Department of Public Expenditure & Reform: Review of the Pilot Affordable Rental Scheme Business Case

Objectives

The Business Case states that the core objectives of the Affordable Rental Scheme are to:

- Provide long-term affordable residential accommodation for low to moderate income households in urban areas of high demand, in a mixed tenure context, promoting stability in the sector while also reducing pressures on social housing lists; and

- Provide an economic incentive to facilitate an increased supply in the housing rental market by large-scale and long-term professional providers.

The rationale for intervening in this way is set out as:

- At the current costs of development, the option of purchasing a property is not open to many on median levels of income; and

- In that context, rental may be the only realistic option for such groups with rent costs high relative to incomes.

The Business Case sets out a Programme Logic Model.

In terms of the further development of the Business Case, there is a need to:

- Clearly articulate the economic justification for State intervention of this nature. The justification should set out the general case for intervention and should not confine itself to the affordability of a particular transaction by a specific cohort. It should identify the market failure that is to be addressed and show that in the absence of State intervention the market failure would be unresolved and that no other policy action would be more effective at addressing this market failure;

- Set out the main quantitative metrics relevant to each element of the Programme Logic Model so that they capture the extent of the problem, the levels of demand for affordable accommodation and supply of same, the number of tenancy agreements, basic demographic information relevant to the Scheme, in particular, household size, net income and rent but not limited to these, and the impact of the Scheme in terms of its overall objectives of duration, mix of tenure, impact on demand for social housing, the associated increase in supply of rental units by large-scale and long-term professional providers.

Business Case - Methodology

While the business case presents a significant level of detail on the proposed scheme, critically, some standard appraisal steps do not appear to have been undertaken. Ordinarily, these would include:

1. Define the objective
2. Explore options taking account of constraints

3. Quantify the costs of viable options and specify sources of funding
4. Analyse the main options
5. Identify the risks associated with each viable option
6. Decide on a preferred option
7. Make a recommendation to the Sanctioning Authority

Importantly, the Business Case appears not to have considered, in particular, step two – the exploration of options. Instead the analysis / detail presented focuses on variations of one option and it appears to be a case making exercise for a pre-determined scheme.

Thirdly, the business case, while touching upon some risks, potentially lacks detail on some of the more fundamental risks inherent in this scheme. Chief among these is the fact that such a scheme does not appear to have been tried previously, either in Ireland or internationally, thus creating uncertainty as to the potential outcomes of the scheme. This needs to be considered in detail before any public funds are committed.

In terms of the further development of the Business Case, there is a need to:

- Provide an analysis or a summary of the earlier stage where it is determined that the approach that is the central focus of this Business Case is shown to be a more effective approach than other potential incentives that might also achieve the stated objectives, e.g. existing policies and schemes such as those relating to Approved Housing Bodies or Housing Assistance Payment or Rent Supplement, tax incentives such as reductions in VAT on construction, cut in development levies or other costs, reform of elements within construction costs, etc.

- Provide a review of other relevant public policies. This would locate the proposed initiative in the context of other government policies and show how what is being proposed complements and addresses existing gaps (or highlights potential risks or unintended consequences that might need to be addressed in the design of the policy implementation). Moreover, have interactions with other schemes or measures in this area been considered and the impacts this may have? Has there been any consideration or analysis of this? What will be the impact on rents / prices? Will selecting rents based on 2016 data reinforce record high rents or set a rent floor? Have these issues been considered?

- Present a full economic appraisal of the scheme with the Business Case including the monetisation of the benefits.

- Present a full consideration of the risks associated with the proposed scheme. In terms of setting these out it might be useful to examine the experience of other countries in implementing schemes of this kind and the lessons that they have learned.

- Incorporate sensitivity analysis. This has been provided to a certain extent with rental inflation projections. However, in this case, what has been chosen as the most likely scenario should be reframed as a central scenario given its likelihood. An upper bound scenario could then be added to the analysis to provide a more robust range of rental inflation outcomes / projections. There is potential to include a more detailed sensitivity analysis of the income data used for tenant eligibility. This could take account of the differences in gross and net incomes of households with and without children. Such differences may be important from an eligibility point of view, especially at the upper end of proposed eligibility limits.

Applicant Households

The intention is that an applicant household would have to be able to meet the cost of 70% of the rent and the subsidy should be capable of bridging an affordability gap by bringing the proportion of a household income expended on rent to around or below 30%.

In terms of what is meant by affordable residential accommodation for low-to-moderate income households, the Business Case proposes that eligible applicants would have to meet two income related criteria:

- Net household income would have to be within specific bands; and
- Rent for the unit would have to represent more than 30% of this net income before the subsidy is applied.

While primarily focused on low-to-moderate income households, the Business Case accepts that the Scheme would be open to those on the housing lists or entitled to apply for social housing who can afford a discounted market rent.[1]

With reference to varying types of accommodation, the Business Case defines low-to-moderate income in terms of net income bands:

	1 bed apartment	2 bed apartment	3 bed apartment	3 bed house
Min Net Income (Gross)	34,913 (35,500)	35,575 (39,000)	38,238 (42,600)	38,238 (42,600)
Max Net Income (Gross)	42,000 (48,000)	46,000 (53,600)	50,000 (59,200)	50,000 (59,200)
Rent	1,054	1,276	1,553	1,252
Rent as % of Net Income *ex ante*				
Min. Net Income	36%	43%	49%	39%
Max. Net Income	30%	33%	37%	30%
Rent as % of Net Income *ex post*				
Min. Net Income	25%	30%	**34%**	27%
Max. Net Income	21%	23%	26%	21%

Note: The gross incomes are based on the property being occupied by two adults each earning the same income and including children in respect of 2 and 3 bed units.

[1] It would appear that any providers or households who enter into the Scheme would not be in a position to benefit from other social housing supports as the Business Case states that in respect of properties developed under the Scheme households may not receive HAP, units will not be eligible for entry into RAS arrangements and households may not be in receipt of Rent Supplement at point of entry into the Scheme (does this mean they can receive Rent Supplement after entry?)

The above table also shows the share of net income consumed by rent both before the application of the subsidy and after it has been applied.

As set out in the Business Case, the pilot is expected to include some 2,000 households.

In terms of the further development of the Business Case, there is a need:

- Given the assumptions used to estimate gross incomes, it might be more illustrative to provide a range of gross incomes that includes situations where there are single person households and households composed of two adults but one income. These changes in assumption impact on the estimated gross income.

- Ensure that the credibility of the Scheme as outlined by the Business Case is not undermined by criticisms of unfairness it might be better if the impact of the Scheme was to ensure that the *ex post* rental cost was within a percentage point or so of 30% of net income.. From the Table above, it is clear that after the subsidy is applied, those who earn most, benefit most. As set out, the greater the income, the smaller the proportion of it that is consumed by rental costs when compared to those who earn less.

Applicant Providers

The Scheme and subsidy will apply only to residential units which are new to the rental market. In particular, the Business Case notes that there would be a requirement that providers would have to have a minimum of 15 units per block, development or street.

The benefits of the Scheme for the provider are set out as:

- Subsidy of 30% of market rent to be paid over a period of 20 years;
- Reduced risk on income therefore reducing financing costs of delivery;
- The assumptions underpinning the viability of the scheme deliver
    - 15% developer margin and
    - 7% gross yield.

The Business Case notes that a 15% developer margin is consistent with the current market and it is claimed that such as profit margin is required in order to be able to raise funds from backers. The NDFA notes that a 15% developer profit margin appears on market for a build-to-sell model but that they would have expected this to be lower for a build-to-rent model (with returns reflected in the ongoing yield and residual capital value).

With regard to the 7% gross yield the Business Case notes that the Housing Agency has advised that this level is a realistic approximation of market expectation for property investment and also note that IRES REIT, a listed property investment firm, has an expected gross yield in the range of 8.5% to 9%.

In terms of the further development of the Business Case, there is a need:

- To set out how what is being proposed will increase the supply of units.

- Place the supply side elements of the scheme, in particular, the 15% developer margin and 7% gross yield, in context of other initiatives that have been introduced by the Government to reduce construction costs;

- Indicate whether the existing initiatives to reduce costs have been taken into account in arriving at the construction cost and rental affordability calculations set out in the Business Case, or if not, what impact taking them into account would have on these estimates;

- Explain more clearly why the development margin and gross yield are in line with the current market. The Business Case suggests that the proposed scheme will attract a lower cost of finance versus a property operator seeking to raise finance for a rental model which is 100% exposed to market risk, but it is not able to substantiate this claim stating that there are no comparisons for the Affordable Rental models in the Irish market.

- Set out more clearly what is meant by, and the implications of, the NDFA's observation that the provision of new build stock for the pilot scheme appears somewhat optimistic.

- Given the requirement that providers will need to make available at least 15 units in a block, development or street, the Scheme is focused on large scale providers. There is a risk that this could be portrayed as a transfer of taxpayers' money to large-scale property companies, some of whom may have acquired properties post-crisis. There are some notable large scale providers with sizeable property portfolios and plans to increase supply significantly over the next year or so.

- The potential distortionary impacts of this scheme in terms of the behaviour of renters and developers within and outside the scheme could be assessed in more detail. For example, is it expected that this scheme will have impacts on developer decisions in the normal private rented market or owner occupier market? If so, what might these be? What would be the effect of them? Is development in one area of the market likely to be displaced as a result of this scheme? These and other issues would benefit from further consideration.

- Moreover, the issues of viability for developers will presumably be impacted by changes in price such that, for example, it may become viable to develop units in certain areas over the short to medium term (given the significant price inflation prevalent at present). This would bring into question the targeting of such a scheme in one particular area (e.g., postcode, town or city) over others. This could be considered further.

Administration of the Scheme

Under the Scheme, providers are to be responsible for the selection of tenants from the list of households registered for the specific units at the particular location. This approach maintains the private nature of the relationship between the provider and the tenant.

In addition to this, the Department of Housing, Planning, Community & Local Government is of the view that the provider of the accommodation would appear best placed to confirm and review tenant eligibility, based on the provision of the necessary documentation by the applicant household and subject to set rules, and to oversight and audit. The Business Case also notes that the provider will also have primary responsibility for monitoring household compliance.

The Scheme proposes that an administration fee of 5% of the subsidy should be paid to providers, in part to compensate providers for this work as well as to increase the attractiveness of the Scheme.

In terms of the further development of the Business Case, there is a need:

- To set out alternative approaches to determining eligibility and monitoring on-going compliance with the Scheme that allocates central roles to State agencies. These can then be compared against the proposed approach to arrive at a conclusion about which approach will best protect the interests of the State.

Evaluation

The Business Case commits to undertaking a formal review of the implementation, operation and costs associated with the pilot scheme at end 2017. The evaluation of the pilot scheme would focus on:

- The terms offered by the scheme to providers, tenant eligibility and administrative aspects; and
- To test if the assumptions underpinning the scheme are shown to be sound and effective in practice.

In terms of the further development of the Business Case, there is a need:

- To set out a summary of the alternatives that were considered at the initial appraisal stage. This would help to put in context the preferred approach that the Business Case is developing.

- Explicitly state whether or not the evaluation will examine the ongoing rationale for the Scheme and the decision as to whether or not the pilot should be mainstreamed. What criteria would be used to arrive at such decisions.

- Provide detail on who will undertake the review as well as on the level and type of data that will be collected to allow for this evaluation to be effective including who will collect data on the scheme, how will it be stored, will it facilitate a robust review. These questions would need to be addressed from the outset and considering what the terms of reference for a review would look like would facilitate this.

- While not directly related to the evaluation of the pilot Scheme, the timeline as provided is proposing to get the views of the CSO and NDFA after the Government has agreed to the Scheme. As the observations of both of these bodies may be critical to determining whether or not the Scheme as presented can be implemented, it seems reasonable that they should be providing their final views on the Business Case prior to a Memorandum being brought to Government.

Costs

The focus of the Business Case is very much on the pilot phase of the Affordable Rental Scheme. From this perspective the estimated cost of providing 2,000 units over the 20 year lifetime of the scheme is estimated in the Business Case as ranging between €268.6m and €290.5m.

In terms of the further development of the Business Case, there is a need:

- While details of the costs have been set out, there is no Net Present Value (NPV) analysis completed and no attempt to monetise the benefits that would accrue from such a scheme.

- To be clear as to whether or not it is intended to extend the Scheme beyond those included in the initial pilot. Pilot exercises are usually undertaken with the purpose of testing a policy proposal in advance of a decision to implement a scheme more fully. There is no mention of opening up access to the Scheme. If the scheme were extended to include the potential number of eligible people as outlined in the Business Case, then the Scheme could cost between €275.3m and €346.2m a year.

Combined observations of D/PE&R's Housing Vote Section and Irish Government Economic & Evaluation Unit
18 November 2016