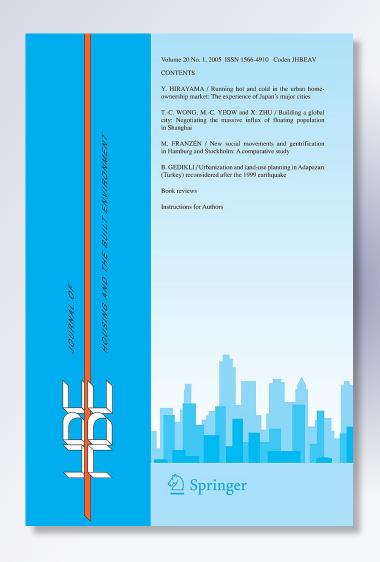
The credit crunch and subsidized low-income housing: the UK and US experience compared

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ARTICLE

The credit crunch and subsidized low-income housing: the UK and US experience compared

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Abstract This paper examines how the mortgage crisis and subsequent recession have affected subsidized rental housing in the United Kingdom and the United States. These two nations approach the housing needs of low-income households in very different ways and to very different degrees. In the UK, non-profit housing associations are pivotal to the production and management of affordable rental housing; in the US, the affordable housing system revolves mostly around a single program, the Low-Income Housing Tax Credit. Yet the crisis destabilized key parts of both countries' subsidy systems and raised important questions about their sustainability in the future. The UK responded sooner and arguably more effectively than the US to the crisis. However, over the longer term, the prospects for affordable housing development are likely to be more difficult in the UK than in the US.

Keywords Subsidized housing · Social housing · Housing associations · Low-income housing tax credit · Housing policy in the UK and US · Financial crisis

1 Introduction

Most of the research, policy analysis, and reporting on the crisis in housing and mortgage markets that has beset much of the developed world since 2007 has focused on homeownership—on collapsing house prices, surging rates of mortgage foreclosure, and the uncertain shape that mortgage lending will take in the future. While the homeownership sector was hit extremely hard by the crisis, so too was rental housing, and within it, subsidized housing for low-income households. This article examines how the crisis has affected subsidized rental housing in the United Kingdom and the United States. These two nations approach the housing needs of low-income households in very different ways, using quite distinct methods of providing subsidy. Yet the crisis destabilized key parts of both countries' subsidy systems and raised important questions about their sustainability in the future.

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In the UK, non-profit housing associations had become increasingly reliant on the market to supplement government grants for the development of low-income rental housing: bank loans accounted for an increasing portion of development costs; additional funding was derived from the development of housing for sale in the private market; and a significant proportion of new housing originated from "Section 106" agreements, by which private developers ceded a portion of the housing they built to housing associations. In the US, most of the subsidized low-income rental housing built since the late 1980s was financed through the sale of tax credits. Private investors purchased rental housing in order to take advantage of federal Low-Income Housing Tax Credits; the proceeds of these sales provided essential equity for housing development. The crisis greatly diminished these market mechanisms in both countries.

In assessing the impact of the housing crisis and subsequent financial crisis and economic recession on subsidized rental housing in the UK and US, I draw from a combination of government reports, academic studies, articles from the trade press, and interviews. The interviews focus mostly on the impact of the crisis on housing associations in the UK; there was less need for interviews on the impact of the crisis on the market for tax-credit housing in the US, since the subject is less complex and has been fairly well documented in several key reports and other publications (e.g., Belsky and Nipson 2010; Ernst and Young 2009; Smith and Handelman 2009; Joint Center for Housing Studies 2009b; Schwartz 2010). The UKbased interviews involved government officials, senior executives at 11 housing associations and at one arms-length management organization [a non-profit manager of housing owned by a local council, and the chief executive of England's federation of housing associations. Although the housing associations covered by the interviews do not constitute a random sample, they hold property throughout England and in other parts of the UK as well. Several of the nation's largest associations are included. Collectively, the housing associations interviewed for the study owned or operated about 324,000 housing units, more than 12 percent of the sector's total housing stock. In addition, one of the housing association executives interviewed for the study also serves as the chairman of a coalition of 15 large London-based housing associations, which together account for 360,000 homes (280,000 additional units, when the housing of the two member organizations interviewed for this study are excluded). (See bibliography for list of interviews.) Finally, most of the research was focused on England. All of the interviews involved housing associations based in England, although some owned rental housing in Scotland and in other countries of the UK. Moreover, some of the government data used for the study applies only to England. England accounts for 84 percent of the UK's population (Office for National Statistics 2009).

The paper is organized in six parts. Part 1 briefly sketches out the scope and impact of the housing and mortgage crisis in the UK and US. Part 2 describes the primary systems of housing subsidy in the two nations. Part 3 details the effect of the crisis on subsidized housing in the UK and US. Part 4 examines how the government in the two countries responded to the crisis as it affected subsidized housing. Part 5 discusses the future prospects for affordable housing in the two countries in the wake of the crisis, and Part 6 offers some concluding observations.

2 The crisis in the UK and US

The housing and mortgage crisis hit both the United Kingdom and the United States, but conditions deteriorated earlier and more severely in the United States. As shown in Table 1, the housing market, whether measured in house prices or construction activity,



Table 1 Selected indicators of housing market and economic conditions: US and UK

	2000	2006	2007	2008	2009	Percent change	nge				
						2000-06	2006-07	2007–08	2008-09	2006–09	2007–09
House price in	House price index (avg. monthly rate)	dy rate)									
SO	108.1	186.7	171.0	139.8	136.4	72.7	-8.4	-18.2	-2.5	-27.0	-20.3
UK	92.5	167.0	183.4	167.4	168.0	80.4	8.6	-8.7	0.3	9.0	-8.4
Housing completions	letions										
SN	1,573,700	1,979,400	1,502,800	1,119,700	796,000	25.8	-24.1	-25.5	-28.9	-59.8	-47.0
UK	176,750	212,800	225,330	182,960	151,620	20.4	5.9	-18.8	-17.1	-28.8	-32.7
Housing starts											
Sn	933,800	1,204,900	1,025,000	780,900	495,000	29.0	-14.9	-23.8	-36.6	-58.9	-51.7
UK	186,190	223,970	228,650	134,500	106,780	20.3	2.1	-41.2	-20.6	-52.3	-53.3
Mortgage foreclosures	slosures										
US (rate)	0.4	0.5	0.7	1.1	1.4	14.6	51.1	50.7	32.7	202.1	100.0
UK (number)	30,000	20,900	26,200	40,000	47,700	-30.3	25.4	52.7	19.3	128.2	82.1
Unemployment	Unemployment rate (avg. monthly	thly rate)									
Sn	4.0	4.6	4.6	5.8	9.3	15.2	0.0	26.2	59.5	101.3	101.3
UK	5.6	5.5	5.4	5.8	7.8	-1.8	-1.8	7.4	34.5	41.8	44.4
			. 00								

Source: House Price Indexes: US, Case Shiller 20-city composite index; UK: CLG mix-adjusted index

Housing completions and starts: US: US Census Bureau; UK: CLG live tables

Mortgage foreclosures: US: HUD, Housing market conditions; UK: CLG live tables

Unemployment rates: US: Bureau of labor statistics, UK: Office for national statistics



peaked in 2006 in the United States, and in 2007 in the UK. By all measures, the downturn was steepest in the US. For example, while in the US house prices (as measured by the 20-city Case Shiller house-price index) declined by 27 percent from 2006 to 2009, in the UK they declined by 8.4 percent from 2007 (the peak year) to 2009. Similarly, while housing completions declined by nearly 60 percent in the US from the peak year of 2006 to 2009, they declined in the UK by "just" 32 percent from the peak year of 2007 to 2009. Housing starts, however, declined at similar rates in the two countries from their peak year to 2009 (59 percent in the US, 55 percent in the UK).

Although the two measures of mortgage foreclosure for the US and UK are not directly comparable, they indicate that foreclosures increased more rapidly in the US. Unemployment, a measure of overall economic conditions, also increased more sharply in the US than in the UK. Nevertheless, the downturn in the housing market and the related fall in the mortgage market (collapse is the more apposite word for the situation in the US), triggered severe turmoil in the financial sector in both countries. Both saw major banks and other financial institutions fail and the government invest billions of dollars or pounds to keep others afloat, in some cases nationalizing them in the process. Both countries injected billions more to stabilize their faltering economies.

3 Subsidized housing in the UK and US

Although the United States has four times as much housing as the United Kingdom, it has only 25 percent more subsidized rental housing (see Table 2). About 7.6 million

Table 2 Social Housing in the UK and US (million)

	Total	Pct total housing stock (%)	Pct total renting housing (%)
UK			
Total occupied housing stock	26.65		
Housing associations	2.38	9	29
Local authority	2.59	10	32
Housing benefit for private renters	1.21	5	15
Total social housing	6.17	23	76
Excluding housing benefit	4.97	19	61
US			
Total occupied housing stock	110.69		
Public housing	1.16	1	3
Other housing with project-based subsidies	1.78	2	5
Vouchers	2.28	2	7
Low-income housing tax credit	1.90	2	5
Other federally subsidized housing	0.50	0	1
Total	7.62	7	22
Excluding vouchers	5.34	5	15

Source: Schwartz (2010); Wilcox (2009)

UK figures exclude housing benefit received by residents in council and housing association-owned housing UK data also excludes households in subsidized low-cost homeowner housing



households reside in federally subsidized housing in the United States, accounting for about seven percent of all occupied housing and 22 percent of all rental housing. About 6.2 million households in the UK receive housing subsidies, accounting for 23 percent of the occupied housing stock and 76 percent of all rental housing. This contrast reflects fundamental differences in how the two nations approach housing and social policy more generally. The UK, like most other Western European nations, has long provided more extensive and more generous welfare benefits to its residents than has the US, often providing near-universal coverage (Barr 2001; Castles 2010; Esping-Andersen 1990). In the United States, social welfare benefits tend to be more limited and are often more tightly rationed (Skocpol 1995). In regard to housing, rental subsidies are available to nearly all low-income renters in the UK, but in the US, eligible households are not automatically entitled to rental assistance; for every renter with federal rental subsidies, three others receive no assistance at all² (Schwartz 2010).

In the UK, the government has subsidized much of the rental housing built over the past 100 or so years (Malpass 2005). The government built and operated most of the rental housing constructed from the 1930s through the 1980s, with local councils playing the lead role. Non-profit housing associations developed most of the rental housing built since the late 1980s but received substantial government subsidy to do so. The private market generated relatively little new rental housing, focusing mostly on homeowner housing (Kemp 2010; Lowe and Hughes 2002). Moreover, virtually all low-income families in Great Britain are entitled to rental subsidies in the form of Housing Benefit (Stephens 2005). This program is designed to ensure that households have a minimum income after paying for their rent. The government covers the entire rent (up to a certain limit for housing in the private rented sector) for households with incomes at or below the social assistance rate. The subsidy tapers off sharply for households with higher incomes (Stephens 2005). Housing Benefit is Britain's largest subsidy for housing and is one of its largest expenditures in the social security budget (Pawson and Wilcox 2010).

In the United States, most rental housing is under for-profit ownership and is not subsidized. As noted above, only one-fourth of all eligible low-income renters live in federally subsidized housing. In the UK, housing associations are currently central to the development and management of affordable rental housing. In the US it is not an institution but a program, the Low-Income Housing Tax Credit (LIHTC), that is essential to the development of subsidized rental housing. Other federal subsidy programs, including public housing, have produced little new housing since the 1980s. The only other federal program besides the LIHTC to expand significantly since the 1980s is the Housing Choice Voucher program (formerly known as Section 8) (Schwartz 2010). Both housing

³ An exception is "buy-to-let" housing. For about 10 years prior to the onset of the credit crunch, a growing number of mostly individual investors acquired houses and apartments to rent out. In some cities, real estate developers constructed properties targeted to buy-to-let investors. Lenders devised mortgages specifically for buy-to-let investors. The buy-to-let market was an early casualty of the credit crunch. The number of new buy-to-let loans dropped by more than 70 percent from 2007 to 2009 (Council of Mortgage Lenders 2010a; see also Kemp 2010).



¹ These figures do not include households subsidized through state and local housing programs that do not rely on federal funding. They account for a very small share of the nation's subsidized housing and are concentrated in a handful of states (Mueller and Schwartz 2008, Schwartz 2010).

² Unlike renters, homeowners in the United States are automatically eligible for housing subsidies in the form of mortgage-interest and property-tax deductions and capital-gains tax exemptions of up to \$500,000 from the sale of residential property (Schwartz 2010).

associations and the LIHTC, in quite distinct ways, rely on market mechanisms to finance low-income rental housing. Both were severely tested by the credit crunch.

That rental housing subsidies are far less prevalent in the US compared to the UK is reflected in the former country's more severe problem of housing affordability. Although housing affordability data in the two countries are organized differently, the incidence of housing cost burden is clearly much greater in the US. In the UK, renters pay an average of 22 percent of their *disposable* (post-tax) incomes on rent, and 36 percent spend 30 percent or more of their income on rent (Communities and Local Government 2010a). In the US, renters on average pay 33 percent of their *gross* (before tax) income on rent, and 51 percent spend 30 percent or more of their gross income on rent (US Census Bureau 2008). Were the UK's housing affordability data expressed in terms of gross income instead of disposable income, the disparity between the two countries' housing affordability problems would be wider still. Moreover, more than 20 percent of all renters in the US spend more than *half* of their gross income on rent, including more than 45 percent of all renters in the bottom quartile of the income distribution (Joint Center for Housing Studies 2009b). The UK does not report on such severe levels of housing cost burden, perhaps because the availability of Housing Benefit greatly reduces its incidence.

3.1 UK: housing associations

The vast majority of subsidized rental housing produced in the United Kingdom over the past two decades has been provided by housing associations. These non-profit organizations specialize in the development and management of affordable housing for low- and moderate-income households. As of 2009, they owned nearly 2.4 million housing units (Tenant Services Authority 2010b). This represents about half of all social housing but more than 90 percent of all social housing built since 1990. About 1,700 housing associations operated in the United Kingdom as of 2009, but most are small, owning fewer than 250 homes. More than 95 percent of all housing owned by housing associations is controlled by 393 associations that own 1,000 or more housing units (Tenant Services Authority 2010b). Moreover, 44 percent of the housing is owned by 59 associations, each owning at least 10,000 housing units (Tenant Services Authority 2010b). Similarly, a relatively small share of all housing associations have been actively engaged in developing or acquiring new housing; most focus on the management of their existing stock (Harriott and Matthews 2009).

More than 90 percent of the housing owned or otherwise managed by housing associations consists of social housing. This housing is highly regulated, with rent increases, tenant eligibility criteria, among other aspects, largely determined by the government (Harriott and Matthews 2009; Malpass 2010). The great majority of social housing residents have very low incomes, and most are retired, disabled, single parents of young children, or otherwise out of the labor force (Wilcox 2009: Tables 31C and 34 to 38). More than two-thirds receive rent subsidies (Housing Benefit) (Wilcox 2009: Table 116C). The importance of Housing Benefit to the finances of social housing, and of housing associations, cannot be exaggerated. Housing Benefit assured housing associations of a steady cash flow enabling housing associations to borrow on very favorable terms (Harriott and Matthews 2009; Stephens 2005).

Although social housing comprises the vast majority of their property, housing associations have also built or acquired substantial amounts of housing for higher-income households since the early 2000s. These include various types of "low-cost homeownership housing" and "intermediate rental" housing (Housing Finance Group 2010: 35).



Low-cost homeownership housing and market-rate housing for sale in the open market were important sources of revenue of housing associations, enabling them to crosssubsidize the development and acquisition of social housing.

Housing associations finance housing development through a combination of government grant, debt, and their own resources. In recent years the government reduced the level of grant funding from as much as 80 percent of total development costs in the 1980s to about 40 percent or less by the mid-2000s. In the 2000s it was common practice for the government to seek the lowest bids on proposed developments. The government would provide grants to the associations that promised to build housing with the least amount of grant. The rest of the development's cost would be covered by debt and other resources (Harriott and Matthews 2009).

Housing associations relied heavily on bank financing to fund their development. Banks and other lenders historically provided housing associations with loans on very favorable terms. Until the advent of the credit crunch, banks priced loans to housing associations at 20 to 30 basis points above LIBOR (House of Commons, Communities and Local Government Committee 2009). A housing association's borrowing is limited by (a) its "interest cover" (operating revenue must exceed interest cost by a minimum amount, usually five to 10 percent; and (b) its "gearing" (the total debt of a housing association must not exceed a specified proportion, usually 60 to 65 percent, of the book value of its assets). As a rule, older housing associations, especially those with properties in the more affluent south of the country, had much greater borrowing capacity than newer associations.

In addition to debt, housing associations often relied on their own assets and revenue to help fund housing development. Most often they built market-rate property for sale and/or property targeted to somewhat lower-income households through shared ownership programs, in which households acquired a portion of the equity in their home and the housing association held the balance. By producing market-rate or shared-ownership housing, housing associations could request lower levels of grant from the government and thus be better positioned to receive funding. Profits from property sales typically covered about 10 percent of the total development cost of social housing (Housing Finance Group 2010).

Much of the housing developed by housing associations since the mid-1990s involved "Section 106" agreements. Part of the Town and Country Planning Act of 1990, Section 106 requires developers to help meet the local community's need for infrastructure and affordable housing. In order to obtain planning permission to build, developers must reach agreement with local authorities about the scope and extent of their contributions (Monk et al. 2005; 2006). Housing associations almost always develop the affordable housing included in Section 106 agreements.

Section 106 accounted for a large and growing share of the affordable housing produced in England during the 2000s. Its share of total affordable housing completions in England grew from 20 percent in 2000 to nearly 65 percent by 2007. Most Section 106 housing was built in the London metropolitan area and elsewhere in the south of England, where the housing market was most vibrant. In 2007, for example, London, the East, Southeast, and Southwest accounted for 74 percent of the affordable housing completed under Section 106 (Communities and Local Government 2008).

3.2 US: low-income housing tax credit

The United States has relied heavily on the tax code to incentivize private investors to finance low-income housing over the past quarter century. While there has been very little production of new housing with direct federal subsidies (e.g. public housing) since the



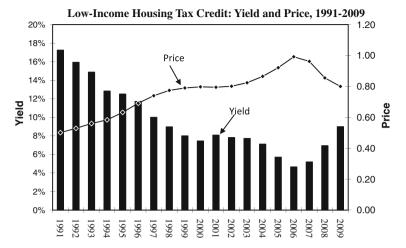


Fig. 1 Low-income housing tax credit: yield and price, 1991–2009. *Notes*: 2009 is to May; Chart refers to unguaranteed mulitinvestor funds. *Source* Ernst and Young, Unpublished data

early 1980s,⁴ more than two million units of rental housing for low-income households had been built since the mid-1980s with tax incentives, primarily the Low-Income Housing Tax Credit (LIHTC). The LIHTC is by far the nation's largest subsidy program for the development of low-income rental housing. Moreover, the LIHTC is often used in conjunction with other federal and state housing programs, including tax-exempt bonds, block grants, and the HOPE VI program for redevelopment of distressed public housing (Schwartz 2010).

Established by the Tax Reform Act of 1986 the Low-Income Housing Tax Credit (LIHTC) provides investors with a dollar-for-dollar reduction in their federal income taxes. Investors purchase interests, usually as limited partners, in qualified low-income housing developments and are entitled to claim a tax credit for 10 consecutive years. The amount of the tax credit depends on total development costs, the use of other subsidies, the extent to which the property is occupied by low-income households, and the location of the property. Projects involving construction or substantial rehabilitation are entitled to a nine-percent annual credit; projects financed with tax-exempt bonds or that involve acquisition only or minor amounts of renovation receive a credit of about four percent (Schwartz 2010).⁵

The LIHTC is not automatic. Developers must apply for the credits as if they were direct subsidies. The program resembles a block grant in that the state agencies that allocate the credits devise their own priorities and criteria for awarding credits to proposed projects. Such priorities and criteria may concern the types of people to be housed, the location and type of the housing, and the type of developer (for-profit, non-profit). Each state is allocated a finite amount of tax credits each year.

⁵ For example, a low-income rental property that costs \$10 million to develop, \$9 million of which constituted allowable expenses, would generate \$810,000 in nine-percent tax credits annually for ten years $(9,000,000*\ 0.09=810,000)$. For details on the mechanics of the LIHTC see Schwartz (2010).



⁴ With very few exceptions, the only new public housing to be built since the mid-1980s has been to replace public housing that had been demolished. Virtually no privately owned housing with direct federal subsidies has been built since the mid-1980s. See Schwartz (2010).

Until the onset of the crisis, the LIHTC was widely considered one of the most successful housing subsidy programs in US history (Belsky and Nipson 2010; Erickson 2009; McClure 2006). Over time it became increasingly efficient, generating increasing amounts of equity for housing developers. At first, the program generated less than 50 cents in equity for every tax credit dollar—that is, housing developers received 50 cents or less for each dollar in tax credits that were allocated to a project. Transaction costs and investor profit accounted for the other 50 percent. By the mid-1990s the program yielded more than 70 cents in equity, and by the mid-2000s developers received upwards of 95 cents or more for each tax credit dollar (See Fig. 1). As a result of the program's increasing efficiency, developers required less "gap subsidy" to make up the difference between the tax credit equity, the mortgage, and the total development costs (Schwartz 2010).

Over time, investors accepted lower and lower yields on their tax-credit investments, thereby paying more and more for each tax-credit dollar (Ernst and Young 2009). Part of the reason for the decreasing yields is that the tax credit proved itself to be a relatively low-risk investment (Schwartz 2010). Equally important, financial return was not the only motivation, or even the primary motivation, for investing in tax-credit projects. Investments in LIHTCs helped depository institutions (commercial banks and savings banks) receive favorable "Community Reinvestment Act" (CRA) ratings for their purchases of low-income housing tax credits. The Community Reinvestment Act requires depository institutions to serve all areas from which they draw deposits. Poor compliance with the act can jeopardize a bank's acquisition of another financial institution or its expansion into a new geographic area (Immergluck 2004). Investment in LIHTCs is counted as part of an institution's CRA-related investments. In other words, many financial institutions pursued tax-credit investments primarily for CRA-related purposes, less so for financial gain (Ernst and Young 2009; Smith and Handelman 2009; Joint Center for Housing Studies 2009b; Traylor interview).

In addition, Fannie Mae and Freddie Mac were obligated by Congress to serve underserved populations and communities (Schwartz 2010). Investment in tax credits was one way of meeting these annual goals. Together, these two institutions accounted for about 40 percent of all LIHTC investments as of 2006 (Smith and Handelman 2009).

4 The crisis and subsidized housing

4.1 UK: impact on housing associations

The credit crunch hit housing associations in several ways. The downturn in the housing market left housing associations with large amounts of homes they could not sell, it reduced the market value of the associations' housing stock and land holdings, and it

⁷ The LIHTC's rental limits constrain the amount of market-rate financing that can be used. Since rents are capped at what a household earning 60 percent of the area median income can afford (assuming an affordability standard of 30% of income), mortgage debt service payments combined with other operating costs cannot exceed this amount.



⁶ The amount that investors will pay for tax credits is determined by the yield they desire from their investment (discount rate). The higher the yield, or discount rate, the less investors will pay. For example, if investors demanded a yield of 20 percent, they would pay \$4.2 million for a project that generated \$1 million annually in tax credits for 10 years; but they would pay \$7.7 million for the same amount of tax credits if they required a yield of five percent.

stymied Section 106's ability to generate new affordable housing. Banks sharply increased the cost of credit for housing associations.

Demand for for-sale homes and shared-ownership housing plummeted, reducing revenue for housing associations (Dowler 2009). As noted above, housing associations had increasingly been building housing for sale in the open market to generate additional revenue to help fund development of social housing. Much of this housing involved shared ownership schemes in which the buyer purchased equity in the property in several installments over time, usually beginning with a stake of 25 percent. The crisis left housing associations with thousands of unsold housing units. While economic recession accounts for some of the reduced demand for housing, another factor was the tightened underwriting standards adopted by mortgage lenders. By 2009 lenders required borrowers to provide larger down payments, usually 20 percent, and they became leery of providing mortgages for shared ownership housing, viewing such loans as equivalent to subprime mortgages (housing association interviews; House of Commons, Communities and Local Government Committee 2009). Making matters worse, the downturn in housing prices reduced the market value of many of these properties below their original development cost. If housing associations could not sell housing intended for homeownership, they couldn't recoup their original costs, much less yield a surplus. Furthermore, these unsold properties tied up significant amounts of debt, preventing housing associations from using this debt to finance new housing (Tenant Services Authority 2010a: 9).

Not only did housing associations have difficulty selling new homes, their sales of existing properties also decreased. Fewer households who had previously purchased shared-ownership homes acquired additional equity in their homes, and fewer social housing tenants exercised their right to buy their homes. From 2007 to 2008, the number of housing association tenants exercising their right to buy their home dropped by 77 percent from 4,690 to 1,064 (Wilcox 2009: Table 20d). In total, proceeds to housing associations from the sale of new and existing properties decreased by more than £286 million, or 42 percent, from 2008 to 2009 (Tenant Services Authority 2010b).

Besides curtailing the ability of housing associations to generate funds to support development of social housing, the crisis also reduced the amount of housing acquired from private developers through Section 106 agreements. The crisis did not reduce the volume of affordable housing produced through Section 106 agreements in the short term. In 2008, these agreements accounted for more than 27,000 affordable completions in England, up five percent from the year before. But these involved developments that had already been in construction or were in the construction pipeline by the time the crisis arrived in late 2007 (Communities and Local Government 2008). Private-sector housing starts dropped by 48 percent from 2007 to 2008 and by 22 percent in 2009 (Communities and Local Government 2010a). Fewer starts will translate into less affordable housing produced under Section 106.

The most immediate impact of the credit crunch for housing associations involved their banks. Over the course of the past two decades bank loans had become increasingly central to the operations of housing associations. As government grants for housing development declined, housing associations financed a growing portion for their development costs with debt. For many years, banks charged housing associations low rates of interest, usually 20 to 30 basis points above LIBOR (Orr interview; House of Commons, Communities and Local Government Committee 2009). To protect themselves against subsequent increases in interest rates, housing associations often hedged their loans with interest rate swaps or



other derivatives. The relationship between housing associations and banks changed abruptly with the advent of the credit crunch.

In the face of the credit crunch banks increased interest rates sharply and otherwise made access to credit more difficult and expensive. Not only did they charge more for new loans, they sought to rewrite the housing association loans they had outstanding. Housing associations seeking additional financing found that banks demanded rates as high as 300 basis points above LIBOR, often more than 10 times higher than their previous rates. A number of lenders refused altogether to lend to housing associations (Hilditch 2009; House of Commons, Communities and Local Government Committee 2009; housing association interviews).

Not only did banks charge much higher rates for new loans to housing associations, they also sought to rewrite their existing loans, at higher rates and with shorter maturities. The covenants for housing association loans typically required banks to agree to changes in organizational structure, mergers with and acquisitions of other associations, and other significant changes. Covenants also specified maximum debt coverage ratios and debt-toasset value ratios ("gearing"). If an association breached these covenants, the lender had the right to call in the loan or set a higher interest rate. Prior to the credit crunch, banks routinely approved organizational changes without changing the loan; and when debt service or gearing shifted above the maximum threshold, banks usually gave the associations time to correct their finances before calling in the loan. The credit crunch saw banks abruptly change their stance towards housing associations. By all accounts they were eager to rewrite existing loans at higher interest rates and with shorter maturities, and saw even the slightest breach of covenant as an opportunity to do so (Tenant Services Authority 2010b; housing association interviews). For example, lenders would not approve plans of housing associations to consolidate subsidiaries into a single division unless the interest rate of the financing was increased and the maturity of the loans was shortened. As a result, housing associations sought to avoid making any change that could trigger a loan restructuring, even at the cost of significant savings (House of Commons, Communities and Local Government Committee 2009; Tenant Services Authority 2010a; housing association interviews).

In addition to much higher interest rates, and pressure to rewrite existing loans at higher rates, about 40 large housing associations faced large margin calls. These associations had taken out "stand-alone" interest rate swaps to protect themselves from higher interest rates in the future. However, the terms of these contracts entitled the associations' counterparties to demand additional collateral if interest rates fell below a critical threshold, usually three

 $^{^{8}}$ Most loans issued to housing associations and other borrowers in the UK are at variable rates. Interest rate payments may fluctuate over time with changes in a benchmark standard, usually LIBOR. Interest rate swaps enable housing associations and other borrowers to reduce the uncertainty of future debt-service costs by paying a fixed amount over a specified period of time. Most housing associations have interest rate swaps "embedded" in loan agreements with their lenders. Under this arrangement, housing associations pay a fixed amount in debt service payments. The lender enters into an interest rate swap with a separate counterparty, in which the "bank 'swaps' the fixed rate received from the association for a variable rate from [the] counterparty" (Harvey and Webb 2008). A much smaller number of housing associations have taken out "stand-alone" interest rate swaps. Instead of having the bank enter into an interest rate swap with a counterparty, the housing association does so itself. The association pays the counterparty an amount based on a fixed interest rate, the counterparty pays the association an amount based on a variable rate, which the association then pays to the bank. The advantage of stand-alone swaps is that they may be less expensive than embedded swaps, for which there is no price competition; banks offer them on a "take it or leave it basis" (Harvey and Webb 2008). The disadvantage, is that under certain circumstances, including rapid decreases in interest rates, counterparties can demand additional collateral from the housing associations. See Harvey and Webb (2008) for a succinct explanation of both types of interest rate swaps.



percent. When interest rates fell below three percent in late 2008, these associations were asked to supply more than £400 million in additional collateral, most of which had to be in cash (as opposed to securities and other assets) (Obertelli 2010; Tenant Services Authority 2010b). Most associations had interest rate swaps "embedded" in their loan facilities and therefore did not confront margin calls; only those with separate, stand-alone contracts were exposed (Harvey and Webb 2008; Tenant Services Authority 2010a and 2010b; see also note 13 above).

4.2 US: impact on the LIHTC

The housing and financial crises sharply diminished the market's appetite for LIHTCs and for tax-exempt housing bonds. The market for tax credits peaked in 2006, as shown in Fig. 1. Yields increased slightly in 2007 as Fannie Mae and Freddie Mac cut back their taxcredit investments for tax-related reasons. As a result, developers received slightly less money for each tax-credit dollar. The situation deteriorated further in 2008 and 2009. The federal government took Fannie and Freddie into conservatorship in September 2008, effectively nationalizing them. As de facto elements of government, they no longer needed to pay income taxes, and even if they did, their billions of dollars in losses would have vitiated the need for tax credits. Making matters worse, the federal government closed down several major banks for insolvency, further reducing the roster of tax-credit investors. Finally, the crisis has diminished the remaining banks' desire for tax credits. With little or no taxable income, banks had much less need for tax credits. Moreover, banks were wary of investing in tax credits over a ten-year period when the volatile economic environment made it extremely difficult if not impossible for a bank to forecast its taxable income from one year to the next. And while demand for tax credits among financial institutions plummeted, there were no investors from other sectors positioned to take their place. Non-financial corporations had long since departed from the tax-credit market, priced out by the banks and the GSEs. Individuals had not been a significant source of investment since the early 1990s. In the current economic climate it is highly unlikely that other sectors would suddenly pick up the slack. The Low-Income Housing Tax Credit is an extremely complex program, and even in the best of times non-financial corporations and individuals would be wary of plunging in (Belsky and Nipson 2010; Schwartz 2010; Joint Center for Housing Studies 2009a, b).

As a result of curtailed demand for tax credits, yields increased sharply and the amount of money developers received per tax-credit dollar decreased. Figure 1 shows that the yield of tax-credit investments nearly doubled from 2006 through May 2009, when it reached 8.9 percent, the highest level since 1997. During this time the amount of money developers received per tax-credit dollar declined by 20 percent, from 99.2 cents to 80 cents (or lower). As of August 2009, developers were receiving about 65 cents per tax-credit dollar, and in some cases less (Ernst and Young 2009; Smith and Handelman 2009). In May 2009 it was reported that tax-credit equity investment was likely to total \$4 billion to \$4.5 billion for the year, down from about \$9 billion in 2007 (Pristin 2009; see also Ernst and Young 2009). Demand for tax-credit projects in many parts of the country evaporated altogether.

⁹ Passive loss restrictions imposed by the Tax Reform Act of 1986 severely limit the ability of individuals to invest in LIHTCs.



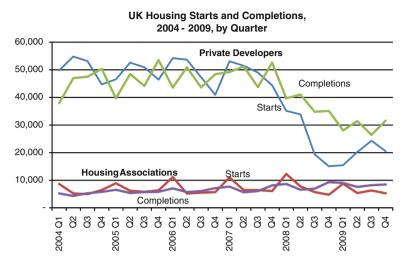


Fig. 2 UK housing starts and completions, 2004–2009, by Quarter. *Notes* Data under-report housing association starts and completions, and overestimate private building. *Source* Communities and Local Government (2010a): Table 211 and Field interview

5 Government response

5.1 UK

The British government responded quickly to the crisis. By late 2008 it had started to provide additional grants to housing associations to help them convert unsold ownership (outright and shared) into either social housing or intermediate rental housing, on condition that the associations intended to continue building housing (Kerslake interview). In addition, the government provided increased funding for development of social housing, increasing the amount of grant provided per unit in recognition of the greatly reduced ability of housing associations to generate revenue from the sale of ownership housing. As a result of increased government spending, housing associations increased their housing production during the credit crunch while private-sector construction plummeted (Fig. 2). Private-sector housing completions decreased by 23 percent from 2007 to 2008, and by 22 percent the following year. Housing associations' completions increased by 14 percent in 2008 and by six percent in 2009 (Communities and Local Government 2010a). 10

The government's support for housing associations was part of a larger effort to bolster the construction industry and stimulate the economy. The government's Kickstart program, established in 2009 with £1.06 billion in funding, sought to "unlock stalled housing development affected by the economic downturn" (Housing and Communities Agency 2009). The program provided grants and/or low-interest loans to cover infrastructure and other development costs for developments that had already secured planning permission but had been unable to obtain financing. The government also created "Homebuy Direct"

¹⁰ The data reported here and represented in Fig. 2 understate the amount of housing produced by housing associations and exaggerate the amount developed by private builders. Shared-ownership housing and housing built as part of Section 106 agreements tend to be reported erroneously as private construction (Field interview).



to help low- and moderate-income households obtain mortgages and purchase newly built homes. The program provided eligible borrowers with an "equity mortgage" for up to 30 percent of the purchase price, which would supplement a conventional market-rate mortgage (Housing Finance Group 2010).

Finally, the government also provided funds for the first time in many years for local councils to develop housing. The government decided to allocate funds for the development of council housing to "unlock" land for housing development that local councils owned but were reluctant turn over to housing associations but willing to develop themselves (Kerslake interview).

Altogether, the government committed about £5 billion on Kickstart, Homebuy, and other efforts to revive the housing sector, including the conversion of unsold housing developed by housing associations to rental housing. It also accelerated spending for the renovation of social housing still under council ownership. These outlays, however, did not constitute new financial commitments on the part of the government. Instead, the government carried forward funding that had been budgeted for 2010 and 2011 under its 2008–2011 Housing Programme (Housing Finance Group 2010; House of Commons, Communities and Local Government Committee 2009).

5.2 US

The federal government, as part of a broader effort to revive the economy, passed legislation in 2008 and 2009 to strengthen the LIHTC program. The Housing Economic Recovery Act of 2008 (HERA) temporarily increased the amount of tax credits that state housing finance agencies could allocate to low-income developments. It increased the amount of tax credits allocated to each state from \$2.00 to \$2.20 per capita and it set the larger of the two tax credits at a minimum of nine percent.

While these measures increased the amount of tax credits that could be allocated—in terms of the number of properties funded and the amount of credits received by individual properties—they did little to improve investor appetite for tax credits. President Obama's economic stimulus bill of February 2009 took a different approach to support the LIHTC and thereby increase housing construction. The American Recovery and Reinvestment Act included two provisions for the LIHTC: the Low Income Housing Tax Credit Assistance Program (TCAP) and the Low Income Housing Tax Credit Exchange Program (TCEP). TCAP provided \$2.25 billion in grants to state housing finance agencies. These funds provide necessary gap financing to projects that did not receive sufficient equity from the sale of tax credits. Projects that had received tax credit allocations in fiscal 2007, 2008, or 2009 were eligible for the program. The TCEP program allows state housing finance agencies to exchange a portion of their nine-percent tax credits (but not their four-percent credits) from fiscal 2008 and 2009 for cash grants. Instead of allocating tax credits, the state agencies could then provide funds directly to developers of low-income housing. In effect, the program gives states the option of replacing tax credits with block grants (at 85 cents per dollar of tax credit). Unlike tax credits, block grants enable the states to provide equity directly to eligible housing developments (National Low Income Housing Coalition 2009a, b; Citizens Housing and Planning Association 2009). 11

¹¹ In addition to the TCAP and TCEP programs, the Obama administration's economic stimulus legislation included \$11 billion in other housing-related initiatives. None of these expenditures, however, were designated to help finance new housing. Instead the funds were allocated for such purposes as renovation of existing public housing (\$4 billion), renewal of housing subsidy contracts (\$2 billion), homelessness



In 2010, Congress extended the TCEP program for another year. It also introduced legislation, still pending as of December 2010, to further strengthen investor demand for the LIHTC. The proposed law would enable investors to apply the tax credit retroactively towards taxes paid over the previous 5 years¹²; it would modify tax law to enable closely held corporations and partnerships to utilize the tax credit; and it would set the smaller tax credit at a minimum of four percent, just as previous legislation set the larger credit at nine percent (A rescue for affordable housing 2010).

6 Future prospects

6.1 UK

The prospects for increased government support for affordable housing in the UK are extremely slim. Even before the election of May 2010 that brought into power a Conservative-Liberal Democratic coalition government, it was widely expected that subsidies for social housing would decline as the government sought to reduce its fiscal deficit, which had more than doubled from 2008 to 2009 (Rogers and Dowler 2008; Orr interview).

In its election campaign, the Conservative party pledged to reduce government spending sharply to decrease the deficit. On May 26, 2010, just 2 weeks after the start of the new government, the Homes and Communities Agency announced £230 million in cuts from existing programs and suspended spending on several housing programs, including Kickstart, the local authority new-build program, and uncommitted funds from the National Affordable Housing Programme for 2008–2011 (Lloyd 2010).

One month later, in its Emergency Budget of June 2010, the Coalition government further reduced housing assistance, most notably in Housing Benefit. The following are some of government's major changes in Housing Benefit:

- The maximum eligible rent available to Housing Benefit recipients in the private rental sector will be reduced from the 50th percentile of local area rents to the 30th percentile;
- Housing Benefit levels will be capped at a maximum level, regardless of local market rents (e.g., £340 per week for a three-bedroom home);
- Housing Benefit will be reduced for households with non-dependent adults;
- Housing Benefit will be reduced for households in social housing who occupy more space than is deemed necessary;
- Housing Benefit for single persons between 25 and 35 years of age will be reduced to the equivalent of a single room with shared bathroom and kitchen facilities (Doward 2010, National Housing Federation 2010a; Vine et al. 2010).¹³

Footnote 11 continued

prevention and rehousing (\$1.5 billion), and mitigation of the neighborhood effects of mortgage foreclosure (\$2 billion) (Schwartz 2010: 314–315).

¹³ Not all of the changes in Housing Benefit involve subsidy reductions: Disabled recipients will be entitled to increased Housing Benefit to cover the cost of an extra bedroom for a non-resident caregiver. In addition, the government announced plans to consolidate Housing Benefit with several other benefit programs, into a single program, Universal Credit, which would be phased in over 4 years starting in October 2013. Among other things, the Universal Credit would limit the total income a household may receive from benefits. On



At present, investors can carry back tax credit by only 1 year. By giving them the ability to carry back credits against taxes paid over the previous 5 years, Congress hoped to allay concern among potential investors that their future tax liabilities would be insufficient to warrant investment in tax credits.

The government announced additional spending cuts in October 2010 in its first Comprehensive Spending Review (HM Treasury 2010) and called for other changes that are likely to increase the costs of developing and managing social housing (Inside Housing 2010). First, the government allocated only £4 billion in grants over the next four years for the construction of new social housing, a reduction of 63% when compared to the previous spending review period. To offset the potential resulting loss of new social housing, the government authorized housing associations to increase rents to 80 percent of market levels, an increase that the government said would enable housing associations to finance housing development with bank loans (HM Treasury 2010). The higher rents, presumably, would be covered by the Housing Benefit program (Communities and Local Government 2010b). The government also mandated changes in the way that social housing is managed, including the replacement of "lifetime tenure" by a more "flexible" tenancy with a minimum duration of 2 years, a requirement that small households move out of units with excess space, and an increase in the rents charged to new occupants of existing housing (HM Treasury 2010; Communities and Local Government 2010b).

While the government's decisions to date will reduce public subsidies (Housing Benefit) for households in the private rental housing market, the impact of the proposed changes for social housing is more ambiguous and geographically uneven. While several measures, such as reductions in Housing Benefit households with non-dependent adults, will likely reduce Housing Benefit for tenants in social housing and in the private rental market, the government's decision for housing associations to raise rents to 80 percent of market levels should boost rental income from Housing Benefit. The government's policy decisions as of December 2010 are likely to be particularly difficult for housing associations located outside of London and other parts of southern England where housing prices and rents are highest. In the most expensive housing markets, housing associations will probably be able to finance new social housing with rents set at 80 percent of market levels (Riley interview; Brown 2010). But in northern England, Northern Ireland, Scotland, Wales, and other less affluent regions of the UK, market rents are significantly lower, and rents set at 80 percent of market levels will probably not generate sufficient revenue to cover the necessary debt service costs for new housing development. In addition, even if it were feasible to finance the acquisition and development of new social housing with rents at 80 percent of market levels, the increased levels of bank debt could jeopardize housing associations' loan covenants. As noted above, total debt must not exceed about 65 percent of the book value of an association's assets (gearing), and interest payments must be less than about 90 percent of net income (interest cover). Housing associations are unlikely to agree to build or acquire social housing if doing so would threaten their loan covenants (Riley interview).

In addition to changing fundamentally how new social housing is financed, the Coalition government's budget reductions and other policy changes are likely to pose other challenges to housing associations. First, changes in the duration of guaranteed tenancies will probably increase operating costs, as increased turnover will likely lead to increased vacancy losses and increased expenditures for renovations (Riley interview). Secondly, reductions in Housing Benefit for households with non-dependent adults, and households occupying units with excess space are also likely to cause rental arrears among housing association tenants to increase (Riley interview; National Housing Federation 2010b).

the other hand, the program would provide slightly more generous benefits for low-income workers (Pawson 2011).



Footnote 13 continued

Third, apart from cuts in housing programs, housing associations will also be adversely affected by reduced government support for local councils. In its Comprehensive Spending Review, the Coalition government announced that spending for local governments would be cut by more than 25 percent over 4 years (HM Treasury 2010). It is estimated that reduced government funding will cause local councils to lay off up to 500,000 workers, including 140,000 in 2011 alone (Bury 2010). To the extent that the minority of housing association residents who are employed work for the government, mass layoffs could cause many of these residents to fall into arrears. In addition, many housing associations administer a variety of community service programs in such areas as employment, recreation, health care, and environment, many focusing on children, youth, and the elderly. Facing severe budget cuts, many local governments will likely reduce or eliminate their support for these programs, diminishing important sources of revenue for housing associations, but more importantly reducing the quality of life in many communities (Aviston interview).

On top of sharply reduced government funding, housing associations will almost certainly obtain much less housing through Section 106 than in the years preceding the credit crunch. The private housing market is unlikely to return to its previous pace anytime soon (Council of Mortgage Lenders 2010b; Housing Finance Group 2010). Moreover, housing associations do not expect that revenue from sales of housing for outright and shared ownership will increase sufficiently to offset reduced government assistance (housing association interviews). While sales of shared homeownership housing have improved in the south of England, they remain very low elsewhere.¹⁴

6.2 US

The prospects for subsidized housing development in the United States are probably less grim than they are in the UK, in part because the US government's aspirations for providing affordable housing have always been far less ambitious. Whereas the UK will almost definitely need to allocate additional subsidy if construction of social housing and other types of affordable housing is not to decrease, the US is not in the same position. If the LIHTC continues to falter, the government could decide to replace it with a form of direct subsidy. After all, the program is essentially a block grant in which states allocate a finite number of tax credits, instead of a finite amount of money, to housing developers (Schwartz 2010). Moreover, tax expenditures are no less costly to the government than direct expenditures; they are just treated differently from an accounting standpoint.

Most of the legislative changes to the LIHTC since 2008 have sought to increase the amount of equity generated through the tax credit and to unlock projects that had received tax credits but were unable to attract sufficient equity from private investors (Joint Center for Housing Studies 2009b). Even under the most optimistic scenario, it is highly unlikely that the tax credit will generate as much equity for housing as it did before the onset of the housing crisis. This will mean that tax-credit housing will require more subsidy from other sources than was the case in recent years.

If the price of the credit does not recover, or if it remains very difficult to attract investors for tax-credit properties in certain parts of the country and for properties with

¹⁴ The above summary of how budget reductions and other policy changes instated by the Coalition government are likely to affect housing associations and social housing is provisional; the details of several policies had yet to be fully worked out as of December 2010, and government may adopt additional changes to address some of the problems discussed above.



four-percent tax credits, the government could decide to replace the program with direct subsidies. It could, in other words, replace the LIHTC with a program modeled on the TCEP program. Instead of allocating tax credits, state housing finance agencies would allocate cash for the development and acquisition of low-income rental housing. This would not involve any increase in government spending; it would require a change in the character of that investment from a tax expenditure to a direct expenditure.

In the short term, replacing the tax credit with a block grant would probably provide a more stable source of funding, at least under the current administration. Over the longer term, however, direct federal expenditures for housing are more volatile than tax expenditures. For example, controlling for inflation, the budget for the HOME program, a federal block grant program for housing, declined by more than 16 percent from 2000 to 2008 (Schwartz 2010). Proponents of affordable housing have long found the vagaries of the tax-credit investment market more predictable and thus preferable to the vagaries of the Congressional appropriation process. It remains to be seen if the crisis has reversed this situation, with political vagaries now more stable than those of the market.

Another potential downside of replacing the LIHTC with a direct subsidy is that asset management could suffer. One benefit of using tax credits instead of cash, is that the participation of private investors provides an extra layer or two of oversight to ensure that the housing is managed appropriately and well. Asset management also helps insure that a property's physical needs are addressed over time. Without the participation of private investors, oversight of tax-credit properties would rest on state housing finance agencies or other governmental units who may not be adequately staffed or motivated to provide the same degree of vigilance. In addition, banks may perceive a higher degree of risk in lending to projects that lack tax-credit investors. As a result, they may charge higher interest rates and impose higher fees and stiffer underwriting standards for properties that lack private investors who have a stake in the property and are looking after its capital needs and overall management (Acierto 2010).

7 Conclusion

Although the United States and the United Kingdom subsidize low-income housing in very different ways and to very different degrees, both nations have relied on markets to generate subsidy. The collapse of the housing bubble and the subsequent financial crisis and recession undermined key aspects of both countries' subsidy systems. In the UK, the crisis curtailed the ability of housing associations to generate revenue from the sales of new and existing housing to cross-subsidize the development of new social housing, and it reduced the amount of affordable housing generated through Section 106 agreements with private developers. The crisis also caused bank financing to become more expensive and more difficult to obtain. In the US, the crisis eviscerated the market for Low-Income Housing Tax Credits, the paramount source of funding for affordable rental housing. It also sharply reduced demand for tax-exempt housing bonds, another important funding source, one that was often coupled with the tax credit.

The UK responded sooner and arguably more effectively than the US to the crisis as it affected the production of low-income housing. The UK's government provided financial assistance to help housing associations convert unsold properties to rentals, and it increased funding for new development. As a result, housing associations continued to build and acquire affordable housing at a similar pace as before. Housing associations fared much better in the crisis than private for-profit developers. In the US, the government attempted



to assist tax-credit properties that had been unable to attract sufficient, if any, private investment. Other legislation is pending that could increase demand for tax credits. As of December 2010, the market for tax credits remained unstable. It is stronger in the more robust housing markets, especially in major metropolitan areas on the east and west coasts, where major banks continue to be motivated by the CRA to invest in tax-credit properties (Belsky and Nipson 2010). Investor demand for tax credits is weakest for properties in rural and old industrial areas. The market for four-percent tax credits used to augment tax-exempt bonds remains moribund (Belsky and Nipson 2010).

Yet, the future for the development of additional affordable housing is likely to be more fraught in the UK than in the US. The UK faces reduced funding for affordable housing, and housing associations, especially outside London and the Southeast, are not likely to offset these reductions through the sale of new homes or through Section 106 agreements with private developers. As a result, housing associations will be under severe pressure to reduce costs, develop economies of scale, and become more entrepreneurial, strategic, and innovative. In the US, if the market for tax-credits does not recover sufficiently, the country has the option of converting the program to a direct subsidy, probably in the form of block grants. The total level of subsidy provision would not change, just the form that it takes.

In both countries the credit crunch revealed weaknesses and tensions in their systems for providing affordable housing that had been obscured by an overheated market. In the UK, rising house prices and easy access to mortgage credit may have enabled housing associations to operate at less than optimum efficiency. In the United States, the market for housing tax credits was extremely narrow and was not based primarily on financial return. Large financial institutions, motivated chiefly by regulatory concerns, had bid up the price of tax credits beyond what other non-financial corporations were willing to pay. The mortgage crisis removed several of the biggest tax-credit investors from the market and otherwise reduced demand among the remaining investors.

Most fundamentally, the credit crunch teaches us that market mechanisms are unstable platforms for the delivery of affordable housing. The amount of housing produced usually correlates highly with robust market conditions. When housing and/or financial markets falter, funding for new affordable housing declines. However, the need for affordable housing varies much less over time than the vicissitudes of the market. If a government is to address its nation's need for affordable housing, it will ultimately need to provide direct subsidies.

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