correction, doing enormous social and economic damage in the process and destroying capacity within the home building and other dependent industries.

26. HBF’s own survey evidence has revealed that, since the crisis first emerged in August 2007, site visitor numbers have fallen less dramatically than reservations of new homes[6]. While there are fewer potential buyers looking at new homes (i.e. fewer site visitors), some of these potential buyers are subsequently unable to buy because they cannot secure a mortgage on affordable terms. Put another way, if mortgage funding had not dried up, we would have seen a much less severe contraction in new home purchases.

27. While we do not have precise statistics, HBF estimates that site visitor numbers have fallen about 25% from pre-crash levels over the last 12-15 months, whereas net reservations[7] have been down by 40-50%.

28. Further evidence to support this view comes from house builders’ cancellation rates which are reported to have been at abnormally high levels. Many potential customers are subsequently having to cancel their reservations because they are unable to obtain a mortgage.

29. Because home builders have seen effective demand for their products fall very dramatically, they have had to cut back severely on house building. They cannot afford to build properties they are unable to sell as this would lead to a costly build up of unsold stock and work in progress. They have stopped building on some live sites, and not

[6] A ‘reservation’ is the first formal step towards home purchase in which a purchaser puts down a reservation fee (typically in the £500 to £1000 range) to secure a plot and begin the formal legal purchase process. It is taken by the industry as the earliest indication of serious intent to buy, so that reservation levels are a good early indicator of effective demand.

[7] ‘Net reservations’ measure gross reservations over a period less cancellations of reservations in that same period.

started many potential new sites. A priority for many companies at present is to reduce unsold stock and work in progress.

30. In addition, because a majority (58% in 2006-07) of Affordable Housing is delivered through S106 agreements on private housing sites, we also anticipate a substantial drop in Affordable Housing delivery as a consequence of the fall in overall house building activity.

31. Even on sites where house builders wish to build the Affordable Housing units so as to maintain activity and generate cash, there are obstacles. On sites where the affordable units are ‘pepper potted’ (i.e. affordable plots are scattered throughout the site), stopping work on the market housing inevitably means stopping work on the affordable units. Also, RSLs are having problems going ahead with S106 Affordable Housing. Their ability to fund such acquisitions has been damaged by their inability to cross subsidise from market and shared-ownership sales, funding costs have risen sharply because of the steep rise in LIBOR, and new funding is very difficult to obtain.

32. Latest CLG statistics showed a 27% year-on-year drop in private housing starts in the first half of 2008, with a 20% drop in private completions. However more up-to-date figures from NHBC show private registrations in the third quarter of 2008 were down 67% on a year ago, with a 50% drop in the first nine months, a worsening trend we expect to be reflected in subsequent CLG figures.

33. HBF does not forecast house building numbers, but many in the industry believe we will see private housing numbers fall well below 100,000 over the next couple of years, and some are predicting numbers as low as 60,000. If this happens, then to hit the Government’s 2016 and 2020 targets we would have to assume quite unrealistic rates of growth of new home building once the recovery emerges in 2010 or 2011. On conservative assumptions about new build completions in 2009 and 2010, we estimate completions would have to grow by around 20% per year for the next five or six years to hit the targets. Such sustained high rates of growth would be unprecedented. For example, in the boom years of the 1980s, completions growth averaged 5% per year.

34. The fall in volumes because of the credit crunch has been accompanied by falling new home prices. The UK does not have an accurate new home price index, but we suspect the falls recorded by the Nationwide and Halifax indices for all prices are probably a good guide to trends in new home prices. In some inner-city and town-centre locations with a surplus of new apartments, prices have fallen by more than the market average.

35. Reduced prices for new homes built on sites which house builders already own hit profit margins. Such reduced profit margins are unsustainable for any length of time.

36. Falling volumes and falling prices have also resulted in reduced land values. It is difficult to judge the market price of residential land at present because so few sites are being sold. However we suspect any transactions taking place are at heavily reduced prices compared with prices that would have been achieved up until Summer 2007. Falling house prices have a magnified impact on land values (see Appendix 1). For complex brownfield sites, regeneration sites or major strategic greenfield sites with very heavy infrastructure requirements, where the land value is in any event a relatively small proportion of the sales value, falling sales prices quickly drive land prices below zero. (A negative land value means the total cost of development exceeds the total sales value of the development.)

37. Falling house and land values have a number of consequences for house builders and housing development:
    - As noted above, house builders' profit margins on already-owned sites are sharply reduced - unsustainable in the longer-term, although unavoidable in the shorter term;
    - Most land owners (whether private developers, the public sector or others) will be very reluctant to sell at severely reduced land prices, particularly owners of urban brownfield sites which will have an existing or alternative non-residential use value;
    - There is much less land value available to fund policy demands such as Affordable Housing, infrastructure, zero carbon, Lifetime Homes, higher space standards, building regulation changes, etc.

38. As already noted above, we can only begin to solve the current housing crisis by a restoration of mortgage finance to match demand, and some relaxation of current very onerous mortgage terms, although no one would argue for a return to the excessively lax mortgage terms of the pre-crisis period. All other solutions are either relatively small scale in relation to the downturn, or would require unrealistically large amounts of public expenditure.

39. Therefore home builders eagerly await the findings of the Crosby Review of Mortgage Finance. Assuming the review will identify recommendations that would make a real difference, we would urge the Government in the strongest possible terms urgently to implement these recommendations. This is not just critical for the home building industry, but the health of the national economy depends on reversing the current disastrous downturn in the housing market and home building. In addition, we are concerned about lenders' policies towards lending on new homes. In some cases these are particularly restrictive, so that the industry tends to be heavily reliant on a small number of lenders.

40. The Government will be anxious to minimise the fall in house building for a number of reasons. Falling private house building is reducing delivery of Affordable Housing. The fall will move housing provision away from the housing targets. The further house building falls, the harder it will be to achieve the targets once the recovery begins. And the greater the loss of capacity within the industry – trade, technical and managerial people and skills, and companies – the more difficult it will be for the industry to gear up production in the recovery, and the longer it will take to move up towards the targets. Also, loss of capacity and expertise within the home building and related industries will have an adverse impact on R&D and innovation at a time when the industry is being asked to prepare for very significant changes in the run-up to zero carbon in 2016. And finally, the greater the downturn in house building, the greater the direct and indirect costs to the wider economy. New house building accounts for around 1% of GDP, so that a halving of output would reduced GDP growth by around half a percentage point. But the total impact will be larger, once the multiplier effects of new housing expenditure on the whole economy are taken into account. Research for HBF has suggested there were about 300,000 people employed in house building in Great Britain before the crash, quite apart from the many supply industries and professions dependent on the industry and the wider economic impact of new home building. We suspect that somewhere between one third and one half of these house building jobs will be lost.

41. (The impact of the falls in house building and land values on a range of other Government policy objectives is discussed in the final section.)

Non Market-based Delivery: An Alternative Model?

42. As already discussed, the current housing delivery model is heavily market based.

43. The Committee's Inquiry asks submissions to address "the financial viability and ongoing business of housing associations". While we are not qualified to answer this precise question, we think it is important to put this in a wider context, asking whether the current largely market-based delivery model for new housing will be fit for purpose in the future. In particular, we would ask whether making the delivery of well over half of all Affordable Housing (as defined in PPS3) dependent on S106 agreements on private housing sites, and therefore on market trends, is sensible. Should the quantity of Affordable Housing delivery be driven by the housing market cycle, or by public policy objectives largely independently of housing market conditions?

44. We are very mindful that, at this early stage, it is much easier to ask questions about the future delivery model than to provide definite answers. A great deal more thought and research is required by everyone involved in housing policy and delivery.

45. Before considering whether a viable alternative delivery model is available, we note that one very important policy reason for linking Affordable Housing delivery to the development of private housing sites is to ensure we build mixed communities and avoid large concentrations of social housing. Any new proposal for a less market-dependent housing delivery model would have to take account of this public policy objective.

46. It has been suggested that local councils and other public bodies should embark on a major house building programme to fill the gap left by the steep fall in private, market-based house building. We believe there are significant obstacles to this proposal.

47. The public finances are going to be under extreme pressure over the next few years. A major public sector house building programme, beyond the CLG's current three-year funding programme, would require substantial additional public expenditure and borrowing.

48. Also, few if any local authorities have the capacity for initiating and managing a major house building programme. Council house building has been at insignificant levels since the early 1990s. Even if this capacity could be re-established, it would take time, and thus would be unlikely to lead to any significant increase in public house building for some years.

49. It has been suggested that the current crisis will provide opportunities for local authorities and RSLs to buy land from house builders at very low prices. While this may indeed be the case, it is difficult to see quite what housing delivery benefits this would bring. Simply buying land would leave unresolved the funding and capacity issues raised above. Also, the recent OFT report on home building concluded:

> "the public sector accounts for between a quarter and a third of all land currently deemed suitable for residential development"[8].

50. This suggests land ownership is not a significant constraint on the public sector's ability directly to provide new housing, so that further increasing public sector land holdings would not, in itself, produce any increase in house building.

51. Finally, the current mix of tenures and surveys of tenure aspirations suggest there is no case for a major long-term public house building programme. Regular surveys by the Council of Mortgage Lenders (CML) since the 1970s show very high proportions of people aspire to own their own home. While public attitudes to owner occupation may be dented

[8] OFT. *Homebuilding in the UK. A market study*. September 2008. Paragraph 5.12, page 106

by the current housing crisis, past evidence suggests this will prove short term. There will always be an essential place for sub-market Affordable Housing for those households unable to enter or sustain home ownership for financial or other reasons. We also believe there needs to be a healthy, well-managed professional private rented sector to accommodate the needs of mobile households and those households who are able to afford market housing but do not wish to own a home. However we believe a long-term policy aimed at producing a higher proportion of public and social housing than is demanded or needed by households would not be sustainable.

52. Therefore there is no obvious realistic alternative to the current largely market-based model for housing delivery. If this conclusion is correct, then the public and private sectors need to consider what changes will be required to the existing model to ensure the home building industry is able to raise housing numbers to meet the targets once the market recovers. Issues such as the cost impact of regulation (see final section below), the funding and delivery of Affordable Housing and infrastructure, ensuring the creation of mixed communities, barriers to house building industry entry and expansion, and how to recover lost industry skills and capacity, will have to be addressed. The new build sector, especially inner-city development and regeneration schemes, have been heavily reliant in recent years on investors and buy-to-let purchasers. If there is a permanent fall in demand from small scale investors, we need to seek an alternative model for the private rented sector, probably involving investment by large financial institutions. For regeneration projects, there are very difficult issues to be resolved on both the supply/cost side, as well as on the demand side.

GOVERNMENT RESPONSES TO THE CREDIT CRUNCH

53. The MPC's half percent cut in Bank Rate on 8 October represented a major, and very welcome policy change. We would urge the MPC to make further significant reductions to help support the UK economy. Indeed HBF had been warning for many months of the dangers the severe housing downturn posed to the wider economy, and we had urged the MPC to cut rates by half a percent as early as May. While significantly lower interest rates are a necessary condition, they are clearly not sufficient on their own to restore the housing market, not least because recent cuts have not fully carried through into lower mortgage rates.

54. The Bank, Treasury and Prime Minister have announced a range of draconian measures to restore liquidity to the banking system, to recapitalise the banks and to restore confidence to the financial sector so that banks will start lending again. However to date most of these measures have not been directed at reviving mortgage lending. The one exception was the Government's statement on 13 October:

"As part of its investment, the Government has agreed with the banks supported by the recapitalisation scheme a range of commitments covering:

- maintaining, over the next three years, the availability and active marketing of competitively-priced lending to homeowners and to small businesses at 2007 levels".

55. While this commitment is very welcome, it is not yet clear quite what it means, nor how it is to be achieved. It is somewhat worrying that in the last few days, Government statements about restoring lending have mentioned small businesses, but have avoided any mention of mortgage lending.

56. Therefore at present it seems unlikely mortgage lending will recover for some considerable time without further, targeted measures. As noted above, we very much hope the Crosby Review will recommend effective measures, and that the Government will implement these urgently. This is our best hope for recovery.

57. The Government has announced a range of measures to help the housing market, including a number targeted at new home building which are most welcome to the industry. We fully appreciate that CLG can only work within its existing budgets, so that new measures have to involve re-allocation of existing funds (both programmes and the timing of expenditure), rather than new money, and that their impact is therefore limited.

58. The key expenditure commitments of direct benefit to private home builders have been:

- An additional £100 million to expand the Open Market Homebuy scheme for purchases of new build properties (target: 2,500 first-time buyers in 2008-09) (announced 14 May);

- £200 million Housing Corporation funding for RSLs to buy stock units from home builders (14 May); CLG later (16 July) announced that "more funding, beyond the £200 million already allocated to buy unsold stock from house builders for affordable homes, could be made available". A National Clearing House was also established to deal with large tranches of new homes (500+) from individual home builders;

- £300 million for a new HomeBuy Direct scheme (October 2008) (target: 10,000 first-time buyers over two years), in which qualifying first-time buyers can buy new homes on a 75% shared-equity basis, with the Government and house builders jointly funding the retained 25% equity share.

59. The industry very much welcomed the £100 million extension to Open Market HomeBuy, and the £200+ million funds for RSL purchases of house builders' stock.

60. The industry is also very positive about the £300 million HomeBuy Direct scheme which was designed in consultation with HBF and house builders. and which built on EP's First-time Buyer Initiative which proved very successful for house builders.

61. While these initiatives are focussed on first-time buyers and the lower-priced end of the market, it is essential that liquidity is restored at every level of the market. Enabling first-time buyers to purchase does not necessarily have positive knock-on effects on housing chains if those further up the chain have no access to mortgage funding.

62. We also welcome the CLG and Housing Corporation's recognition that whereas all publicly funded housing, and housing provided on EP land, must be built to Code Level 3 of the Code for Sustainable Homes, and to higher space standards than in the market sector, RSLs may be able to relax these requirements when buying private stock if all the RSL's other requirements are met. This seems a sensible and pragmatic approach in current circumstances.

63. Some commentators have dismissed the measures targeted at private new homes as a drop in the ocean. However £600+ million to benefit the industry could hardly be described as small scale, even though the actual housing numbers involved may be relatively modest when compared with the very large anticipated falls in new home building over the next few years. The measures will definitely help house builders financially, and will therefore help preserve jobs and capacity within the home building industry. And of course they will also bring new homes within the reach of large numbers of first-time buyers and help RSLs boost their stock of affordable homes at very keen prices.

64. Because the credit crunch and resulting downturns in effective housing demand and house building have hit delivery of Affordable Housing, the CLG's existing Affordable Housing targets are not likely to be met, and its three-year programme funds will not be fully spent. Therefore we hope additional funding from later in the CLG's three-year programme can be brought forward to assist house builders and social housing providers deliver additional housing numbers. Future funds targeted at private housing may also begin to boost housing numbers. At present, the industry's priority is to reduce unsold stock levels. Once these have been significantly reduced, the focus of new measures can shift to helping house builders continue building on sites that would otherwise stop production, or start sites that would not otherwise start. However this will require RSLs to be realistic about the price they pay for newly started dwellings. At present, RSLs are

driving very hard bargains with home builders for existing stock because home builders are anxious to generate cash, even if this means selling at a loss in some cases (i.e. below build costs). However we understand RLSs are then assuming they can persuade home builders to start new dwellings for the same low prices. Clearly a house builder will not start a site if the sales revenue is not sufficient even to cover the build costs.

65. We noted above that the reduction in cross-subsidy from market and share-ownership sales and higher funding costs are an obstacle to RSLs going ahead with S106 affordable units on private housing sites. To assist RSLs, and therefore house builders, the Housing Corporation (HCA after 1st December) and CLG should consider increasing grant rates to bridge this gap so that Affordable Housing units can be delivered. The additional funding could be achieved by bringing forward funding that is not likely to be spent from later in the CLG programme. We note that we suspect grant will have to be increased more in the south than the north. This arises because the "subsidy" from residential land values has been substantially higher in the south than in the north, so that grant levels have been lower. Therefore the gap that needs to be covered by increased grant is larger in the south.

66. A range of other housing measures have been announced, notably lifting the stamp duty threshold to exempt all properties below £175,000 (2 September). It is difficult to judge the likely impact of the stamp duty change, given that the mortgage famine is by far the most serious brake on demand. However it is a welcome contribution to the package of measures.

67. Government and mortgage industry measures to reduce repossessions, while not directly relevant to house builders, are nonetheless very important to the overall housing market. Quite apart from alleviating the social cost of repossession, forced sales of repossessions in the early 1990s contributed to undermining house prices, and therefore damaged the wider housing market and house builders. We must try to avoid allowing the same situation to develop over the next few years.

68. The industry welcomes the measure introduced by English Partnerships to help house builders maintain production on EP sites.

69. Given the viability problems created by escalating regulatory demands (see final section below) against falling home and land values, it is essential that local authorities adopt a realistic and flexible attitude towards the renegotiation of S106 agreements and other policy demands, or negotiation of new S106 agreements. Otherwise sites will not be viable and no housing delivery will be possible. It is important too that CLG gives strong

leadership on this issue as some local authorities are making unrealistic demands and ignoring the impact of the credit crunch on development viability and housing delivery.

70. HBF and the New Homes Marketing Board have suggested the Government should introduce some form of first-time buyer deposit scheme. Even when mortgage funding does become more readily available, it seems inevitable loan-to-value ratios will remain much lower than in recent years, so that first-time buyers will need to raise much greater deposits. Such a scheme will not provide an immediate remedy, but we should be considering longer-term measures as well as short-term crisis responses. We have also suggested the Treasury should once again consider allowing residential property to be included as investments within SIPPs.

71. We are concerned about the increased cost and reduced availability of credit to house builders. Some well-known large companies have heavy debts which are having to be renegotiated. However, many small to medium-sized companies rely heavily on bank borrowing on a project-by-project basis. Restrictions at this level will push many house builders into insolvency, thereby reducing even more the ability of the sector to revive itself in the upturn.

THE CREDIT CRUNCH & OTHER GOVERNMENT NEW HOME POLICY ASPIRATIONS

72. Apart from the numerical housing targets (discussed above), the Government has a number of other important policy aspirations which involve new housing. The policy and regulatory costs imposed on residential development by these policies have increased substantially in recent years, and are set to increase even more dramatically over the next eight years. These costs pose a major threat to the viability of many, if not most housing developments. If not reassessed, these costs will make it impossible to achieve the Government's numerical housing targets. These major policy areas are: Affordable Housing, Other S106 demands and the CIL, zero carbon, Lifetime Homes and higher space standards.

Affordable Housing

73. As already noted, 58% of Affordable Housing in 2006-07 was delivered through S106 agreements on private housing sites, up from 49% only two years earlier and 31% in 2001-02[9]. Even where Housing Corporation grant is available, there is still a substantial element of 'subsidy' out of land value. Affordable Housing contributions are a pure cost to development as they do not in any way enhance the sales value of the open-market

[9] CLG statistics. Published 12 June 2008

dwellings on a site. Indeed, Affordable Housing may even depress open-market sales values.

Other S106 Demands/Community Infrastructure Levy (CIL)

74. As well as Affordable Housing demands, many local planning authorities require a residential developer to meet a range of other demands through a S106 agreement over and above what is strictly necessary to enable the development to go ahead: public open space, education, transport and highways, community works and leisure, health facilities, etc. As most of these contributions to off-site infrastructure will not provide a direct benefit to home buyers on the site, they will usually not result in any increase in sales values. Therefore they too are a direct cost on the development, to be funded out of the land value. The proposed CIL is intended to encompass these off-site infrastructure costs, so that S106 agreements can be scaled back purely to site-related costs. While we do not yet know at what levels local authorities will set their CILs, current tariffs vary from around £5,000 per dwelling up to in excess of £20,000 per dwelling.

Zero-carbon Target

75. The costs of achieving the Government's zero-carbon target by 2016 will be substantial. Research for CLG estimated that the cost of achieving the energy requirements of Code Level 6 (zero carbon) would be between £21,251 per dwelling for a flat and £38.817 for a detached house[10]. Most developers suspect home buyers will pay only a modest premium for such dwellings, if any premium at all. Therefore most of the additional cost will have to come out of land values. Code Level 3 is already required for all dwellings purchased with Housing Corporation grant or on EP land, so this cost is already having to be built into S106 Affordable Housing production.

Lifetime Homes

76. The Government has indicated it will consider imposing Lifetime Homes standards on new housing some time after 2010. This would add directly to housing costs. Also, because these standards may reduce the number of dwellings that can be developed on some sites, there will be a reduction in the gross development value, and therefore the land value, of these sites. We consider it unlikely these standards will bring any sales price premium, so the additional cost and reduced development value will have to come out of land values. While the Government has suggested the additional cost will be around £800 per dwelling, evidence from home builders building in Scotland (where Lifetime Homes is part of the building regulations) suggests that it is more likely to be nearer £2,000 per dwelling.

---

[10] CLG. *Cost Analysis of the Code for Sustainable Homes. Final Report*. July 2008. The costs quoted are based on the "Medium Case".

Housing Space Standards

77. Britain has among the smallest average dwelling sizes in Europe, and sizes are undoubtedly smaller than in other English speaking countries. We believe this is primarily a reflection of land shortages and housing undersupply. The Housing Corporation and EP have imposed higher space standards than apply to normal open-market housing, and some local authorities wish to introduce such requirements. While we understand these pressures, the inevitable consequence will be fewer (larger) dwellings per hectare of developed land. And because house builders are unable to achieve a pro rata increase in sales values commensurate with the increases in floor areas, policies on space standards tend to depress land values.

Total Regulatory Cost Impact

78. Initial rough estimates by HBF suggested the average cost of Affordable Housing demands, likely levels of the proposed CIL, and the cost of achieving zero-carbon, could add as much as £2.9 million per hectare to residential development costs. The latest (January 2008) Valuation Office Agency (VOA) statistics put the average price of residential land in England and Wales, excluding London, at around £2.95 million per hectare. So the regulatory cost of just three policy objectives is now equal to the average land value. In other words, many sites are pushed to or beyond the limits of viability. This would suggest a large proportion of housing sites will not be viable, in the sense that there will be insufficient – or indeed zero, or even negative – land value to persuade land owners to sell their land for residential development.

79. And of course the VOA data largely pre-date the impact of the severe housing downturn on house prices and land values. Current and future regulatory costs, at the much lower land values caused by the credit crunch (see Appendix 1), will render most housing development unviable.

80. Central Government and local authorities have three possible responses to the viability crisis:

- They can stick to their multitude of policy aspirations – Affordable Housing, sustainability and zero-carbon, S106 and/or CIL, Lifetime Homes, higher space standards, etc – and accept that far too few homes will be delivered, with all the adverse economic and social consequences this will bring;

- They can directly fund the cost of their policy aspirations through gap funding to make residential schemes viable;

- Or they can scale back very significantly their policy aspirations in order to ensure that more land is viable for residential development, and therefore that increased numbers of new homes can be delivered. At the very least, the Government needs to re-assess its timetable for planned building regulations changes, zero carbon, Lifetime Homes and funding of community infrastructure through S106 or the proposed CIL, given the extreme pressures the industry will be under for the foreseeable future.

81. This means some very difficult political trade-offs are going to have to be made between housing numbers and other policy aspirations. To assist with these decisions, HBF has been doing considerable work with member companies and Government officials to improve our understanding of the financial implications of policies and regulation for different development types (e.g. regeneration sites, large-scale greenfield sites, etc.)

82. The conflict between housing numbers and other policy aspirations could be resolved by large-scale public subsidies, through which the state would effectively fund the cost of Affordable Housing, zero carbon, Lifetime Homes, infrastructure, etc. But this hardly seems a viable proposition given the severe constraints on public expenditure that are going to be required in future years.

83. It should finally be noted that these trade offs are just as relevant for housing delivery by RSLs or any public body. Just because an RSL develops land, or a local council, this does not change the basic costs of development or the costs of additional policies such as zero carbon. Of course public bodies could put their own land into such development at very low or zero cost, with this lost land value effectively providing a hidden subsidy to cover the cost of these policy objectives. However because public bodies would not receive a market value for their land, there would be a loss of funds for other public policy requirements (e.g. new hospitals funded through NHS land sales, or new military equipment from MOD land sales). Accepting low or nil value for public sector land is not a free lunch.

84. Some sites would still not be viable for residential development even the public sector were to put the land forward at zero land value because the cost of development would exceed the total sales value of the development. Many regeneration sites now produce large negative land values – i.e. the high cost of development and the cost of meeting current and future policy objectives far exceeds the total development value of the site. In effect, the land owner of such sites would have to pay a developer to develop the land. If the land was in public ownership – for example owned by EP – the public sector would have to accept nil value for the land and also contribute a sizeable subsidy, or gap

funding, to make the scheme financially viable. While this does happen sometimes, it is clearly not a sustainable solution in any but the most exceptional cases.

John Stewart
Director of
Economic Affairs

APPENDIX 1
BRIEF DESCRIPTION OF RESIDENTIAL DEVELOPMENT ECONOMICS

A financial appraisal of a residential development site has three basic steps:

- The total <u>sales value</u> of the homes planned to be developed on the site, known as the Gross Development Value (GDV);

- The total <u>cost</u> of developing the site – construction costs, site infrastructure costs, any abnormal costs (e.g. demolition, decontamination), profit, interest, overheads, tax, S106 obligations, etc.

- The GDV less total development cost is the “residual value” available to pay for land.

Some additional policy costs, such as zero carbon, will add to construction costs. Others, such as the proposed Community Infrastructure Levy (CIL), will be a separate additional cost. Most policy costs will add very little, if anything, to sales values and the GDV of a site, whereas most will increase the development cost. If the GDV remains static (or even falls if a regulation reduces the density, and therefore number of units on the site), while the cost goes up because of increased regulation, the “residual value” left over for land will be reduced.

A reduction in sales values has a geared impact on land value. This can be illustrated by a simple example:

- Suppose the total sales value of a site (GDV) is £1 million;
- With total development costs of £750,000;
- The residual land value is £250,000, representing 25% of the GDV.

Now suppose house prices fall 10%, so that the sales value (GDV) of the site is now only £900,000. If we hold the development costs of the site constant (a fall in sales values will have no impact on most costs), the residual land value now drops to £150,000 (i.e. £900,000 minus £750,000). In other words, in this example a 10% fall in house prices produces a 40% fall in land value.

If the land value represents a relatively small share of the GDV, then a fall in sales values will severely reduce or even wipe out any residual land value. In the example above, if the total cost of development had been £950,000, so that the residual land value was only £50,000, or 5% (perhaps a very costly regeneration site), then a 10% (£100,000) fall in the GDV would leave the site with a negative land value of -£50,000.