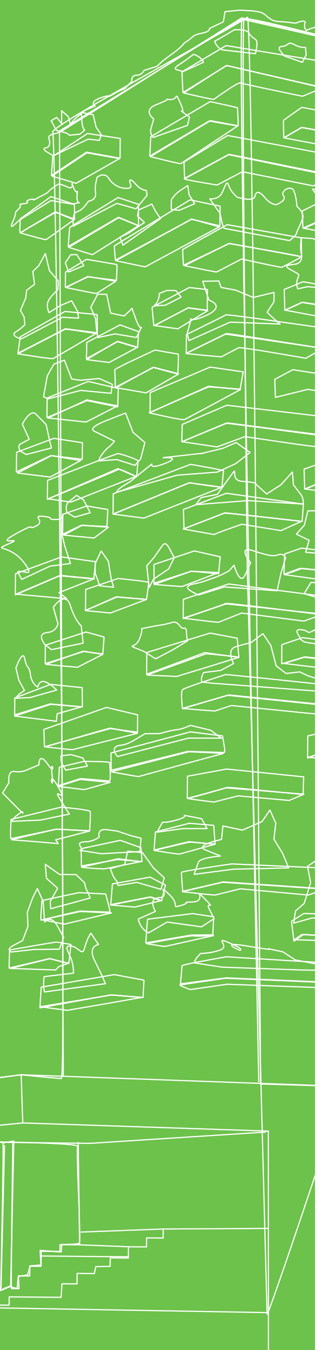

Solving Europe's housing challenge:

Aligning institutional capital to public policy ambitions through an industrial housing strategy

Research

INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. Our aim is to improve the accessibility of non-listed real estate vehicles for institutional investors by promoting greater transparency, accessibility, professionalism and standards of best practice.

As a pan European body, INREV represents an excellent platform for the sharing and dissemination of knowledge on the non-listed real estate industry.

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> Bridge between development and institutional investment capital required

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Europe's housing crisis is of pandemic proportions. A failure to either identify or deliver on housing need over previous decades has led to chronic undersupply, resulting in an affordability crisis across every housing segment. Policy measures aimed at moderating rents alleviate the symptoms for those with appropriate housing, but they are not a remedy. A rapid, decade long acceleration of supply that is unimpeded by either economic cycles or obstacles at the local scale is the cure to rehabilitating Europe's housing markets. Given the magnitude and financial cost of the challenge, realising this ambition requires institutional capital at scale.

This paper builds on INREV's previous research papers including Housing Middle Income Europe: the intermediary investment opportunity amid diverse residential market structures and Unlocking affordable PRS to address the twin challenges of housing need and decarbonisation. These recent papers explore the diverse structure of European housing markets, the scale and appetite of institutional investment and beyond their required capital, the wider benefits that such investors deliver for housing market structures and tenants.

The current paper considers the compatibility of institutional capital with public housing policy objectives. It demonstrates the strong alignment of its long-term income profile and the compatibility of its underlying beneficiaries with public policy objectives. Distinguishing institutional capital from other private capital sources, it provides analysis to demonstrate that pension fund and insurers' long-term, patient capital is particularly suitable for addressing the housing challenge and aligning with public stakeholders. It also outlines constraints on the use of such capital and considers how this could be remedied.

Key points:

> At 26% of their real estate portfolios, institutions are already significant investors in housing in Europe, holding €573 billion in residential assets. Expanding this investment is crucial for amassing the capital required to address the housing challenge, crudely - and conservatively - estimated at €12 trillion across all segments.

> Institutions are attracted to housings' long-term, predictable income stream and given its bond like qualities, require a lower risk premium over bonds relative to other sectors. They also recognise that for long-term strategies, housing for modest and middle income households at affordable rents can generate a higher return absolutely and per unit of risk than either premium residential or rents inflated by scarcity value. It also provides a strong opportunity to deliver on environmental and social sustainability ambitions.

> Expansion of institutional capital at scale is required to deliver housing targets over the next decade. However, risk management negates their ability to have development capital at risk. A solution to bridge from development to institutional investment in housing is required. As an aligned partner, institutional capital may require supports to maintain financial viability and mobilise it through economic cycles. Public expenditure on housing should be reevaluated and optimised to maximise outcomes across all segments.

> Multiple barriers at the local level are impeding implementation of housing strategy and their removal will accelerate delivery, permit the growth of modern methods of construction, greatly de-risk development and investment, and mobilise capital at scale.

> There are good examples of public / private models across Europe that are harnessing institutional capital to deliver on specific goals, however they are insufficient in isolation as a solution to the housing crisis.

> An industrial housing strategy is required that aligns all stakeholders to delivering on an agreed plan for housing, explicitly recognising and supporting stakeholder requirements and enabling stakeholders to commit to delivering through a multi-decade horizon. Industrial strategies need to extend from setting policy targets across segments and creating frameworks that mobilise institutional capital through to system change that provides for efficient deployment and delivery at the local scale.

Chapter 1

Introduction

Europe's housing challenge stems from chronic undersupply of appropriate housing, with scarcity impacting on rental affordability through the spectrum of housing segments and tenures. Disequilibrium in any one segment causes demand displacement to others, exacerbating the demand and supply balance of adjacent segments.

In some markets – most markedly in those that are traditionally characterised by high rates of owner occupation - this is changing the tenure structure and culture of housing systems. New long-term segments in the private rented sector (PRS) are emerging to bridge the void between publicly regulated and owner occupied housing provision. This void includes three elements of unmet demand: spillover demand from the undersupply of regulated forms of housing, spillover demand from households that are locked out of owner occupation and who do not qualify for regulated housing, and growing demand from households seeking PRS tenure by preference. Expansion of this segment at scale has the capacity to improve housing affordability across multiple income segments and reduce pressure on publicly regulated housing.

INREV's paper Housing Middle Income Europe explores the tenure structure and housing market dynamics across Europe. Although housing market structures are extremely diverse they share the common factor of an overriding undersupply of housing that is denying many households the basic need for appropriate housing and challenging the security of housing for those that have it given pressures on housing affordability.

Harnessing institutional capital is an opportunity to scale much needed housing delivery and to begin the journey of repairing broken housing markets. Households that find themselves locked out of regulated housing and owner occupation segments require alternative solutions that offer the security of a 'forever home'. Mirroring regulated housing provision, housing certainty generates benefits for individuals and wider society through increased stability for employment, education and community and in turn, health and well-being.

The immediacy of the housing challenge, particularly given the housing affordability burden is greatest for the most vulnerable households, has led to piecemeal policy development. Efforts to moderate rental development through regulation may alleviate symptoms in the short-term, yet do little to address the long-run undersupply of appropriate housing. Indeed, where rent regulation fails to provide for appropriate rental progression, policy development occurs without consideration of financial viability. Equally where policy inconsistency increases risk and uncertainty, such short term remedies can constrict future supply.

The housing challenge demands an industrial strategy that puts the root cause of the housing challenge – housing scarcity – at the centre. Rather than solely reacting to its symptom - the deterioration of affordability - such an industrial strategy requires a more holistic, multi decade approach to developing a housing solution masterplan.

At a regional level, the European Parliament agreed in 2021 that access to affordable housing of an appropriate quality is a basic human right, prompting the European Commission to establish its Affordable Housing Initiative. It is also a priority of the UK Government who have tasked Homes England with ensuring the ambition of 1.5 million new homes by 2029 is realised.

There is no one size fits all for Europe's diverse socio-political housing culture and variation in concentration of unmet need[1]. The embedded differences in socio-political culture, established housing market and legal structures across countries, require tailored solutions that are hard to shape or incentivise at an EU level. However, the scale and commonality of the housing challenge has led to the appointment of an EU commissioner for housing regardless. This will be helpful in identifying and sharing best practice approaches to delivering housing solutions against need across financial structures, capital sources, planning, materials and construction methods.

This paper identifies the need for an industrial housing strategy for all markets that aligns public and private stakeholders over a long-term horizon, mobilising institutional capital through economic cycles, together with other long-term stakeholders as well as those with a shorter-term business cycle such as contractors, that play a fundamental role in delivery.

1 For a comparison of housing market structures and role of public and private stakeholders see paper
INREV (2024) Housing Middle Income Europe: the intermediary investment opportunity amid diverse residential market structures

The paper first sets out the compatibility of long-term institutional investment capital for delivering housing policy objectives, distinguishing long-term institutional investment objectives from other private sector capital strategies and explaining the role of housing investment in institutional portfolios. Second it examines their risk adjusted return objectives, highlighting both the lower risk premia associated with residential and the intrinsic value profile of investment strategies, delivering benefits for both investors and residents. Third, it considers the need for institutional investors to develop a deeper understanding of public and not-for-profit objectives and governance, with a view to developing stronger alignment of the overarching objectives of publicly funded enterprises with those of institutional investors.

It also examines the role of public monies in delivery of both regulated and PRS housing. The paper also demonstrates the importance of consistency in supply delivery against the context of financial viability and barriers to policy implementation at the local scale. In the final section the paper argues that the scale of the housing challenge in every market requires an industrial, long-term housing strategy, devised by multiple stakeholders to align their interests and enabling them to commit to delivering on objectives. Outlining current challenges, this paper explores the potential for direct and indirect financial and non-financial policy levers to be employed within an overarching industrial strategy to smooth investment flow and housing delivery.

Chapter 2

Compatibility of long-term institutional capital with delivering housing solutions at scale

> The investment profile of pension fund and insurance companies' real estate investments are focused on lower risk adjusted income return strategies and distinct from other sources of private capital which have a greater emphasis on growth.
> Institutional long-term, patient capital is particularly suitable for addressing the housing challenge as it has the capacity to scale and align closely with public and stakeholder objectives.
> Institutions' fiduciary duty to underlying pensioners and savers requires them to deliver an appropriate risk adjusted return and supports may be required through an economic cycle to keep the flow of capital turned on.
> Risk management negates their ability to have development capital at risk and a mechanism to bridge from development to institutional investment in housing is required.

Real estate is a dynamic asset class and offers investors a wide range of investment risk profiles that range from speculative and high risk opportunities focused on mispricing and cyclical timing through to acquisition of fixed income at the low to modest end of the risk adjusted return spectrum. As a result, the range of real estate investors and their investment objectives are equally diverse, including institutional investors such as pension funds and insurance companies, sovereign wealth funds, foundations and charities, publicly listed companies and REITS, private companies, large family offices often representing intergenerational wealth held in trust, as well as High Net Worth Individuals (HNWIs) and other private investors.

Shared alliances across the private sector often mask the different return objectives of long term institutional investors from the wider private sector, which includes those focused on growth and more cyclical investment, concerned with market timing.

Broadly, institutional investors with a fiduciary duty to fulfil the future income requirements of their underlying savers and investors are focused on lower risk-adjusted return income strategies. As real estate has a lower liquidity, transparency and higher specific risk it rewards longer term investors that don't need short term liquidity with a risk premium over other fixed income products such as bonds.

Figure 1: Investor objectives by investor type

Pension funds/Insurance companies

Income	Growth
• Liability matching • Long-term secure income • Low risk • Risk premia for illiquidity, transparency • Hold through cycles	• Immature pensions in growth phase • Proprietary capital • Cyclical timing • Development or leasing risk • Medium term, cash out

Foundations, Family Offices, HNWIs

Income	Growth
• Short-term requirements • Low predictability of volume or timing • Require high liquidity	• Of the corpus (total capital base) • Medium to higher risk and return • Medium duration • Capital locked away to cash out • Cyclical

These characteristics differentiate long-term institutional capital from other private sector investors and make it an appropriate source of capital to address the multi-decade horizon associated with solving Europe's housing challenge. For institutional investors, the housing sector offers a set of distinct investment characteristics that make it particularly beneficial for delivering on their investment objectives.

Long-term, patient institutional capital that has the capacity to hold through cycles for a back-ended return enhancement is particularly suitable for addressing the housing challenge. Institutional investors' income investment requirements are not merely distinct because they are more focused on longer-term income, but because their liabilities are more certain in terms of timing and quantum. As a result, institutional investment has the capacity to act as patient capital enabling decision making to consider sustainable long-term, cumulative returns through the investment horizon.

2.1. Institutional capital is aligned with the scale and duration of the housing challenge

Institutional investors have the capacity to greatly accelerate housing supply across multiple regulated and non-regulated segments. An industrial strategy has the capacity to influence the scale and direction of capital across segments and through the projected time horizon.

Scale and timing are crucial. Based on housing policy stated requirements over the next ten years and the average cost of delivery per housing unit reported by active stakeholders, an estimated €11.8 trillion of capital is required to meet the housing requirements of seven countries[2]. Harnessing institutional equity capital is crucial to realising this ambition.

Undersupply is not the only issue facing housing markets. There is also concern as to the quality of existing stock and embedded within this issue, the need to decarbonise existing stock and improve energy efficiency. Institutional investors are committed to the UN 2030 Agenda for Sustainable Development and understand the interaction between energy efficiency, total housing costs and housing affordability[3].

Institutional investors also offer an opportunity to professionalise the PRS, especially in markets where ownership is highly fragmented and the majority of landlords are 'moms and pops' entities. Indeed, even in markets such as Germany where lifelong renting has long since been embedded as a tenure choice, individuals and small private investors represent over half of rented housing supply, with private housing companies including institutions representing less than a quarter[4].

Institutional investors also have the capacity to align with public and third sector stakeholders and commit to the implementation of a long-term strategy. This also offers opportunities to develop mixed tenure solutions at the local level which offer stronger community cohesion benefits, leading to better social outcomes including employment, education, health and social mobility.

2.2. Addressing constraints on institutional capital

Although long-term investors have the capacity to hold existing assets through a cycle, an issue that can arise is that capital allocation to real estate can turn on and off depending on shorter term movements with other asset classes. This can result in a stop-start pattern in the delivery of housing which needs a continuous flow of capital to ensure that supply doesn't continue to lag demand, resulting in bottlenecks that increase volatility and risk. Adopting a long-term investment perspective and focusing on the cumulative impact of returns through the investment horizon reduces this risk. However, where market conditions challenge the financial viability of delivering housing at a rent affordable to households in any target income quintile some form of support may be required to enable institutional investors to bridge the viability gap at points through an economic cycle.

A further challenge is that new supply requires development capital. Although a number of large institutions may have access to proprietary capital for use as development capital at risk, institutional capital at scale does not have this capacity as it cannot expose its underlying savers and pensioners to this risk. However, they can acquire assets upon completion with stabilised income streams. The development risk associated with PRS investment is relatively low as the sheer scale of unmet demand reduces the market timing, leasing and disposal risks. However risk and uncertainty concerning planning, timing and management of costs remain. There is a need to bridge the need for development capital at risk and institutions' requirements for stabilised income streams. This is further discussed in chapters 4 and 5.

2 Policy or national housing organisation stated housing needs as collated by Housing Europe for England, France, Netherlands, Germany, Ireland, Spain and Sweden and selected INREV members estimation of development cost per housing unit
3 INREV (2024) Unlocking affordable PRS to address the twin challenges of housing need and decarbonisation
4 https://www.brookings.edu/articles/Germany-rental-housing-markets/

In recent years, the collapse of housing for sale markets has offered institutional investors opportunities to forward purchase or forward fund development schemes in a number of markets. As house builders, these contractors have a shorter-term business model focused on production for sale. Should housing for sale markets recover, they are likely to withdraw from this segment of the market. The need to bridge the gap between development and acquisition is recognised by public institutions seeking to support housing delivery such as the European Investment Bank and Homes England who facilitate access to funding at attractive rates.

However, given the scale of the housing challenge and capital required, bridging this gap to ensure there is a mechanism to develop product for institutional capital consumption is an important component of aligning institutional capital within any industrial housing strategy. This requires all stakeholders to understand the investment objectives underlying institutional investment and the specific attributes of housing investment and its role in the wider portfolio.

Chapter 3

Understanding the risk attributes of institutional investment in PRS

- At 26% of their real estate portfolios, institutions are already significant investors in housing in Europe, holding €573 billion in residential assets.
- Institutions are attracted to its long-term, predictable income stream and recognising its bond like qualities, require a lower risk premia over bonds relative to other sectors.
- Institutions recognise that for long-term strategies, housing for modest and middle income households at affordable rents can generate a higher return absolutely and per unit of risk than premium residential or rents inflated by scarcity value.
- A solution is required for the void between development risk capital required for production and institutional capital seeking stabilised income generating assets.
- Multiple barriers at the local level are impeding implementation of housing strategy and their removal will accelerate delivery, permit the growth modern methods of construction, greatly de-risk development and investment, and mobilise capital at scale.

Institutional investors are attracted to the residential sector because of the attractive risk adjusted returns it delivers relative to other asset classes and other real estate sectors. It also offers diversification benefits to the total investment portfolio being more dislocated from economic cycles and has a lower correlation with other real estate sectors. In addition, the sector offers strong opportunities for institutions to invest with purpose and contribute to multiple Sustainable Development Goals (SDGs)[5]. Indeed, INREV's earlier paper links the challenges of housing and decarbonisation and explains how addressing these goals together can unlock value for investors and occupying tenants[6].

As a result of these benefits institutional allocations to the residential sector have trebled over the past decade to €573 billion including direct holdings and indirect investments in listed and non-listed companies and funds[7]. The Residential sector includes a range of housing solutions including senior housing and student accommodation, however PRS accounts for 75% of all such investment. Although allocations have increased across all investors, institutions have increased their allocations to the sector more sharply and at end 2023 it represented 26% of institutional real estate portfolios by value.

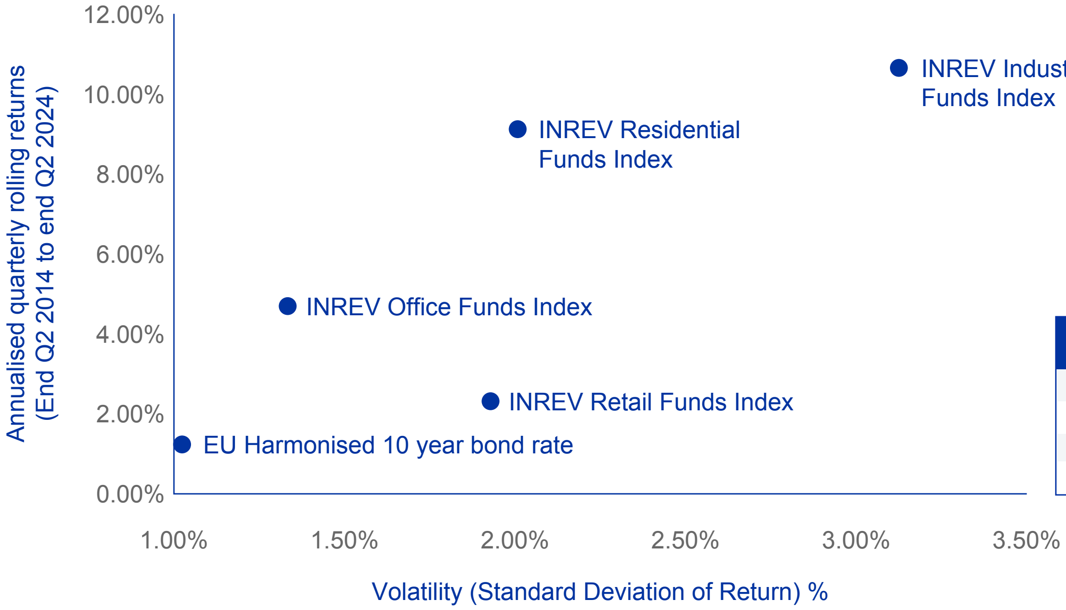
Understanding the risk attributes underpinning this investment growth underlines the suitability of institutional capital, in alignment with the public sector and other long-term stakeholders, to construct and deliver an industrial housing strategy that meets the housing challenge.

3.1. Risk and return performance attributes of housing investment

Investors are attracted to the residential sector due to its capacity to deliver strong and reliable risk adjusted returns. Figure 2 presents the annualised performance of funds comprising residential assets over a ten year horizon. Over the time horizon, residential delivers a buoyant return (9.09%), but not the highest total return which is achieved by the industrial sector (10.62%). Although at 2% the volatility of returns is modest, both office and retail offer lower reward. However, residential delivers the strongest performance when the return per unit of risk is considered (Figure 2).

5 The United Nations set out 17 Sustainable Development Goals in the UN Agenda 2030 *for Sustainable Development*
6 INREV (2024) Unlocking affordable PRS to address the twin challenges of housing need and decarbonisation
7 INREV/ EPRA (2024) Real Estate and the Real Economy

Figure 2: Risk and return by sector (end Q2 2014 to end Q2 2024)



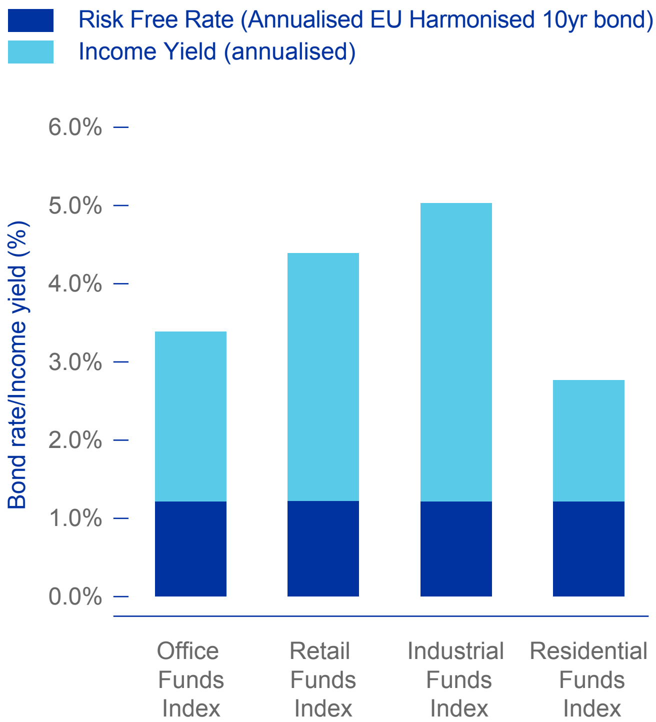
Return/unit of risk	
Office	3.52
Retail	1.20
Industrial	3.40
Residential	4.55

Source INREV Fund Index, Q2 2024

These risk attributes are underpinned by strong macro trends that assist in lowering risk by decoupling performance from economic cycles and in turn, offering additional diversification benefits for the portfolio. Investors understand that the strength of underlying demand for housing is high and durable into the long-term, with household growth expanding from population growth and changing household composition. In addition, income is certain and predictable relative to other sectors as being a necessity, it is less sensitive to changes in household income than more discretionary spending.

Institutional investors consider this more certain and fixed income stream to offer similar attributes as a bond. This is demonstrated in pricing and using a simple analysis of long term bond rates and income yield, it is apparent that institutional investors consider residential to warrant a lower risk premium over the risk free rate than other real estate sectors (Figure 3).

Figure 3: Implied long-term risk premia over bonds by sector, 2013 to end 2023



Source INREV Fund Index. ECB

3.2. Long duration investment horizon and performance

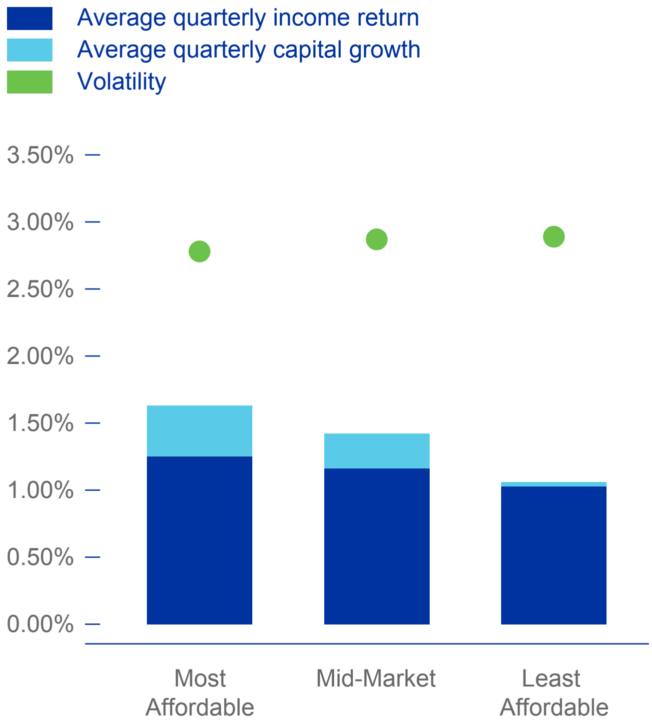
Institutional investors adopting a patient capital approach recognise that the consistency of the long run return from housing requires stability in capital commitments. Not least, this is because they also support the stability of existing holdings by lowering the volatility of the housing market, thereby supporting long-term risk adjusted returns. Equally, they recognise that the strongest risk adjusted income return over the long-term is anchored in moderate rents that are economically and financially sustainable through economic cycles.

This is important because it demonstrates that institutional capital can be deployed across PRS segments spanning a wide range of household income segments. As for investments between asset classes and real estate sectors, institutional strategies in housing are focused on maximising the risk adjusted return over the investment horizon, rather than the absolute total return. This is achieved by creating stable and predictable income streams. As a result, rent levels are optimised to reduce income volatility and avoid sharp cyclical swings. Investment strategy also seeks to maximise net income by maintaining high occupancy levels, avoiding the income void and management costs associated with churn and vacancy.

Investors seek to maximise rental income at a rate that is appropriate to their target market, which is selected on the basis of the optimised volume, durability and income profile of demand over the long-term investment horizon. This optimisation delivers a stronger risk adjusted return over the long-term. Investors will tailor their housing provision to best meet their target residents needs. Investor underwriting does factor in rental growth, usually in line with an appropriate index such as earnings growth, rather than market rate rental growth driven by scarcity values.

This is evidenced by analyses from two of the most mature PRS investment markets, the US and the Netherlands[8]. In the US, approximately 40% of multi-family PRS is in institutional ownership. Although

Figure 4: Investment performance of most affordable has a lower risk return profile



Source: PREA Quarterly, Summer 2024.

regulation is generally lower and supply more elastic, in most major metros there is a supply/demand imbalance that is challenging housing affordability.

Research analysis of the performance of non-regulated housing segments by rental affordability in the US market have demonstrated consistently that investment with rents affordable to households earning 80%, and also between 80% and 120% of Area Median Income (AMI), outperform investments with rents solely affordable to occupiers earning in excess of 120% of AMI (Figure 4 and Table 1)[9,10]. Indeed, the strongest average quarterly return is exhibited by the most affordable segment (80% AMI). As well as average income and capital growth being stronger, volatility is lower, which compounds into a 239 basis point spread per year between returns for the most and least affordable segments.

8 Note that it is difficult to make direct comparison due to significant differences the data. In the US studies assets in the NCREIF database are assigned an affordability category on the basis of a rent to Area Median Income (AMI) ratio for each quarter, with assets acquired as a value added redevelopment or refurbishment strategy stripped out. The analysis of MSCI data is based solely on rental level thresholds in the most recent quarter used as a proxy for differing degrees of affordability within the PRS sector. This is assisted by the compactness of the market geographically, with relatively low variation in the median or range of household incomes between Dutch cities in comparison the much wider geographic and income dispersion across cities in the US.
9 There is no accepted definition of what constitutes 'Affordable' and 'affordability', with definitions varying by jurisdiction, regulation, organisation as well as being user defined. For the most commonly accepted definitions please see [INREV (2024) Housing Middle Income Europe: the intermediary investment opportunity amid diverse residential market structures]. In the research analyses referred to affordability is defined as average rent per unit excluding utilities and taxes, being less than 30% of income.
10 PREA Quarterly (2024) Can investors afford to ignore affordability? The investment characteristics of affordable housing, Research Insights (Summer 2024) PREA Real Estate Association

Table 1: Investment performance of US housing by affordability category, Q1 2008 to Q1 2024

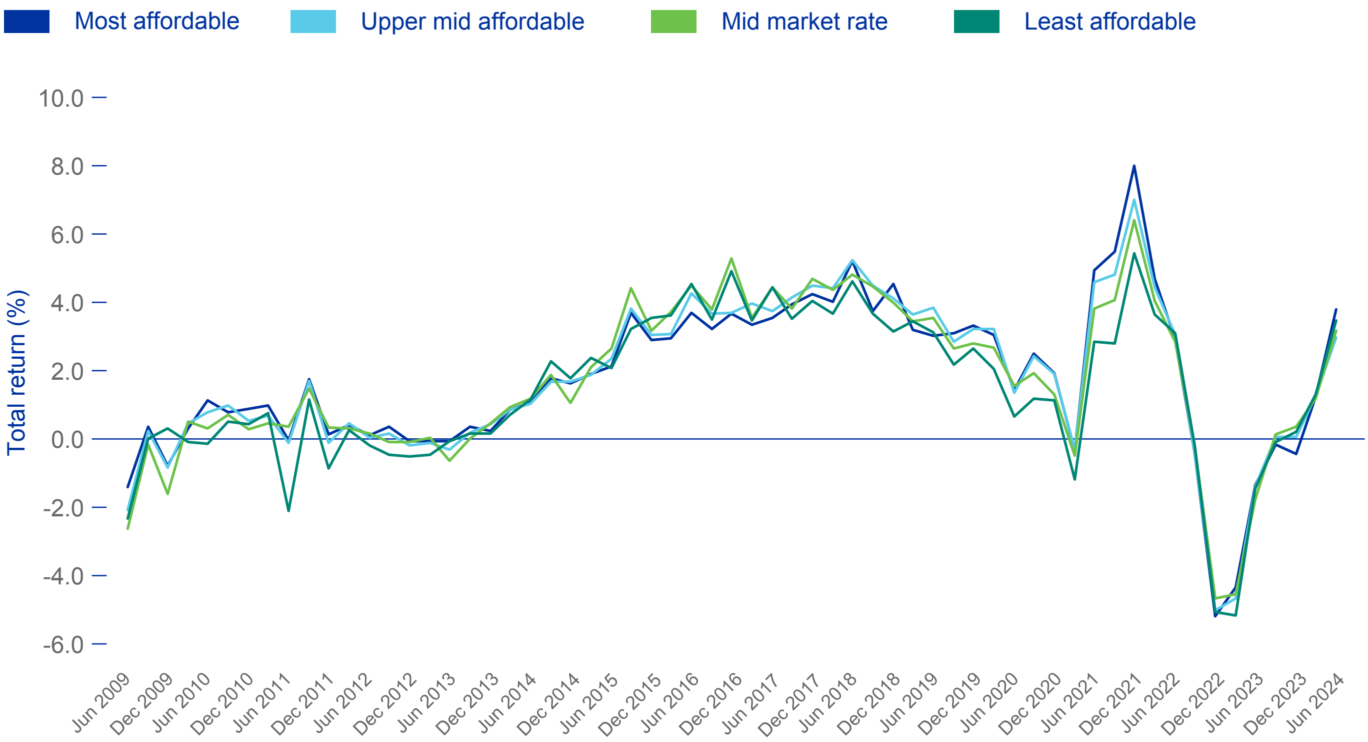
2008 Q1 to 2024 Q1	Most Affordable	Mid-Market	Least Affordable
Compound average annual total return	6.54%	5.62%	4.15%
Average quarterly total return	1.64%	1.42%	1.06%
Volatility of quarterly total returns	2.78%	2.87%	2.89%
Average quarterly Income return	1.25%	1.16%	1.03%
Average quarterly capital growth	0.38%	0.26%	0.03%

Source: PREA Quarterly, Summer 2024.

The greater swings in pricing for the least affordable segment provide an opportunity for investors pursuing more cyclical strategies to deliver higher returns through predicting turning points in the market, investing in downturns and divesting at market peaks. However, this outperformance is accompanied by increased risk and uncertainty and is best suited to growth rather than institutional long-term income strategies.

In Europe, analysis of MSCI data for the Netherlands also indicates that over the long-term the most affordable PRS housing delivers the strongest average cumulative quarterly and annual, total and income returns (Figure 5). However, the volatility of the least affordable PRS segment is lower, although the range between the least and most affordable segments is narrow (Table 2). This may reflect a stronger regulatory environment that is more tenant focused in respect of lease rights, security of tenure and index-linked rents.

Figure 5: Most affordable segment delivers the strongest total return in the Netherlands



Source MSCI Real Assets, 2024

Table 2: Investment performance of housing segments by rent level, Q2 2009 to Q2 2024

	Most Affordable (<€1000)	Good affordability (€1000 to €1200)	Mid market rate (€1200 to €1500)	Least Affordable (>€1500)
Compound average annual total return	7.17%	7.14%	6.85%	5.73%
Average quarterly total return	1.75%	1.74%	1.67%	1.40%
Volatility of quarterly total returns	2.28	2.30	2.30	2.24
Average quarterly income return	0.98%	0.96%	0.90%	0.84%
Average quarterly capital growth	0.76%	0.78%	0.76%	0.56%
Compound average annual income return	3.97%	3.89%	3.66%	3.40%

Source INREV Fund Index, Q3 2024

Indeed, the impact of regulation and regulatory uncertainty is a significant contributory factor to volatility in the performance of residential total returns in the Netherlands (Figure 5). In 2021, rental regulation was introduced to moderate market rate rental growth and also restrictions on the sale of owner occupied housing for conversion to rental housing. Risk and uncertainty increased as the severity and impact of the proposed regulations on the institutional market were unknown. As the rental regulation allowed for rental progression in line with inflation, the markets recovered.

The even sharper downtown in values in 2022 and 2023 reflects geopolitical events and the outworking of loose monetary policy both in the aftermath of the GFC and during the Covid-19 pandemic. This led to inflationary conditions and in turn, higher interest rates. This has resulted in a rebasing of capital market pricing across all asset classes absolutely and relatively, and at the same time increased the return required from real estate in line with bonds rate movements. In INREV's previous paper, analysis of the INREV Asset Level Index demonstrates that income remained a stable component of total return over a 1, 3 and 5 year horizon[11].

In the Netherlands this market adjustment to interest rate movements is exacerbated by uncertainty over the reach of anticipated rental regulation. This regulation involved raising the housing utility point threshold scores whereby properties are included within the regulated sector and have rents determined. More affordable properties were more at risk and therefore experienced stronger volatility during heightened uncertainty. However, the regulation afforded a higher rent to the extended regulated segment, with the regulation primarily seeking to reclassify housing that previously had been regulated but due to location appreciation had fallen out of scope.

This demonstrates how more instable regulatory environments can undermine underwriting and elevate risk for underlying pension and savings plan holders. Equally, the recovery of returns indicates that investment markets can adjust to regulations that seek to manage the pace of rental progression.

Many long-term investors across all markets recognise current market rental levels often reflect scarcity value, rather than underlying affordability and increase risks to income through for example elevating non-payment rates or churn. Their concerns are centred around certainty and stability of any regulation as they are able to effectively price progressive rental development at the outset[12]. However, most recent regulation aims to moderate the rate of rental progression, usually involving a capped and collared index-linked approach[13]. This approach is common to longer term commercial property rental agreements and is not new to investors.

11 INREV (2024) Unlocking affordable PRS to address the twin challenges of housing need and decarbonisation
12 INREV (2024) Housing Middle Income Europe: the intermediary investment opportunity amid diverse residential market structures
13 Hanna Kettunen & Hannu Ruonavaara (2021) Rent regulation in 21st century Europe. Comparative perspectives, Housing Studies, 36:9, 1446-1468, DOI: 10.1080/02673037.2020.1769564 https://doi.org/10.1080/02673037.2020.1769564

3.3. Anti-fragility qualities of net operating income

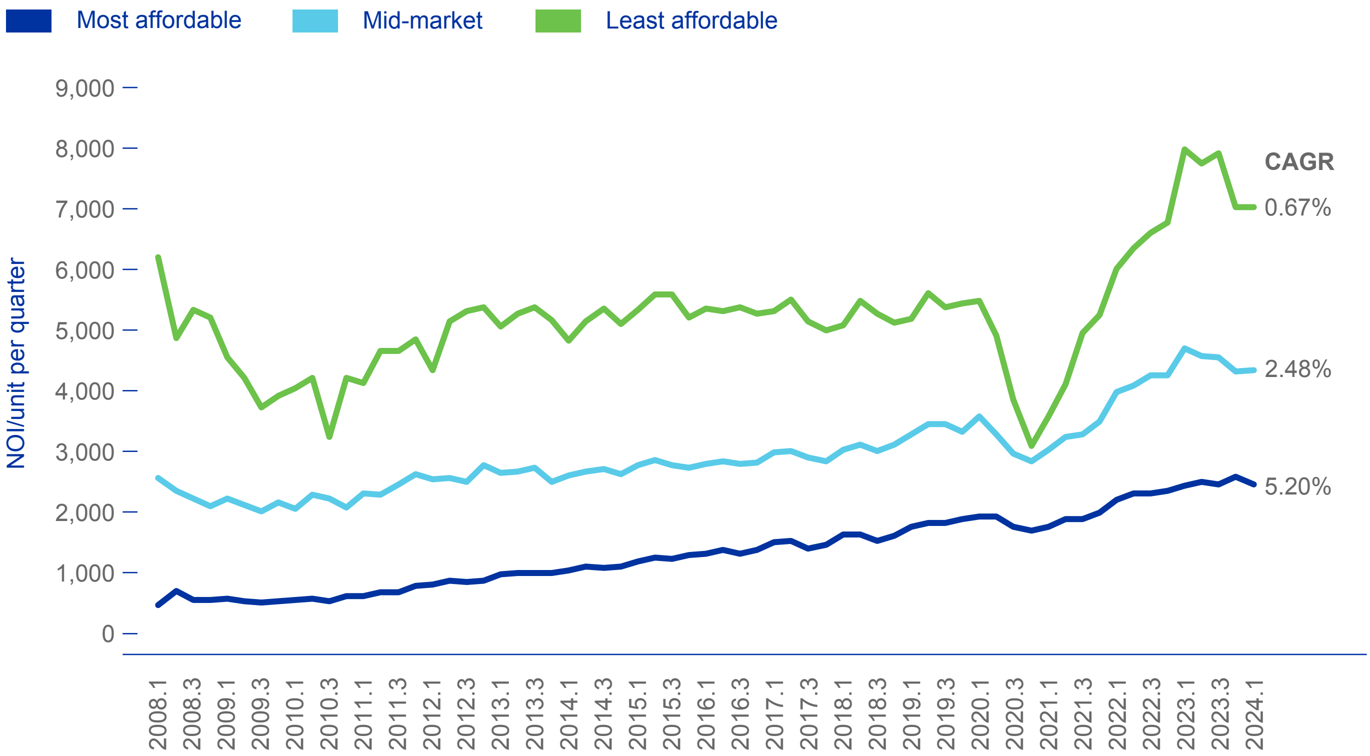
Across most markets, moderate and middle income PRS is generally higher yielding than prime PRS. This assists in generating a higher income and therefore, total return through a long-term investment horizon. However, analysis of net operating income (NOI) data in the U.S. market also demonstrates that although NOI of the least affordable segments is higher, as expected given higher rents, net operating income is considerably more volatile (Figure 6). This reflects the pro-cyclicality of this segment impacting rent and occupancy levels. In contrast, the more affordable segment delivers gradual expansion of net income, which for patient capital delivers a stronger cumulative annual growth rate.

These investment characteristics differentiate institutional long-term income investment objectives from other cyclical investors as explained earlier in chapter 2. It also suggests that while their overarching objectives are different to those of other stakeholders, they are compatible with other long-term housing providers, including third sector affordable housing associations (HA)[14].

In part this reflects the antifragility qualities of more affordable PRS, as the more modest incomes of public and private key workers have lower downward volatility. At the same time, demand for affordable housing expands through downturns as households with incomes more exposed to economic cyclicality seek to lower their outgoings. In many European markets NOI would also be supported by the safety net of social payments, including housing payment support where household incomes are impacted in periods of economic decline.

The expansion of institutional investment into European PRS also suggests that NOIs will benefit from economies of scale as investors grow their portfolios, enabling them to derive benefits from management efficiencies. In addition, the cash surplus expands as amortised costs are paid through the investment horizon, with patient capital rewarded with a waterfall of free cashflow at the end of the amortisation period (Figure 7).

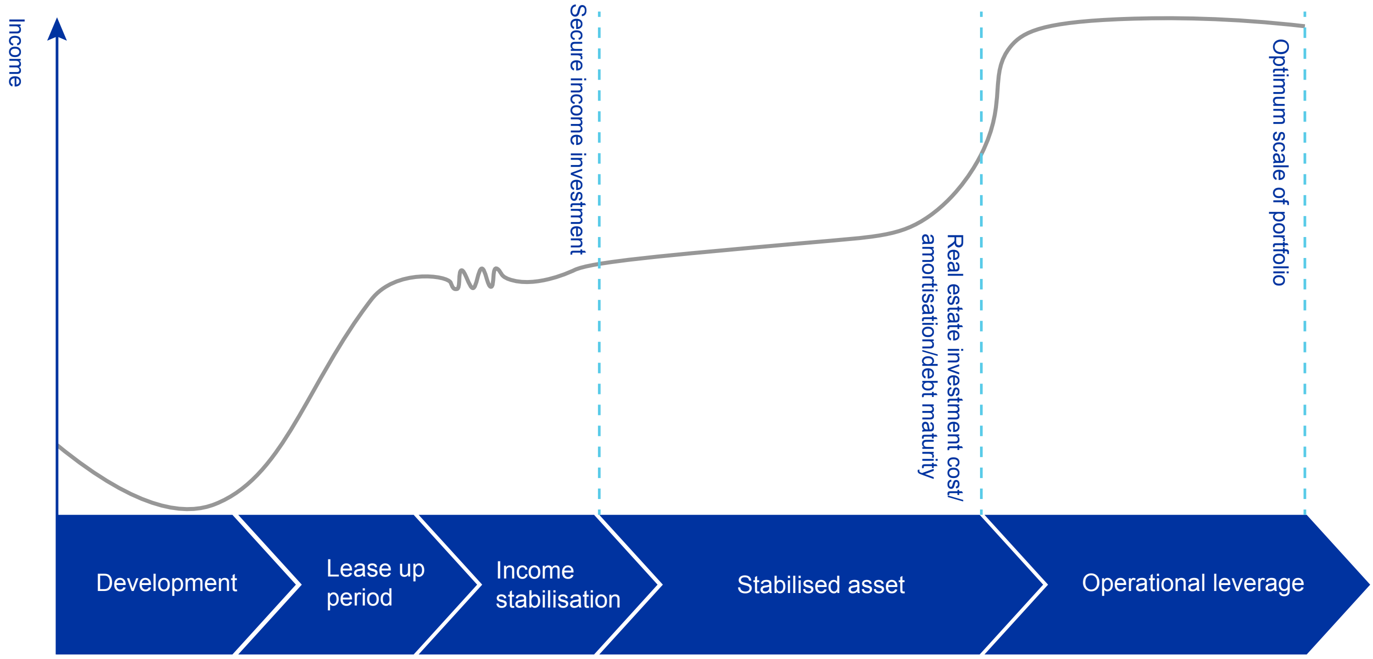
Figure 6: Net operating income demonstrates antifragility qualities of more affordable housing segments



Source: PREA Research based on NCREIF data

14 Not-for-profit housing organisations that develop and manage regulated housing. A range of names are used across countries including Affordable Housing Body, Housing Association and Public Housing Company

Figure 7: Return for patient capital requires a long-term perspective



3.4. Challenges for acceleration of institutional investment

As mentioned earlier in chapter 2, the need for the development of housing represents a hurdle. Although very large institutions with proprietary capital may have the capacity to put capital at risk through development, small and medium sized pension and savings plans have a fiduciary duty to protect the investment – and future income - of their underlying savers and pensioners. Any industrial housing strategy needs to solve for the gap between capital seeking stabilised income generating assets and the production of this product.

The business models of housebuilders and contractors tend to be short-term and their capacity to scale to the housing challenge is at best, unclear. In many markets, buildings cost inflation against low earnings growth and higher interest rates has eroded the gap between cost of delivery and achievable sale price. As a result, existing schemes in the pipeline or in planning are often being forward funded by institutions as PRS, or in some markets by HAs. Although this activity is expanding the rented sector, it is through a reallocation from the for-sale market rather than an expansion of capacity.

Modern methods of construction (MMC) may contribute to the solution, but they require investment to enable the businesses to scale and be financially sustainable. They also share the challenge of certainty and timing with other stakeholders, including institutional investors. Addressing this is fundamental to the implementation and success of any long-term housing strategy. This is because there are multiple barriers to the acceleration of housing delivery at the local level, including where quasi-judicial planning process frameworks and other bureaucratic frameworks persist and lead to drawn out and uncertain timescales. These may be fuelled by opposition from those with vested interests and nimbyism may lead to politicisation at the local level.

This uncertainty increases development risk given heightened uncertainty as to market timing, despite the absence of any risk of supply overhang given the scale of unmet demand for housing. For institutional investors, lengthy delays put capital at risk as allocated funds remain uninvested resulting in a negative real return. It also increases uncertainty around development costs particularly given the inflationary environment for prices of materials and labour, as well as the impact of interest rate movements. For example, in Ireland from 2020 approximately 30,000 housing units funded by institutional capital were held up in planning appeals for over three years, over the course of which changes to density, building standards including increased space standards, as well as interest rate movements had eroded financial viability. Consequently, a significant proportion of the capital withdrew.

Creating a more certain process is also crucial for the expansion of MMC. As a manufacturing industry, having certainty in terms of the timing, volume and therefore pricing of orders is fundamental to viability. Acceleration of housing requires increased certainty of volume and timing at the local level. Any industrial housing strategy needs to ensure that as it designs frameworks that harness and align the capital required, it simultaneously creates the conditions for it to be deployed efficiently.

Chapter 4

Comparison of characteristics of institutional long-term investment management with public and third sector stakeholders

- Pension funds and institutions require returns to be distributed to their underlying pension plan holders and savers, albeit the capital may rotate several times before distribution.
- There is a symmetry between the ultimate beneficiaries of the housing and the investment as they comprise public and private key workers.
- Expansion of institutional investment in PRS housing at scale can deliver the capital required to deliver housing targets over the next decade if it is fully aligned with public and other stakeholders.
- As an aligned partner, institutional capital may require supports to maintain financial viability and mobilise it through economic cycles.
- Public expenditure on housing should be reevaluated and optimised to maximise outcomes across all segments.

The profile of institutional PRS investments targeting middle income households is similar to the financial structure of the Vienna model of affordable housing that forms the basis of regulated housing provision across many countries including Denmark, Finland, the Netherlands and Sweden, as well as segments of regulated housing in Ireland[15]. Rental levels are affordable relative to household incomes, with rental value progression modest and predictable, usually linked to an earnings or inflation index, often with a cap and collar. As for institutional patient capital strategies, a waterfall of free cashflow occurs after the term for amortised costs - including finance – has expired. In affordable housing models, this provides for a rotation of capital.

Where they differ is in the distribution of returns, which is determined by their primary objectives. HAs are by their very nature impact led – with their primary purpose anchored to the social objective to increase access and provision of appropriate, good quality housing. However, they must be financially sound and have strong governance practices in respect of financial management and in respect of tenants, which often include the most vulnerable members of society. Where their activities are supported by public monies they also have a fiduciary duty to act prudently and ensure that its use maximises outcomes in the public interest.

Rental levels are often derived from the amortised costs of development and management. Usually, the sector initially benefits from public funding and/ or access to a relatively low cost of capital. Although the regulations vary across countries, cash surpluses are often used for structural repairs and maintenance, and to support the development or acquisition of new assets. This creates a revolving capital structure that enables the sector to become self-financing over a long-term horizon of forty years or more.

As managers of third party capital and proprietary capital, institutional investors also have a fiduciary duty and are required to have strong financial management and governance practices. However, their primary objective is to deliver appropriate, risk adjusted required returns to their underlying investors – savers and pension holders. Surpluses are ultimately used to deliver those returns, although they may be recycled multiple times prior to distribution. However, given that the rotation of capital is not infinite there is a need to ensure the investment case is compelling in order to expand institutional investor activity and expand the volume of capital available.

Despite the difference between their primary objectives, there is strong symmetry between the ultimate beneficiaries. European institutions manage the large pension and assurance policies of public and private sector workforces, representing key workers across health, education, emergency services, manufacturing and other businesses and services that are crucial to a well-functioning economy and society.

15 For a detailed description of the cost-rental model underpinning the Vienna Model of housing please see City of Vienna (2023) Social Housing – the 'Vienna Model'

The majority of institutional activity in the PRS is focused on the provision of appropriate housing to meet the needs of middle income Europe’s housing needs, ultimately using their pension and savings capital[16]. The investment returns from this activity are then used to fund their future pension and saving plans, making them the ultimate beneficiary. In addition to their patient capital approach to investment, this profile of underlying beneficiaries also differentiates institutional capital from the wider pool of private capital.

4.1. Financial viability of regulated and PRS affordable housing

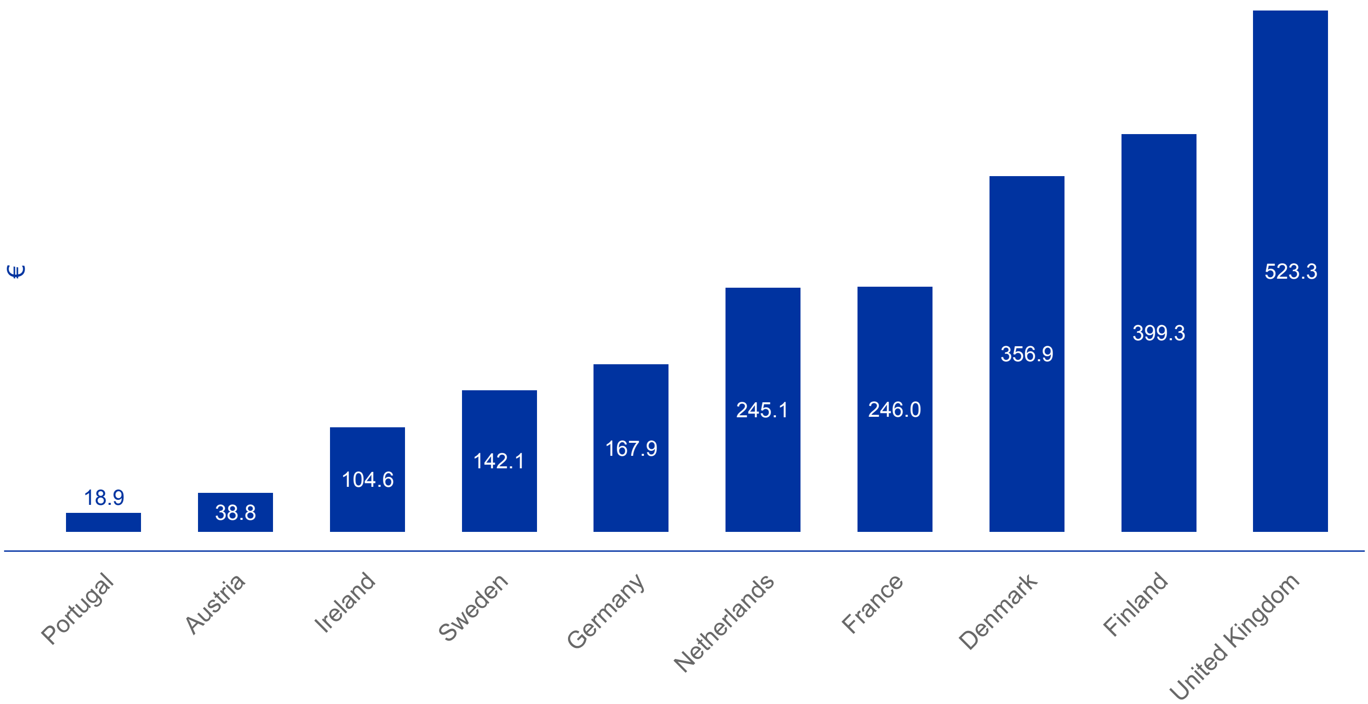
HAs usually benefit from some form of direct (capital grant of loan) and/ or indirect (access to discounted finance, access to public land, infrastructure-ready sites) public subsidy. The nature and scale of funding varies significantly across Europe as the structure of housing markets varies considerably. In some markets, it evolved to extend to middle income households and in others was more limited to low income households[17].

Importantly, in a number of markets including Austria and the Nordics, investment in previous decades has enabled the sector to become self-financing to some degree, lowering public finance requirements. However, access to discounted finance, government guarantor provisions and caps on interest rates, access to land etc remain enabling factors. This assists in levelling the playing field when competing with market rate developers and investors. In other markets such as Germany, portfolios are diminished by assets timing out of their regulatory term or in the UK through policies aiming to extend homeownership through a tenant’s right to buy that dilutes stockholdings. This income leakage impedes the development of a revolving capital model. In these markets, provision is more reliant on direct public capital in the form of a loan or grant, in addition to indirect subsidies.

These direct and indirect subsidies are often not available to institutional investors targeting mid-market rents, particularly where they extend through the third quintile targeting households with 80% to 120% of median incomes. In part, this is historical as in previous decades these households would not have required public supports to access housing at an affordable rent or often for owner occupation.

As investors seek to make a targeted financial return from their investments and distribute profits to underlying investors, there is a perceived conflict that any use of public monies or other incentives to support their activity would benefit the few rather than the many. Yet, this activity is crucial to delivering on housing targets and relieving pressure on other segments, including regulated housing. However, they are competing in the market with more cyclical ‘growth’ investors who will seek to maximise rather

Figure 8: Housing allowance spending per capita (2022)



Source OECD, 2024

16 INREV (2024) Unlocking affordable PRS to address the twin challenges of housing need and decarbonisation
17 [INREV (2024) Housing Middle Income Europe: the intermediary investment opportunity amid diverse residential market structures]

than optimise rent levels. Predicting turning points in the market – buying low and selling high – is fundamental to growth strategies. Institutional investors seeking to deliver mid-market housing may require supports to level the playing field with growth investors at different points in the real estate cycle.

4.2. Public expenditure on housing support payments

In many markets private sector investors do benefit indirectly from public subsidy in the form of individual housing payments. Figure 8 shows the total value of individual housing payments relative to population size by country. Essentially, subsidies for housing are provided to the individual renting rather than to the provider, with payments helping to bridge the gap between what is an affordable rent for the tenant and the contracted rent[18]. Such payments can effectively act as a subsidy to owners as in their absence, affordability would be reduced sharply and risks to income would escalate.

These payments can indirectly underpin market fundamentals with maximum thresholds determining rent levels for assets catering for middle income households. Neither investors or public bodies consider these payments as subsidies to investors or to the provision of housing, as they are perceived as a subsidy to the individual. However, in markets with wide and generous provision it maybe more efficient for the public sector to reoptimise the use of such public monies and directly support the provision of housing at affordable rent levels. This offers the potential for such funding to create a revolving capital base for housing provision over the long-term.

This is demonstrated through the analysis of a case study of a multi-family development in Dublin. A public REIT under financial stress needed to sell a PRS development of 194 homes. Housing Assistance Payments (HAP) were relevant to 75% of leases and represented a contribution to rental income of €3.13 mn per annum, capitalised at €67.5 mn. The cost of acquiring the asset at market value and allowing for maintenance and operational costs, and converting the HAP leases to social leases delivered a benefit to cost ratio of 1.5. The acquisition by a HA was underpinned by access to a public loan facility for 30% of the purchase price repayable at the end of term with the remainder funded by access to a housing finance agency loan at a competitive rate of interest.

Although this example represents reoptimisation of public finances between private and social housing, it demonstrates the potential for public spending on housing to be reconfigured to increase rental affordability and accelerate supply.

4.3. Optimising public expenditure to support and deliver PRS

Optimising public expenditure presents an opportunity to develop a framework that supports institutional investors to deliver housing that is affordable to middle income households, spanning from 80% to 120% of median income. It highlights the need for both investors and the public sector to consider how public supports influence rental levels and whether direct supports to investors might result in better rental affordability and more efficient use of public monies.

Institutional investors want to be part of the housing solution, but current market conditions are impacting on its financial viability. The scale of the shortage of housing doesn't merely require institutions to invest in housing, it requires them to build it. Indeed, it is noteworthy that research analysing the performance of modest income rental housing (MIRH) by metro area highlighted that in the major US metropoles including Chicago, Los Angeles and New York they were unable to identify a large enough sample of assets at rent levels that met MIRH affordability criteria, underscoring the shortage of supply[19]. The issue is also most pronounced in Europe's major cities, with a multi decade response required in order to address the existing supply short-fall and continued expansion of projected demand[20].

Efforts to accelerate supply across all housing segments – public and private - are impeded by a wide range of challenges. These include the scale of inflation in building costs including materials and labour, constrained supply of skilled labour, slow adoption and regulatory hurdles associated with modern methods of construction (MMC), and a lack of certainty of timing in respect of planning permission.

Given rental affordability ceilings - whether regulated or practical given divergence of rental and income development – the rising costs of delivery threaten the financial viability of investment (Figure 9). In turn, this threatens the continued expansion of supply in the near term which leads to a further accumulation in the housing demand backlog. This is evidenced in trends in the volume of new residential business permits which declined as building costs increased (Figure 10).

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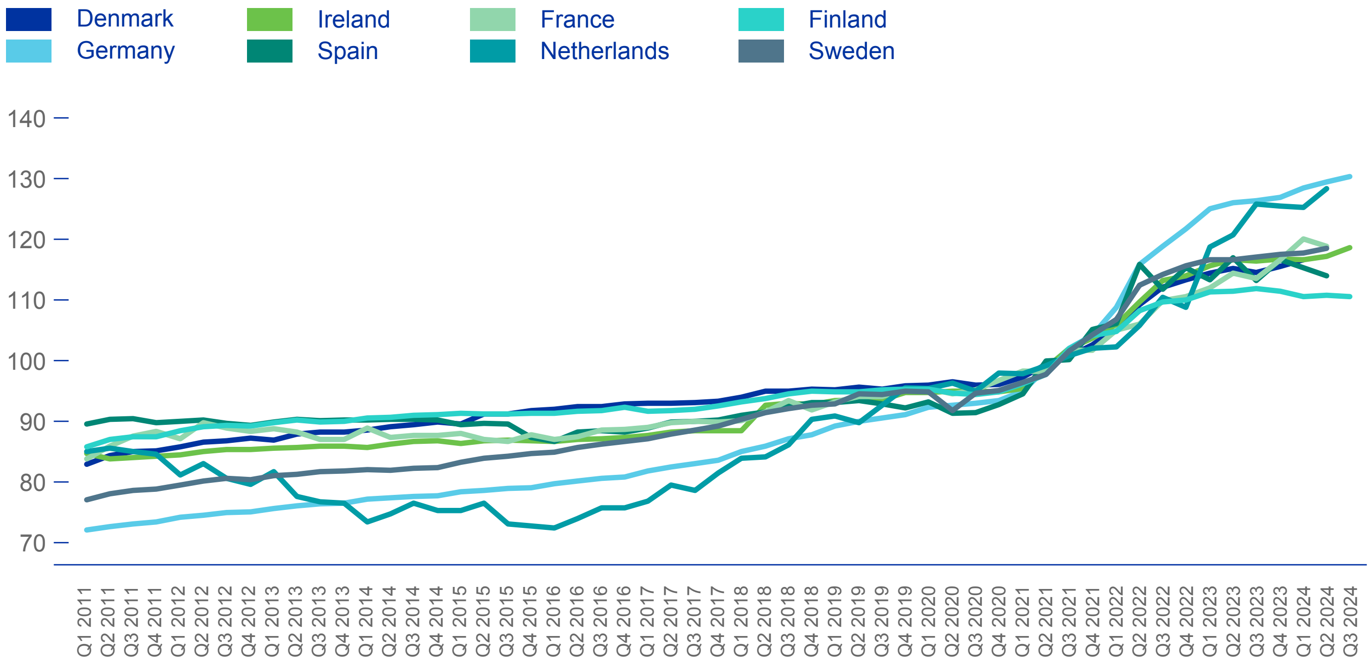
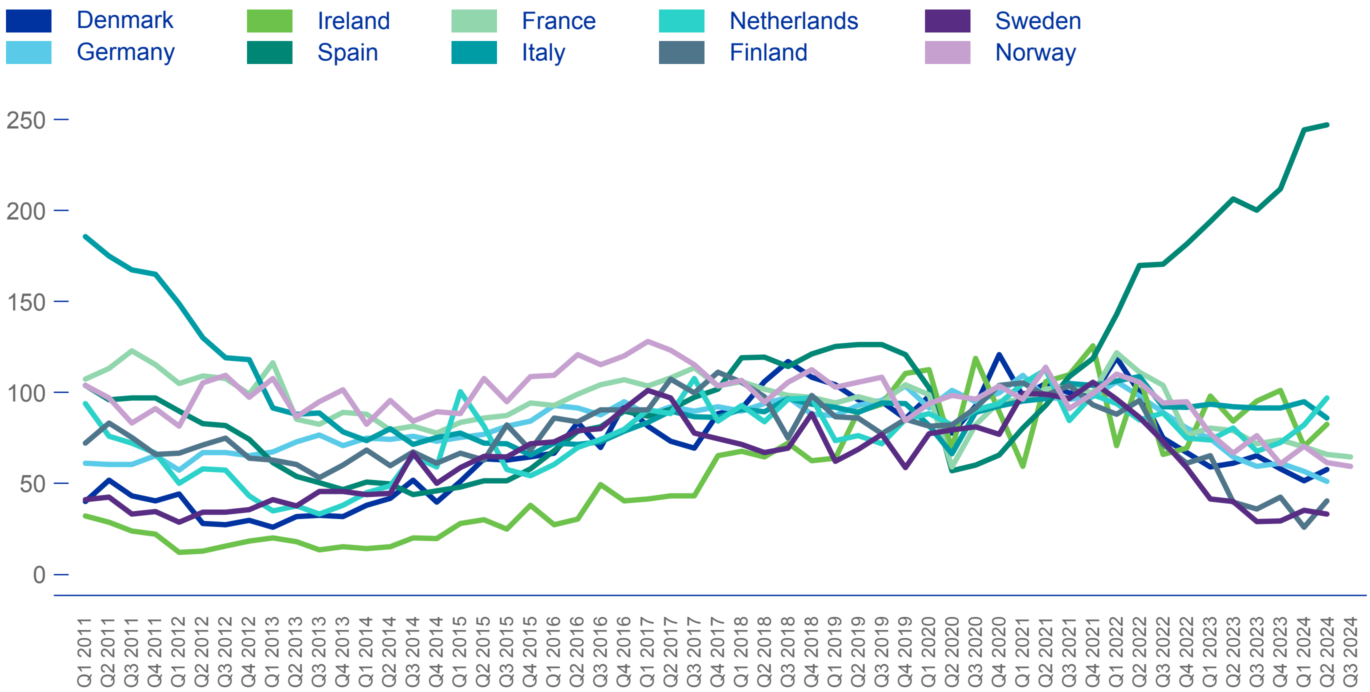
18 Qualifying thresholds vary hugely across countries ranging from universal allowances to narrow income thresholds, as do the maximum ceilings for such payments.
19 This study defines affordability as being rent and utility costs are 30% or less than 80% of the AMI.
20 For breakdown of housing shortage by country and segment, please see INREV (2024) Housing Middle Income Europe: the intermediary investment opportunity amid diverse residential market structures

Figure 9: Index of construction costs (producer prices) 2011 Q1 to 2024 Q3



Source Eurostat (2024)

Figure 10: Index of building permits (number of dwellings), 2011 Q1 to 2024 Q3



Source Eurostat (2024)

Spain is the exception in regards to its rapid acceleration of building permits. This reflects policy initiatives that offer support to private investors, lowers risk and uncertainty of planning and timing, which also aids the expansion of MMC lowering costs (see section 5.2). These policies have been developed by city and regional authorities, with the pathway from policy objectives to implementation prepared and assisted by the use of public land. It demonstrates that creative frameworks can bridge the financial viability gap across social, affordable and intermediate segments and support continued housing supply through real estate cycles. There are a range of stabilisers that can achieve this and the capacity to activate them through a cycle should be built into industrial housing strategies to ensure housing delivery occurs over the next decade and continues without impediment.

Chapter 5

Solving the housing challenge through alignment of public and institutional capital

- An undersupply of housing has resulted in an affordability crisis in every segment of the market and institutional capital is required to rapidly accelerate supply to fully rehabilitate Europe's housing markets, unimpeded by economic cycles or barriers at the local scale.
- There are good examples of public private models across Europe that are harnessing institutional capital to deliver on specific goals across low to moderate and to a lesser extent, middle income housing needs.
- Although they demonstrate that public and institutional investors objectives can be fully aligned and that policy tactics to mobilise capital can be at low or no cost, they are insufficient in isolation as a solution to the housing crisis.
- An industrial housing strategy is required that aligns all stakeholders to delivering on an agreed plan for housing, explicitly recognising and supporting stakeholder requirements and enabling stakeholders to commit to delivering through a multi-decade horizon.
- Industrial strategies need to extend from setting policy targets across segments and structures that have the capacity to mobilise institutional capital through to system change that provides for efficient deployment and delivery at the local scale.

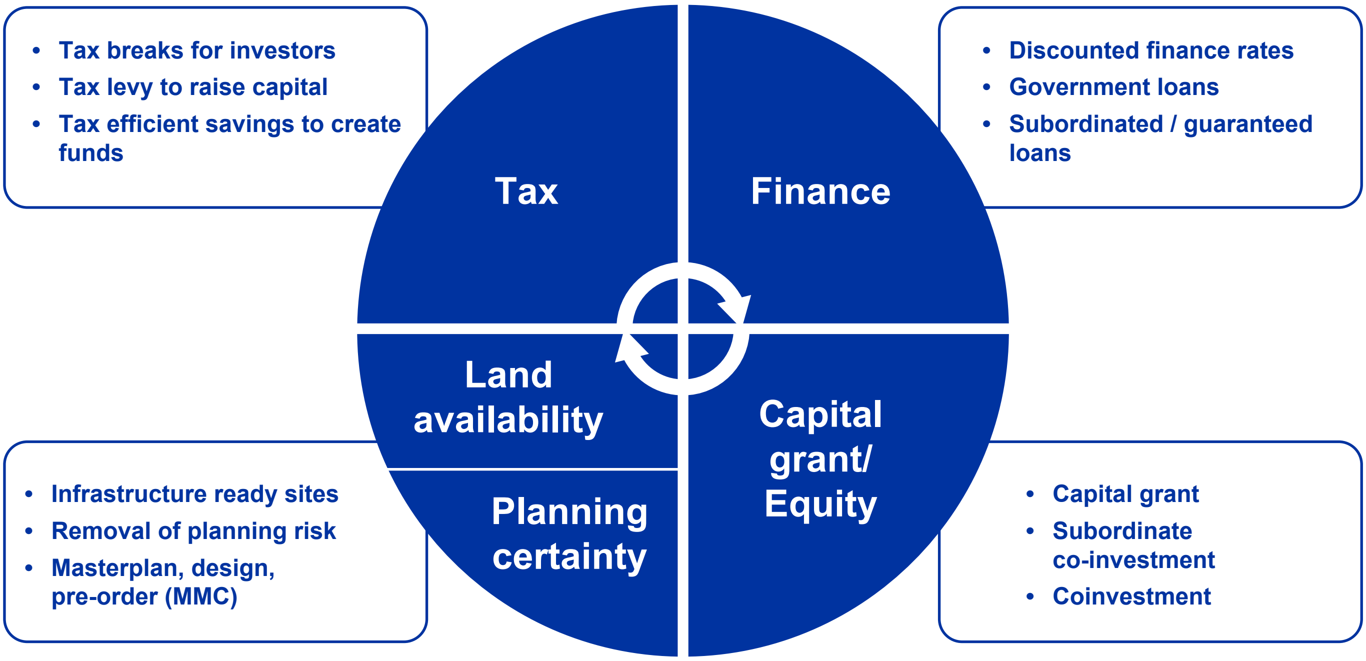
The scale of the housing challenge requires a multi decade industrial strategy. There is an affordability crisis and under-supply of housing in every segment of the market, and these challenges are interdependent. Policy measures aimed at moderating rents alleviate the systems for those with appropriate housing, but they are not a remedy. A rapid acceleration of supply that is unimpeded by either economic cycles or impediments to implementation at the local scale is the cure, and it requires a long gestation period of a decade of more to fully rehabilitate Europe's housing markets.

Equally, the magnitude – and financial cost – of the challenge requires institutional capital at scale to assist in the delivery of housing over at least the next decade. Institutional investor objectives are compatible with public sector goals, but they are not identical. Institutions have a first priority fiduciary duty to protect and enhance the savings of underlying savers and pensioners. Equally, the public sector and other stakeholders supported by public monies have a fiduciary duty to ensure public monies deliver the highest outcomes and beneficial value for citizens. Solving the housing challenge requires these interests to be aligned within a long-term industrial housing strategy that stakeholders can commit to through the required strategic horizon.

There are examples of public private housing models in use in a wide range of countries that are employing institutional capital to deliver on specific policy initiatives to accelerate the delivery of housing in targeted segments of the market (Boxes 1 to 7). The majority of these are employed within regulated social and affordable housing segments and low to modest income households at or below the median income, although there are examples extending through the third income quintile.

Although these frameworks represent progress, they do not form part of an over-arching, long-term strategy that has been constructed to align capital to delivering on an agreed plan for housing across all housing segments, with stakeholders committed to delivering through the horizon. However, together, these public/private arrangements represent a test-bed of different tactics that could be applied or adapted to enable aspects of an overarching industrial housing strategy (Figure 11). Most have arisen from an immediate need to provide supports to bridge the financial viability gap between cost of development and acquisition price, and achievable rent. This support may not always be necessary through a cycle or in every market segment, but an industrial strategy should be agile and be able to deploy stabilising actions when required through the strategic horizon to ensure a consistent flow of capital and ultimately, housing delivery.

Figure 11: Tactics employed to stabilise continued flow of housing delivery



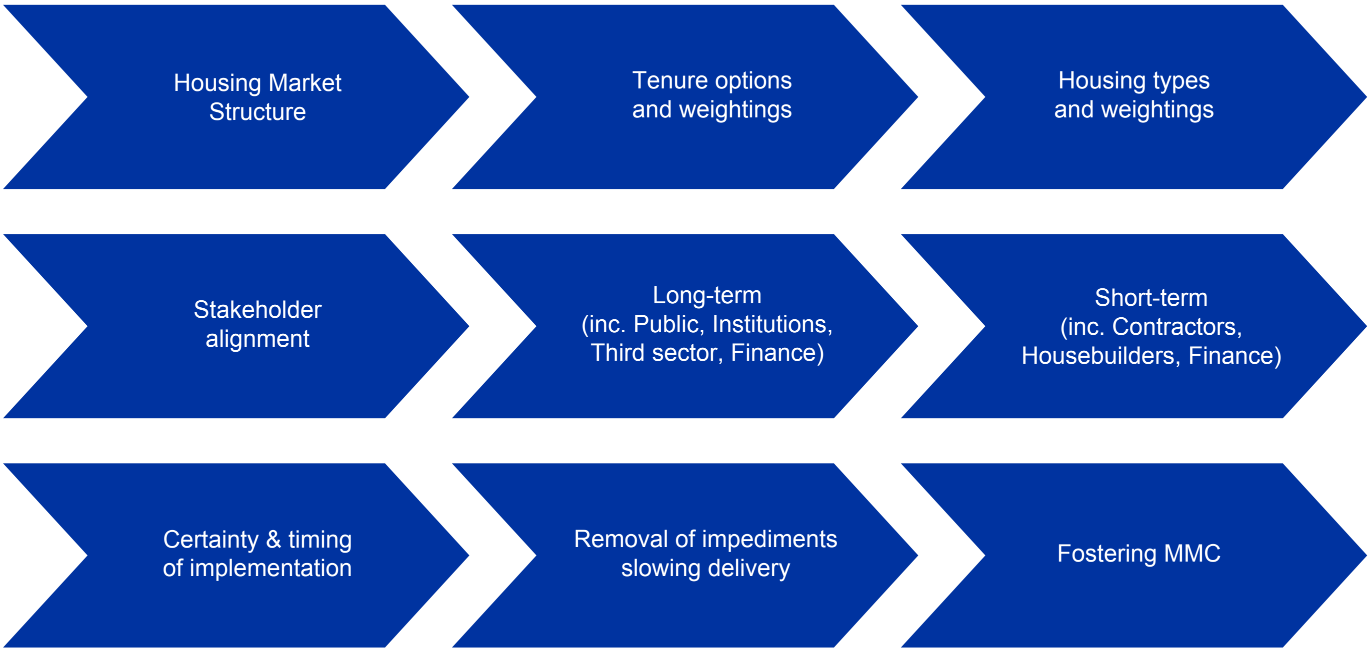
Existing public private initiatives range from those primarily centred on funding and finance availability and costs (Box 1 Mid market rent, Scotland and Box 2 Social and affordable housing, Finland) those using tax incentives (Box 3 Intermediate housing, France, Box 4 1% Logement, France and Box 5 Low and moderate income housing, US), those anchored in land availability, planning and certainty of timing (Box 6 El Plan Vive, Spain) and those based on a capital grant (Box 7 For profit regulated housing, England). Often, these initiatives blend elements together. For example, although the intermediate housing initiative in France is anchored in tax breaks it also represents public and private sector coinvestment. This adds the benefit of increased access to opportunities on public land and facilitates access to European Investment Bank (EIB) funding on attractive terms.

There are many stages and components to crafting an industrial housing strategy (Figure 11). First, it requires policy-makers to identify housing demand across location, tenure and housing type and analyse the housing solutions that might best address that need. This allows for a projection of how the future structure of housing markets might differ and how realising that change might require adjustments to landlord and tenant law and other legal structures. For example, if lower owner occupation rates are expected, adjustments to existing legal frameworks may be required to increase certainty of occupation for tenants. Similarly, there is an opportunity to accommodate more personalisation through providing for homes to be leased as shell structures, as exists in countries such as Austria and Germany where lifelong renting as a tenure choice is an existing segment.

Second, industrial strategies need to identify the stakeholders necessary to realising objectives including capital partners, investors, developers and managers across public, private and third sectors. Different stakeholders across the market have different objectives and different skillsets. Public and NFP housing bodies focused on lower income groups to provide a skill set that extends far beyond housing and into social supports that foster community cohesion and individual engagement to enable residents to thrive rather than merely survive. These specialist skills are less required in third and fourth quintile income housing, where place-making expertise of institutional investment is sufficient to develop community. Although institutional capital can be employed for any segment of the market, how it is used and the role of institutional investors and their relationship with other stakeholders is likely to differ across these segments. These roles and relationships need to be explicitly considered within the industrial strategy.

Recognising and aligning the differing objectives of stakeholders is essential. This paper has demonstrated that the returns required from the acquisition of a long-term, secure and predictable income stream by institutional investors are modest relative to the risk free rate. Its distribution to underlying investors distinguishes them from the public sector, although there is a symmetry in the

Figure 12: Multiple layers to an industrial housing strategy



beneficiaries as they comprise private and public key workers who comprise a large share of households struggling to find appropriate and affordable housing. Moreover, the level of return does not differ markedly from the income coverage required by other stakeholders who require a return to cover finance costs including private sector loans, with those profits ultimately distributed to shareholders as are those of private housing contractors.

Equally, there is some variation across institutions as to the level of risk they are permitted to take. In particular this impacts on the ability to undertake development. A number of very large investors with proprietary capital or who manage capital allocated to marginally higher risk strategies may have the capacity to develop and hold, for which they will seek a higher return. The scale of this capital can be increased and the risk – and therefore cost – reduced by smoothing the pathway to delivery at the local scale, including the use of public lands, streamlining planning and having infrastructure ready sites.

Removing these impediments at the local scale to the implementation of housing strategy is the third tier of the industrial strategy. It is fundamental to securing institutional capital, reducing costs and therefore risks, and to the overarching success of the strategy. This also creates certainty around timescales and as a result, greatly assists in enabling MMC companies to scale. The housing initiative El Plan Vive created by the Comunidad de Madrid provides a useful template for marrying housing policy objectives to practical delivery at the local level (Box 6).

Beyond the very large institutions, most small and medium sized pension plans solely managing their underlying pensioners capital can acquire stabilised income streams, but not put capital at risk to develop them. Given the scale of this capital, bridging this void is crucial and mechanisms beyond forward funding may be required to mobilise it. Again, existing initiatives offer assistance. In France, Caisse de Dépôt recently raised capital through creating an institutional investment fund from its existing social housing portfolio providing institutional investors with secure income stream which provided capital to reinvest in the refurbishment and retrofitting of existing stock and new housing development (Box 3). As well as raising capital from existing portfolios, there is potential for the public sector to develop a system of capital rotation from an initial investment in the new housing supply.

Developing a system of capital rotation adds a further impetus to expanding capital and accelerating housing delivery, while reducing the burden on public spending. Although common to many publicly regulated cost-rental affordable housing systems, the transition to self-sufficiency through closed end cashflow frameworks took decades. However, in addition to the rotation of capital being employed by Caisse de Dépôt, other frameworks are also developing capital rotation models. For example, in Spain (Box 6), capital receipts to the public sector are ring fenced and available to recycle into further support for housing development, reducing the requirement for public sector capital to be replenished.

Box 1: Access to discounted finance through public loan – Mid-market housing, Scotland

In 2018 the Scottish government issued an open invitation to tender proposals for the development of mid-market rental homes (MMR) with an offer of up to 50% public funding. The aim of MMR is to target households on low to modest incomes (below median household income) that do not qualify for access to social housing and for whom home ownership is unaffordable. Following the tender process, the Scottish government developed a framework with an investment manager that is primarily based on a repayable, but heavily discounted finance loan (0.01%). The loan provision essentially seeds a third party fund, with the ambition of attracting institutional capital to accelerate the delivery of affordable mid-market rental homes. The fund attracted institutional capital at a ratio of 4.5 times the loan facility of £47.5 mn, delivering 1,200 MMR homes, providing a significantly better outcome than traditional grant funding.

The investment vehicle forward funds equivalent market rate developments and upon completion leases them at a discount to market value, at a rent equivalent to the 30th percentile of the Broad Rental Market Area (BRMA) rent spectrum. This mirrors the methodology and threshold set for Local Housing Assistance (LHA) payments. On an affordability basis, a 25% rent to household income ratio is targeted. Rental progression is index linked, providing predictable and certain income streams for long-term investors.

This public private funding platform has proved successful at delivering affordable homes to those on below median household incomes including key workers. The Scottish Government has announced a new programme of investment, increasing both its funding and target for MMR homes through the initiative two-fold. This approach can be easily adapted to expand housing delivery in any segment of the PRS market.

Box 2: Discounted finance rates – Social and affordable housing, Denmark, Finland

In many countries, including Denmark and Finland, HAs are able to access discounted finance rates for new construction through conduits that are established and managed by a state-controlled entity. In Denmark, a separate capital centre was established specifically for covered bonds for social and affordable housing which benefitted from a state-backed guarantee. The government also acquires these bonds and converts them into government securities, providing for a further interest rate discount.

In Finland, capital gains tax exempt savings bond are available thorough certain financial intermediaries, with government-backed funds available at pre-subsidised interest rates for social and affordable housing. This is similar to the Livret A savings funds in France[21]. These approaches are easily adaptable for use as an enabler of any housing policy target.

21 The Livret A is a savings product regulated by the State, with interest is exempt from income tax and social security contributions.

Box 3: Tax incentives - Intermediate housing, France

In France, a subsidiary of Caisse de Dépôt (CDC) - CDC Habitat - has responsibility for setting and executing housing strategy for social, affordable and intermediate housing[22]. As a semi-public real estate company, CDC Habitat aligns with Government policies and legal structures and is capitalised from a combination of its own capital and access to funding sources such as the tax exempt Livret A savings bond that provides a funding source for social housing development.

Given the wide scope of CDC Habitat’s responsibility, their activities form the basis of an industrial housing strategy that considers the interaction of different segments of the market on demand and supply. Embedded within this strategy is an example of a public private arrangement that seeks to harness institutional capital for the delivery of intermediate PRS housing, targeting 3rd and early 4th income quintile households.

The initiative is facilitated by the 2017 Finance Law which was introduced to encourage intermediate housing delivery, providing investors with a reduced VAT rate of 10% and exemptions from property taxes for twenty years.

CDC Habitat established Ampere Gestion as an investment management subsidiary that enables it to leverage on its physical, digital and intellectual capital through inviting institutional capital to coinvest in intermediary housing funds. The initiative has harnessed over €4 BN institutional capital since 2018 to assist in delivering just under half of CDC Habitat’s target delivery of forty-five thousand intermediate homes by 2025.

In addition to the tax incentives, institutional investors in the funds also benefit from the improved land availability of partnering a publicly owned entity that is already engaged in regeneration of sites providing mixed tenure housing, including social and affordable.

In exchange, investors are required to lease units at a 20% discount to their market rate for a minimum of fifteen years. Investments are also eligible for preferred rates of finance with the European Investment Bank[23].

CDC Habitat has also partnered with institutional investors in social housing either in separate account structures in respect of public workforce housing portfolios, or through co-investment in its social housing fund. These are created through vesting a portfolio of existing holdings with stabilised, predictable income streams and inviting institutional investors to participate, with such institutional investment enabling recapitalisation that supports CDC Habitat in their continued development of social and affordable homes.

Although Caisse de Dépôt and its subsidiary CDC Habitat represent a unique public investment management structure, many aspects of the approach are replicable and scalable in other countries. Using tax incentives to create frameworks that enable intermediate housing to be both affordable and financially viable has the capacity to harness, direct and shape institutional capital. The use of public land also offers the potential for public-private vehicles that can attract both domestic and international institutional capital.

22 Caisse des Dépôts et Consignations is a major public financial institution dedicated to serving the public interest through its management and development of public assets. https://www.caissedesDépôts.fr/
23 The European Investment Bank is the lending arm of the European Union and for projects aligned with its sustainable development goals it offers attractive finance terms, guaranteed covered loans, tailored finance and access to longer fixed loans.

Box 4: Tax levy as funding pool - 1% Logement, France

In 1952, France introduced a new tax law at 1% of private sector payroll, named the Employers' Participation in the Construction Effort (PEEC) to finance the housing of employees with modest incomes. Commonly referred to as the 1% logement, the rate is currently set at 0.46% and is centrally collected and managed by Action Logement[24]. Amongst the diverse range of solutions offered to support employees housing needs, Action Logement offers finance to qualifying investors seeking to deliver social or intermediate housing. Loans for qualifying intermediate housing - leased at a 15% to 25% discount to market rate - are provided for up to 30% of the gross asset value at a subsidised fixed rate for up to thirty years, with deferred amortisation for up to five years.

Given the stress on public finances, this approach is interesting as although funding is raised through a form of taxation, it is ringfenced and managed by a discrete entity.

Box 5: Tax Credits - Low Income Housing Tax Credits, U.S.

In the U.S. the private sector is incentivised to deliver affordable housing through an annual federal tax credit programme. In 2023 $13.5 BN was distributed at the state level. Developers and financial institutions investing in qualifying investments for Low Income Tax Housing Tax Credits (LIHTC) must adopt tenancy, rent and duration criteria that meet one of the rent to area median income (AMI) tests:

1. A minimum of 20 percent of total units provided to occupiers with an income of up to 50 percent of AMI.

2. A minimum of 40 percent of total units provided to occupiers with an income of up to 60 percent of AMI.

3. A minimum of 40 percent of the units provided to occupiers with an income up to 60 percent AMI, and remaining units provided to occupiers with an income up to 80 percent of AMI.

The gross rent received must not exceed 30 percent of the threshold AMI used. Investors must comply with the tenancy, income and rent tests for fifteen years, while the LITHC is received at an accelerated rate over a ten year period.

The effect of these tax credits is to level the playing field in the market, enabling developers and particularly longer-term investors to compete in the market by trading off tax credit benefits against below market rate rental levels. The tax credits are a tradeable commodity and are an important enabler of affordable housing delivery. In addition, development of the assets will often qualify for financing through tax exempt bonds.

The system also has an important interaction with financial institutions responsibilities under the 1977 Community Relations Act, which requires regulated financial institutions to deliver services to underserved populations in which they receive deposits, savings and investments. Investments in affordable housing meet this criteria and usually also offer the strongest risk adjusted return profile against other investments in low economic development areas.

The LIHTC has proved successful means of delivering affordable housing, with demand for LIHTC supports outstripping allocated funds and is a useful example of how tax incentives can be used to direct and accelerate housing delivery.

24 https://www.actionlogement.fr/bailleur/besoin/produire-des-logements-locatifs-en-metropole

Box 6: Land availability and planning certainty – El Plan Vive, Madrid

Initially devised by the Comunidad de Madrid, Plan Vive harnesses private capital for the delivery of affordable rental housing through creating a framework that balances private and public interests. The provision of public land with predetermined planning permission for affordable housing is central to the model, with interested stakeholders invited to submit bids for the development rights, future income and asset management of sites. Within the plan, the land is provided on concessionary licence for a period of fifty years and on expiry of the licence, the land reverts to the ownership of the municipality. Investors arrange their own development finance and upon completion as an environmentally and socially sustainable asset closely aligned with multiple UN SDGs it qualifies for access to European Investment Bank finance.

Essentially, stakeholders are bidding for the right to develop a fifty year income stream from the provision of affordable housing, with clear rules on the determination of rents, rental development and qualifying tenants. The planning for each site predetermines the number of units to be provided under two regulated lease frameworks, namely Basic Public Protection Housing (VPPB) and Limited Price Public Protection Housing (VPPA). Each type of protected housing has specific criteria regarding size, and eligibility requirements with the aim of catering to different segments of the population in need of affordable housing options. Broadly, VPPB caters for households on low to moderate incomes, while VPPA also extends to households with incomes in the fourth income quintile. To be eligible to lease a housing unit, housing costs cannot exceed 35% of household income.

Through the competitive tender, bidding consortiums of investors, contractors and other parties provide details of their proposals including the range of units they are providing, amenities and proposed rents. The provision of land enables proposed rents to be at 20 to 25% discounts to market rate, with rents indexed to maximum CPI.

In addition to the benefit of land at no cost, the financial viability is supported by a number of factors that enable greater certainty over timing and predictability of costs. Modern methods of construction (MMC) are used enabling the industrialisation of the development process, involving prefabrication of structures off-site and assembly on-site. This results in a 30% reduction in project completion times, a 40% reduction in carbon emissions and a 50% reduction in onsite noise and site waste.

Importantly, proceeds to municipalities are ringfenced and available to reinvest in land assembly and site work such as infrastructure readiness. This rotation of capital assists in enabling a continued flow of institutional capital with the cycle of new assets.

The approach has proved successful and Plan Vive has been rapidly adopted by other regional and municipal authorities across Spain. In Portugal, the cities of Lisbon and Porto are exploring its potential implementation.

Box 7: Equity, capital grant - For-profit regulated housing, England

In the UK, through its housing and regeneration agency Homes England, public sector support for the development of regulated affordable housing has been extended to the private sector. Institutional investors are required to register as for-profit affordable housing providers and therefore be subject to the social housing regulator. For-profit entities are eligible for receipt of capital grant to support the delivery of homes on a secure tenancy, at an affordable rent of 80% of the open market rent. The funding also supports other affordable housing tenures, such as shared ownership.

For-profit entities replicate the activities of the not-for-profit sector with the aim of accelerating delivery. However, in practice it is less of a duplication of activities and has led to partnership and joint ventures between for-profit and not-for-profit stakeholders. Institutional investors bring equity and financial structuring expertise and marry to not-for-profit HAs tenant management, community development and operational expertise.

Institutional capital is already assisting in accelerating housing delivery through direct investment and also through recapitalising existing not-for-profit HAs through the acquisition of existing portfolios, often involving a leaseback to HAs or the award of a management contract. This model is focused on regulated affordable housing for those on low and modest incomes, where the need for housing solutions in the UK is most acute. Indirectly, it reduces pressure on the PRS.

Chapter 6

Conclusions

Europe's housing markets are broken. There is an acute shortage of housing stock, existing stock requires investment to improve its quality and energy efficiency, and the cost of housing – whether to rent, buy or develop – is out of step with household incomes. A crude estimation of the cost of the challenge across seven markets is estimated at almost €12 trillion. This puts the solution beyond the scope of most parliamentary cycles and beyond the financial capacity of public authorities in isolation.

Given constraints on public finances across most countries, harnessing compatible private sector capital has the capacity to greatly accelerate housing delivery. Institutional investors are an appropriate partner to the public sector and share the mission to solve Europe's housing crisis. Understanding that their investment objectives are distinct from most other types of private sector capital is fundamental to understanding why long-term institutional investment is highly compatible with public sector stakeholders. Their low risk appetite is reflected in a modest required return over the risk-free rate.

Moreover, their long-term investment horizon provides for a capacity to commit to the delivery of a long-term industrial housing strategy that rebalances demand and supply and in turn, affordability. At the same time, their activity can assist in resetting housing market structures to better meet household needs. Benefits extend beyond the potential scale of housing delivery to improved quality of housing, management and an expansion of tenancy options available to households, with a focus on environmental and social sustainability.

Institutional capital is key to expanding the scale of housing delivery at pace. Many markets have developed initiatives to harness institutional capital in the delivery of specific housing policies and short term targets. Examples of interventions and policy stimulus that have been employed in different countries as a means of supporting institutional investment in regulated social, cost rental and intermediary housing demonstrate that interventions that mobilise capital are often at low or no cost.

No one intervention is a panacea for the housing challenge and at present they neither emanate from or are embedded in any long-term industrial strategy that aligns all stakeholders in the delivery of a longer-term housing solution. However, together they represent a toolbox of initiatives that might be useful policy levers within a long-term industrial housing strategy through economic cycles. In isolation, these approaches offer useful test-beds of public/ private structures and their outcomes. However, without a long-term strategy aligning stakeholders to the mission, they represent band aids.

Europe's housing crisis is of pandemic proportions and this emergency requires a multi-stakeholder response to develop action plans to remedy it. Institutional investors and the public sector, together with other long-term stakeholders need to align their objectives and together, formulate an industrial housing strategy that they can commit to delivering over the next decade and beyond. Developing a strong understanding of institutional investors return requirements and constraints will greatly assist policy-makers in aligning their ambitions to address the housing crisis.

25 England, France, Netherlands, Germany, Ireland, Spain and Sweden

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