

Development prospects

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Introduction

This briefing summarises a presentation provided by Anna Evans on housing development prospects given at HQN's Scottish spring event *The Scottish Government's agenda for funding new affordable housing* (March 2009). It provides a synopsis of market drivers in the UK, and Scotland in particular, and concludes on short-term prospects for development and implications for the affordable housing investment programme in Scotland.

Summary

- The Scottish Government housing policy Firm Foundations is based on a market-led strategy to increase supply and 'moderate prices'
- Since the credit crunch and the onset of recession, demand has plummeted, in the main caused by a 40%-50% reduction in mortgage finance (Scotland and UK respectively) and a 90% reduction in the number of mortgage products available (across the UK)
- In terms of economic drivers, 15 years of uninterrupted growth is over, with unemployment at a ten-year high, and redundancies that started in the house building sector now progressive across sectors
- Repossessions were up 54% in 2008 and are projected to increase to 75,000 in 2009 across the UK
- The supply response has been the almost cessation of new build in Scotland – from approximately 24,000 completions per annum, or 2,000 per month, to 350 completions in January 2009, 150 of which were in the private sector
- Development constraints add to the problem – the planning system and infrastructure funding requirements on developers and investors. These have been highlighted as priorities for the reconvened Housing Supply Task Force
- Completions in the Scottish housing association sector are down by 40% caused probably by the change in HAG assumptions, but possibly also the lack of Section 75 affordable homes delivered through the private sector
- Council house building may help plug the gap in the short term, but only making a relatively small contribution in national terms, and only in those areas where the local authority can afford to build
- Mid-market rent will also be an opportunity to meet unmet demand at lower grant levels than is required for social rented supply

- Further Scottish and UK intervention is required to help the failing housing market, but the already high levels of UK debt and the extent of further calls on the public purse will mean there is insufficient public finance to solve the problem. As well as any additional financial subsidy, there should therefore be support to find innovative models to fund affordable housing in the future. English colleagues have already started this debate, and Scottish policy and market leaders should quickly engage and learn from this discussion.

Background

The policy context to any discussion on housing development prospects in Scotland is *Firm Foundations*¹ – the Scottish Government’s housing policy document which was published in October 2007, one month after the collapse of Northern Rock and the first signs of the credit crunch. *Firm Foundations* proposed a market led strategy with a target to increase supply from, typically, 24,000 per annum to 35,000 within ten years. The policy premise was that the overwhelming majority of households prefer owner-occupation, and that an increase in supply would ‘moderate prices’ and therefore increase affordability.

Eighteen months later and the economic context has changed the scene dramatically and in a way that governments across the world apparently did not anticipate, and are still grappling with. So what happens with the *Firm Foundations* market-led strategy in the context of recession and an effective cessation of house building?²

This briefing sets out the relevant facts to enable a conclusion to be drawn on the short-term housing development prospects in Scotland and the implications for the affordable housing sector.

Demand drivers – households, the economy and income

Housing demand is driven by three factors – households, the economy and income (and related affordability).

Household demand has two elements – demographic demand and non-demographic demand. In terms of demographic demand, this can be influenced by economic circumstances and specifically migration which is one of the key variables in household projections. In the short-term internal migration may increase as people lose jobs and seek new employment. On the other hand, external in-migration, eg, from the EU Accession States, is likely to level off or decline as there is less service sector employment opportunities. Longer-term demographic recession effects, ie, births, deaths, marriages, etc, are more difficult to predict – these fundamentals take much longer to change and, as we don’t know how long and deep the recession will be, it’s too early to predict any change.

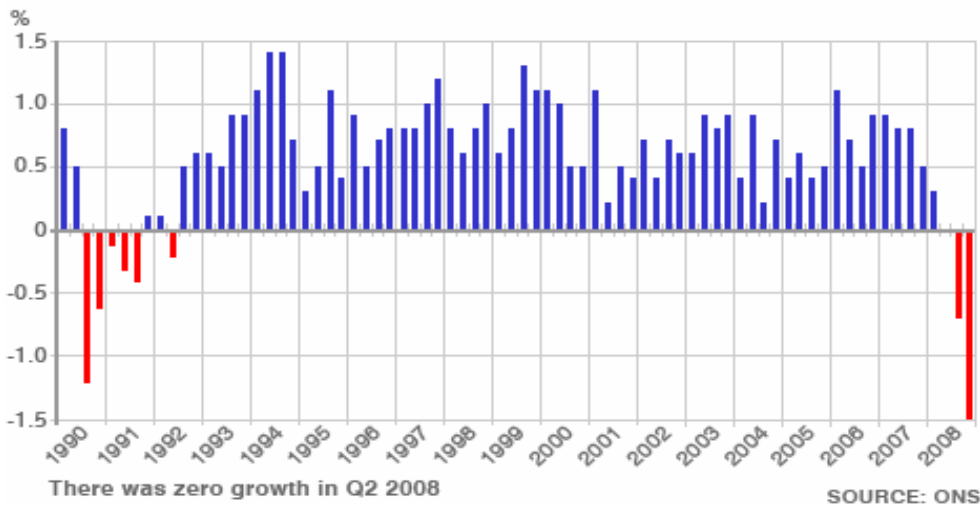
¹ <http://www.scotland.gov.uk/Resource/Doc/201716/0053780.pdf>

² According to NHBC January 2009 data quoted by Jonathan Fair of Homes for Scotland (HQN event 19 March 2009) there were 160 house-building starts for the whole of the month, and only around 350 completions. Of the completions, only 150 homes were in the private sector, the rest were RSL output

Non-demographic demand, ie, household purchasing behaviour and aspirations, has already changed. This is driven by income, mortgage finance and, most importantly in the short term, by confidence. Over and above the availability of income and finance, in periods of uncertainty it's human nature to sit tight and do nothing, and evidence of transactions in the housing market shows this to be true over the last year. According to Registers of Scotland³ the volume of sales transactions over the fourth quarter (October to December 2008) showed a decrease of 53.6% compared to the same period in 2007.

In terms of economic drivers, the 15 years of uninterrupted growth is over.

GDP GROWTH, QUARTER ON PREVIOUS QUARTER



Source: BBC Recession tracker

<http://news.bbc.co.uk/1/hi/business/7789844.stm>

The UK was enjoying a benign climate of easy and cheap personal and business finance. According to the Tenon Group⁴ an adjustment in the economy was overdue since 2005. However, the unprecedented financial crisis made the cyclical fall much harder than most predicted. In 2006 there was £10 billion in mortgage lending per month in the UK and over 50% of this finance was from overseas short-term markets – the harder fall was caused by the abrupt freeze of international banking rather than there being a more gradual market adjustment as occurs in most economic downturns. Most projections now suggest a slow economic recovery from 2011, and 2015 before 2007 prices are restored, if ever. In terms of key economic indicators:

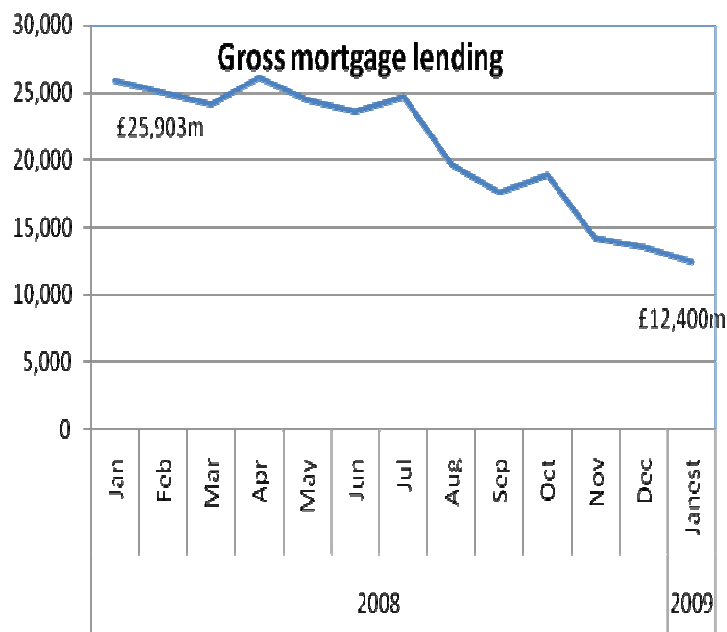
- Unemployment is now at a ten-year high – 2.03m, which is the highest since 1997 (ONS)
- Redundancies in the house building sector in Scotland stands at approximately 25,000 (Homes for Scotland)

³ http://www.ros.gov.uk/pdfs/2009_02_release.pdf

⁴ Credit crunch presentation on 26 February 2009 at McClure Naismith solicitors, Edinburgh, <http://www.tenongroup.com/>

- The fall-out from the financial sector will be felt most during 2009 and 2010 as restructuring takes effect
- Redundancies are now progressive across all sectors as confidence falls
- Repossessions were up by 54% to 40,000 in 2008 but 5,000 less than projected due to falling interest rates and some increasing lender and judicial restraint (Council of Mortgage Lenders – CML)
- Repossessions are projected at 75,000 for 2009, despite lower interest rates (CML).

The final aspect of demand is availability of mortgage finance. The graph below clearly shows how gross mortgage lending has dropped dramatically over the last year.



Source: Council of Mortgage Lenders, February 2009

Graph generated from data on <http://www.cml.org.uk/cml/media/press/2144>

The numbers of UK home purchase loans are down by 52% (January 2009 compared to January 2008), and the value of loans is down by 55%, although in Scotland the fall has been more reserved at 40%. However, the CML suggests Scotland may not be immune to the market downturn with the fourth quarter 2008 down by 23% compared to 14% for the UK as a whole. First-time buyer deposits are now 20% compared to 11% in 2007.⁵ Apart from the drop in volume and value of mortgage finance, the choice of product has dropped by 90% – Homes for Scotland Chief Executive Jonathan Fair recently quoted the number of mortgage products falling from 16,500 in the summer of 2007, to only 1,500 in January 2009 across the whole market.⁶

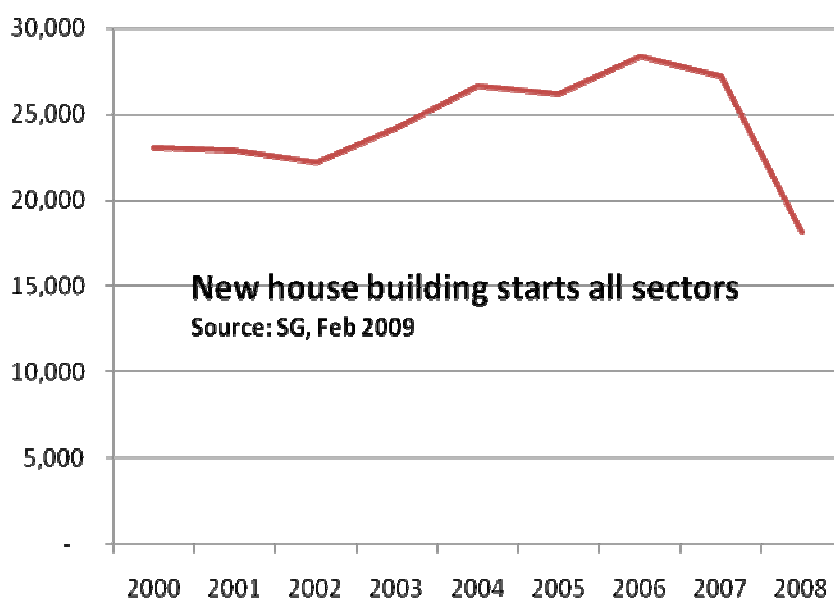
⁵ <http://www.cml.org.uk/cml/media/press>

⁶ Jonathan Fair of Homes for Scotland, HQN event, 19 March 2009

Supply drivers – new build, prices and finance

On the supply side, new-build supply is typically only 10% of the annual total housing supply taking into account all transactions in the existing housing stock and new build. However, new build is important when considering the context of *Firm Foundations* and the Scottish Government policy agenda to increase supply and therefore moderate prices.

The graph below confirms the drop in new-build supply. Scottish Government data shows that new build starts are down 43% and NHBC data shows applications for starts are down 73% on this time last year. Transactions in the existing homes market in Scotland has dropped by 50%.⁷



Source: Graph generated from Scottish Government data
<http://www.scotland.gov.uk/Topics/Statistics/Browse/Housing-Regeneration/HSfS/NewBuildSummary>

The RTPI suggests⁸ there are three effects that cessation of new supply may have:

- In the short term, a stabilisation and reduction of prices: as shown below this has already occurred
- Capacity in the house-building industry will reduce as businesses rapidly downsize and in the medium term the ability to respond to market turnaround will be constrained: as noted above, there have been substantial redundancies in the house-building sector

⁷ http://www.ros.gov.uk/pdfs/2009_02_release.pdf

⁸ <http://www.rtpi.org.uk/download/5432/PPPC-09-09-Networks-Update-January-09.doc>

- In the longer term and when the market returns, there is a likelihood of sharp price increases – depending on how long the recession lasts. This last assertion is dependent on demand drivers as discussed above (demographics, aspirations for home ownership, income and mortgage finance) and at this stage no one can safely predict whether these drivers will be similar to those that have been experienced in the UK over the last ten years.

On prices, Scotland is holding up well compared to the rest of the UK. In January 2009 the average price decrease of 6.3% in Scotland was nearly half that of the UK figure of 11.5%.⁹ However, many forecasters, including Roger Bootle, the former Chief Economist at HSBC, project much greater falls before the end of the recession – as much as 40% in residential values and 70% in residential land values.¹⁰ Homes for Scotland has confirmed its members have already seen falls in residential land values of at least 25%, in most cases 50%, and up to 80% for distressed land sales. This price uncertainty is compounded by the lack of finance to support building programmes – there are many stories coming from developers and housing associations over the lack of finance, and the apparent ‘bad behaviour’ of banks using any excuse to revisit loan agreements in order to change terms.¹¹ Therefore, until there is some sign of reliable stabilisation in the markets – both on prices and credit – there will be little chance of a resumption of private sector house building.

Development constraints

If life is not difficult enough, then consider broader development constraints which arguably provide barriers to development across the UK. The two main issues are the planning system and infrastructure arrangements.

The planning system is set for long overdue reform to be implemented from 1 April 2009. The reforms are introduced by the Planning etc. (Scotland) Act 2006, and may address historical bureaucratic blockages inherent in the pre-2009 regime. According to the Housing Supply Task Force final report,¹² the changes include: more up-to-date development plans which should provide greater certainty; proportionate demands on developers, focused on matters of greatest significance; submission of improved planning applications to speed up public sector response times; streamlined statutory consultation processes by Scottish Government agencies that focus on matters of genuine national interest; and greater understanding and co-operation across the public and private sector. In addition, the major revisions which the Scottish Government has introduced to the housing and planning delivery framework – the revised SPP 3, new Local Housing Strategy Guidance and guidance on identifying housing need and demand – are all argued to make a significant contribution to ensuring that enough new housing of the right type and in the right place is delivered to meet need and demand.

⁹ <http://www.communities.gov.uk/documents/statistics/pdf/1176201.pdf>

¹⁰ <http://www.consultcih.co.uk/news/view.php?id=1013>

¹¹ See HQN briefing *State of the nation* by Anna Evans, December 2009

¹² <http://www.scotland.gov.uk/Topics/Built-Environment/Housing/supply-demand/housing-supply-task-force/HSTFreport>

Arguably the greater constraint, but also implemented through the planning system, is the practice of requiring substantial up-front developer contribution to infrastructure to enable development. There are numerous examples where blockages are created through this mechanism. Shawfair is a recent reported case at the South East Wedge in Edinburgh, which recently lost its development partner the Miller Group, due in large part to this issue. Other large-scale land release examples include Winchburgh in West Lothian, another case study examined by the Housing Supply Task Force. This key issue was highlighted as a priority for resolution by the Task Force's Final Report, and particularly in the current economic climate. It is an area for which the new Minister for Housing and Communities Alex Neil has committed to finding solutions through the reconvened Task Force.¹³

Affordable housing sector

What has been happening in the affordable investment programme while the market sector is been struggling? The Scottish Government investment reform project commenced in 2008/2009, fast on the heels of the publication of *Firm Foundations*. Phase one was revision of HAG levels to a maximum benchmark of £73,000 per unit. Phase two has taken the form of proposals and consultation on the lead developer approach.

According to a recently published CIH report *Arrested Development*¹⁴ housing association new starts were down by 40% in quarter 3 2008, compared to the previous three years 2005, 2006 and 2007. Other key findings of the CIH survey are as follows:

- Over 35% of housing associations may not be able to build new houses given the changed financial climate
- Of those able to build, nearly 50% have had to revise their new-build targets downwards
- Nearly 30% of those able to build said that their plans for new homes have been reduced by between 40-60%
- In order to sustain new building, 22% believed they would have to raise rents
- Nearly 60% of housing associations are finding it more difficult to access private finance for new housing developments
- Nearly 55% have had to raise up to 25% additional private finance to fund new-build schemes, and over 25% have had to raise more than this
- Housing association new-build housing starts in quarter 3 of 2008 were down by, on average, more than 40% compared to the same quarters in 2005, 2006 and 2007.

¹³ <http://www.cih.org/scotland/conferences/SCA-keynote-mar09.pdf>

¹⁴ <http://www.cih.org/scotland/policy/ArrestedDevelopment-mar09.pdf>

In the government's defence it was unfortunate timing that the reform programme had started just as the first signs of the credit crunch and the onset of the economic recession emerged. Further, it is likely that the reduction in housing association output is the result of a combination of the changed financial regime and the lack of s75 affordable homes being delivered through the private sector developer contributions. In response to the downturn in supply the Scottish Government announced a series of support measures to assist homeowners and the house-building industry, and made a further revision to the HAG assumptions in February 2009. The change in HAG assumptions resulted in a stepping back of the original changes implemented in 2008 with the raising of the assumptions by on average 6% (£4,000-£5,000 subsidy per house). In its news release the Scottish Government said:

"These measures have been taken in response to the current financial situation and to support housing associations during this difficult period. The Government is committed to the role of housing associations and to ensuring that they build the maximum number of affordable homes for the public subsidy available."

The Scottish Government has now reverted to the Treasury with a bid for more financial support, but given the already high levels of UK debt and the Bank of England's concern over raising this further,¹⁵ it is unlikely that any additional financial support will be sufficient to make the impact that many feel is required.

The consultation period is now over for the lead developer proposals and based on the strength of feeling already heard from different interests, and the economic context, it is likely that any radical change in the system may be delayed until some stability returns in the market. This general sentiment was confirmed by Bill Barron, Scottish Government Head of Housing Investment Reformat, at the recent HQN event *The Scottish Government's agenda for funding new affordable housing* (March 2009).

In the short term, one of the opportunities for additional affordable housing supply will come through local authorities, but this will be a relatively small national contribution and there will be a council housing postcode lottery depending on where the local prudential borrowing pot can afford this route. Other development opportunities for housing associations and local authorities will be to meet unmet demand through mid-market rent, still relatively untested, but feasible with low or no levels of grant in some higher priced markets.¹⁶ The Scottish Government and housing providers may also wish to more actively explore the flexible tenure mooted in *Firm Foundations*: to some extent this is already occurring by default where unsold housing association shared ownership and shared equity properties are being converted to social rent until such time as there is recovery in the markets.

¹⁵ <http://news.bbc.co.uk/1/hi/business/7961900.stm>

¹⁶ The Scottish Government has provided some broad guidance on mid-market rent – letter from Scottish Government to CIH, SFHA, Homes for Scotland and CML dated 20 October

Conclusion – firm foundations?

This briefing has deliberately focused on the housing market on the basis that public sector policy is looking to the market to improve supply and moderate prices (*Firm Foundations, 2007*). However, as the evidence shows, demand has plummeted mainly as a result of the lack of mortgage finance, and increasingly due to falling consumer confidence. Supply has followed suit with retrenchment in the housing-building sector, with downsizing and resulting redundancies now occurring progressively across other sectors in the economy. House prices are falling and affordability increasing albeit to a lesser extent in Scotland than the rest of the UK. At the same time, the unfortunate timing of affordable housing investment reform has had a negative effect on housing association outputs, although the local authority sector may help plug some of the gap in the short term, as could mid-market rent. Meanwhile the UK and Scottish Governments are taking stock and hopefully will provide some further tangible support to the failing markets. However, given the huge calls on the public sector purse, it is unlikely that the Government will be able to provide sufficient financial support, and so should act as an enabler to find innovative solutions. English colleagues have already started the debate in exploring new models to deliver affordable housing, and Scottish policy and market leaders should quickly engage and learn from this discussion.

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