

Rental Income Guarantee Scheme

Support for new purpose build-to-rent Private Rented Housing in Scotland

A Joint Market Engagement Document from the Scottish Government and the industry-led Private Rented Sector Working Party



**The Scottish
Government**
Riaghaltas na h-Alba

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1. Ministerial Foreword

Cabinet Secretary for Social Justice, Communities and Pensioners' Rights, Alex Neil



This Government is determined to boost the supply of housing across all tenures. As our Joint Housing Delivery Plan for Scotland (2015) makes clear- a strong and well-functioning housing system has a vital role to play in supporting the development of a more productive, more cohesive and fairer Scotland. A well-functioning housing system that offers good tenure choice helps enhance economic growth, social mobility and place-making - further cementing Scotland as an ideal location to live, work and invest.

Our private rented sector (PRS) strategy – [A Place to Stay, A Place to Call Home](#) – published in May 2013 sets out a clear vision for a PRS sector that provides good quality homes and high management standards, inspires consumer confidence, and encourages growth through attracting increased investment. I see the PRS playing a major role in the expansion of Scotland's housing supply and I want to continue the work this Government has done to make Scotland an attractive place for investors to operate in the long term.

In the last three years, the creation of a new, professionally managed, institutionally invested private rented sector has become an understood and widely shared goal. I am fully supportive of the aim and, through our joint work with Homes for Scotland, and other leading industry representatives there is now a real opportunity to support this sector to grow rapidly in Scotland. The [Building the Rented Sector in Scotland](#) report by the world-renowned Cambridge Centre for Housing & Planning Research, with LSE, demonstrated the clear opportunities to grow this sector. Since this study was published we have continued to work with Homes for Scotland and a range of other industry specialists through the PRS Working Party, to consider its recommendations and take clear actions to capitalise on the potential it identified. As part of this we funded the appointment of a dedicated PRS Champion for Scotland tasked with driving forward several of the key priority areas.

Building on our joint work with this industry-led group we announced on 8 October 2015 that a guarantee scheme designed to help support early movers in this emerging market was in development. This Government has a strong track record of using innovative guarantees to kick-start development and we are now looking to expand this approach to support delivery of new-build PRS homes at scale. This market engagement document is the next stage of the process and I encourage the industry to consider the proposals set out and provide meaningful feedback. This is a tremendous opportunity for government and industry to come together to move on the opportunities to deliver much-needed PRS homes in Scotland.

2. Foreword from the PRS Champion

Gerry More, Homes for Scotland



We have a clear market-led opportunity to increase and accelerate the roll-out of high quality new housing in the private rented sector in Scotland. New purpose Build-to-Rent (BTR) PRS can accelerate the provision of new housing units and set a new standard, through professionalism and service quality, transforming the experience of rented housing in Scotland. We know from our research that, with the right quality of stock, PRS can be a first choice for a whole range of people at different stages in their lives. We also know that there is a lot of interest from developers and investors in the Scottish market.

As PRS Champion, part of my role has been to guide the PRS Working Party, supported by Homes for Scotland (HFS), in its development of a targeted support mechanism to encourage the scale of investment and professionalism that we need to take root in Scotland. I believe our proposal has the potential, as part of a suite of initiatives that we have been working on over the past year and a half, to contribute to making Scotland a "go to" location for high quality rented development. The key to this is the collaboration between government and industry, which has created the conditions for the development of innovative but workable ideas, financial and non-financial, to support the growth of the PRS market in Scotland.

One of our proposals is for a Rental Income Guarantee Scheme (RIGS), designed to address the risks at the early stage of occupancy caused by the immaturity of the Scottish PRS market. The development of RIGS has been led by the PRS Working Party and is supported by a survey undertaken by Homes for Scotland which identified a clear level of interest from the market in this form of financial support. The RIGS proposal has been reviewed by the Scottish Government and further refined in collaboration with a range of leading industry representatives. It now forms part of this market engagement exercise, and we look forward to receiving feedback from the market and other stakeholders through this route in order to put in place practical measures to kick-start development at the pace and scale that there is clear potential for in Scotland.

3. The RIGS Proposal

3.1 Overview

3.1.1 Purpose of this document

Scottish Government (SG) would like to solicit views from the industry and other stakeholders on a detailed RIGS proposal as part of developing its overarching strategy for supporting the growth in the new build for rental market.

3.1.2 Context

Demand in Scotland for new housing stock is expected to grow significantly over the next decade. While the Scottish Government has set an ambitious target of 50,000 new affordable homes to be delivered over the next five years, it also recognises that there is a need for new housing across all tenures and price points.

New, high quality housing built expressly for rental (known as Build-to-Rent Private Rented Sector or BTR PRS housing) is a key element of the housing mix. Some limited development is taking place already in Scotland, but this market is at an embryonic stage. While there is an appetite from the market to invest in this sector, the lack of unit rental data from established developments seems to be an issue holding investors back. Once this market begins to gain traction in Scotland, it should grow rapidly. Stable and predictable levels of occupancy should start to be seen, generating data that will in turn build up market information for future projects.

A key element in the delivery of new, high quality BTR PRS accommodation at scale is the involvement of professional investors and managers.

The hypothesis that has emerged from work to date is that a government guarantee is needed to build investor confidence in a market that is not yet established in Scotland. We wish to test this hypothesis as part of this market engagement exercise.

It should be noted that there are a number of UK Government mechanisms which remain available to support rented housing development, most notably the [Private Rented Sector Housing Guarantee](#) (which is available for Scottish projects). The Scottish Government's aim is to develop a mechanism that complements rather than duplicates these.

3.1.3 The Challenge

There are a number of risks and uncertainties, financial and other, faced by developers and investors contemplating a BTR PRS model. In a mature, fully functioning market, they should be in a position to manage or offload risks efficiently for commercially viable projects. In a market that is immature or suffering from market failure, some of these risks may act as disincentives or absolute obstacles to investment. Where Government identifies that investment may happen too slowly to meet policy objectives or potentially not at all, it needs to consider whether it can or should intervene to address the problem, and over what period of time.

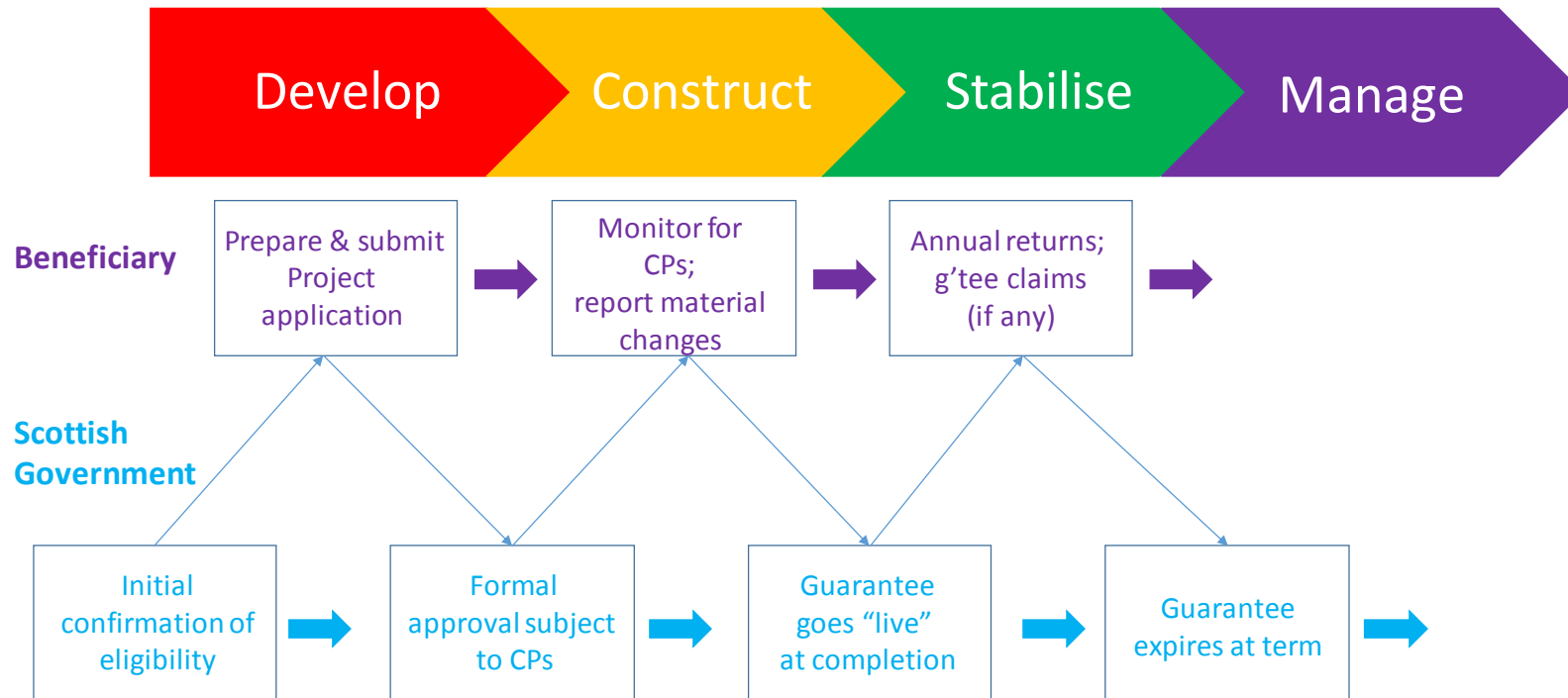
With these issues in mind, a PRS Working Party, with representation from the industry and the Scottish Government, was established to support the PRS Champion to develop new thinking in this area. This Working Party has suggested that the most effective financial incentive to catalyse significant levels of new build rental accommodation is likely to be a rental income guarantee scheme (RIGS), provided by Scottish Government.

This guarantee would address what is seen by the Working Party as the principal area of uncertainty and risk, namely visibility of likely occupancy levels. The proposal is based on underwriting a proportion of the revenue risk for a specific PRS development for a limited period, thereby allowing investors and developers time to become familiar with the dynamics of local rental markets.

3.1.4 Supporting the Project Development Process

The graphic below illustrates how a guarantee could dovetail with the different stages of developing a project, with an application process taking place before work starts on site, followed by a form of undertaking from Government to facilitate the finance-raising process and the guarantee actually going “live” when the project is ready for occupation.

Project Stages



Note: "CPs" = Conditions Precedent

The guarantee is intended to cover the “stabilisation phase” of the project – in other words, the period of greatest uncertainty during the first few years in terms of occupancy and rental levels, as the development stabilises. How it might be structured is explained in more detail later in this document.

3.1.5 The SG Policy Approach to Guarantees

SG believes that in the right circumstances, the deployment of financial guarantees like this to support policy initiatives can unlock investment. At the same time, it is concerned to ensure that such interventions are targeted and effective.

The RIGS mechanism detailed in this paper represents one form of guarantee. The Scottish Government is aware that, for any such proposal, there may be other forms of support that could deliver better value for money and that the case for RIGS needs to be made by comparing it with the alternatives available. If respondents to this market sounding exercise believe there are viable alternatives to the RIGS scheme that do not exist at present, they are invited to respond accordingly.

3.1.6 Market Engagement

We are seeking views on these proposals in Section 4 below. We welcome all input - please give reasons for your answers, wherever possible. Feedback to this discussion document will be an invaluable contribution to the process of developing the rationale for a financial mechanism to support the sector.

This exercise does not cover the social rented or the help-to-buy / shared equity sectors.

While SG is particularly keen to elicit feedback from prospective participants in future PRS developments in Scotland, it recognises and values input from all relevant stakeholders. In order for the data from this exercise to be properly assessed, respondents are requested to identify the sector or interest group to which they belong.

This market engagement exercise will remain open until 22nd April 2016. The SG may decide to extend the deadline at its discretion.

For any queries in relation to this document, please contact Lynsey Thomson (Scottish Government Financial Innovation Unit) via email at lynsey.thomson@gov.scot or by telephone on 0300 020 1226.

3.2 Scheme Eligibility

3.2.1. Qualification Criteria

This section covers what would constitute an eligible project for the purposes of the RIGS.

As a matter of principle, the Scottish Government believes that eligibility criteria should be sufficiently clear and transparent for prospective applicants to make a reliable self-assessment of whether they would qualify.

It is envisaged that a project should qualify for consideration under the scheme if:

3.2.1.1. The project is:

3.2.1.1.1. New build for rental development not already under construction.

3.2.1.1.2. A new build project that has demonstrably stalled and is switching from a build-to-sell model.

3.2.1.1.3 A refurbishment involving change of use from non-residential (e.g. a warehouse or an office).

3.2.1.2 The project as a minimum meets and preferably exceeds current building standards and will be operated with high quality maintenance standards. These will require further definition in due course.

3.2.1.3 The development comprises at least 30 units capable of separate residential occupation.

3.2.1.4 The site is located in Scotland.

3.2.1.5 The land is under the applicant's control and this can be evidenced.

3.2.1.6 The site has outline planning consent.

3.2.1.7 The project is capable of being completed and occupied within 3 years of an in-principle agreement to a guarantee being provided by SG.

3.2.1.8 The project development plan has a clear structure that shows an intent to hold completed units as rental stock for the duration of the guarantee.

- 3.2.1.9 The project has a credible financing plan for the construction and ownership of the project, assuming the completed units are held as PRS stock for the duration of the guarantee.
- 3.2.1.10 The project can demonstrate viability, including an allowance for voids and bad debts that is reasonable in the context of the local rental market (further definition of the local market in this context will be confirmed) and the type of development planned.
- 3.2.1.11 The applicant and prospective owner of the development (if different) are deemed to be fit and proper, suitably qualified and of adequate financial standing to ensure the successful completion of the project.
- 3.2.1.12 The beneficiary of the guarantee must be in the private sector.

3.2. 2 Information required

Applicants will be required to provide information regarding the project in support of their application for the guarantee. This will be subject to further detailed development but in broad terms is likely to cover the following:

- 3.2.2.1 Location;
- 3.2.2.2. Number of units;
- 3.2.2.3 Type of units;
- 3.2.2.4 Planning status;
- 3.2.2.5 Site ownership;
- 3.2.2.6 Expected start and completion dates;
- 3.2.2.7 Financing plan;
- 3.2.2.8 Assumed rents;
- 3.2.2.9. Gross Development Value;
- 3.2.2.10 Proposed management structure and operational strategy;

3.2.2.11 Any communal facilities included in the design;

3.2.2.12 Any design features that make the building particularly suited to a long term residential letting model.

3.3 Indicative Outline Terms

Set out below are the outline terms for a potential rental income guarantee that have been developed by the PRS Working Party at Homes for Scotland (HFS). These have also been the subject of discussions between SG and HFS.

It should be emphasised that these terms are indicative only. They are offered in this market sounding document as a “strawman” for discussion, in order to allow respondents to consider the potential impact of a rental income guarantee on investment strategies for private rented housing.

A number of questions on key aspects are set out in the following section, both on the terms set out below and the wider context of supporting new private rented housing. We would be grateful for your responses to these questions and we would also welcome comments on any other aspects of this initiative.

3.3.1	Scope of the guarantee	<p>The guarantee is intended to compensate for a financial shortfall in qualifying projects arising as a result of lower than expected rental income. This would work as follows:</p> <ul style="list-style-type: none">• An adjusted revenue projection is agreed for the project. The adjusted projection is derived after making an adjustment for voids and bad debts.• For ease of administering the scheme, it is proposed to set a standard adjustment for voids and bad debts of 5%.• The adjusted projected revenue figure would be independently validated at the time by a qualified third party.• During the period for which the guarantee is valid, in the event that the actual revenue is below a set percentage of the projected adjusted revenue (“the ceiling”), SG would
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		<p>compensate the landlord for 50% of the shortfall, down to a lower adjusted revenue figure (“the floor”).</p> <ul style="list-style-type: none">• It is proposed that the ceiling is set at 95% and the floor at 75% of the adjusted revenue.• For example, if actual adjusted revenue in any annual period was 85% of the projected figure, the eligible shortfall would be 10% (95% less 85%). SG would pay compensation to the landlord which was equivalent to 5% of the projected figure. The proportion of the revenue shortfall covered by the RIGS scheme is shown in green in Scenario 1 in the chart below.• If, on the other hand, actual adjusted revenue in any annual period was 65% of projected figure, the eligible shortfall would be 20% (95% less 75%, which is the floor) and SG would pay compensation to the landlord equivalent to 10% of the projected figure. The proportion of the revenue shortfall covered by the RIGS scheme is shown in green in Scenario 2 in the chart below.
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		<p style="text-align: center;">Rental Revenue Risk Sharing</p> <div style="display: flex; justify-content: space-around;"> <div style="text-align: center;"> <p>Scenario 1</p> <p>Scenario 1 shows a total revenue of 100%. The bottom 75% is 'Actual Revenue' (red). The top 25% is split into 'RIGS Shortfall' (green, 10%) and 'Investor Shortfall' (blue, 15%). A dashed line at 95% is labeled 'Ceiling' and another at 75% is labeled 'Floor'.</p> </div> <div style="text-align: center;"> <p>Scenario 2</p> <p>Scenario 2 shows a total revenue of 100%. The bottom 60% is 'Actual Revenue' (red). The top 40% is split into 'RIGS Shortfall' (green, 20%) and 'Investor Shortfall' (blue, 20%). A dashed line at 95% is labeled 'Ceiling' and another at 75% is labeled 'Floor'.</p> </div> </div>
3.3.2	Beneficiary of the guarantee	The beneficiary of the scheme will be the direct landlord of the project. This must be a body corporate. In some circumstances this may be a Special Purpose Vehicle incorporated for the project, but this is not considered essential.

3.3.3	Issuer of guarantee	The issuer of the guarantee will be the Scottish Government.
3.3.4	Change of ownership	In the event of a change of ownership of a project while it benefits from a guarantee under the rental scheme, it is envisaged that the guarantee may be transferred with the project, subject to SG's approval of the new body obtaining the assets, provided that the project remains whole. Disposing of elements of the project separately would invalidate the overall guarantee.
3.3.5	Guarantee fee	A guarantee fee would be payable in advance at a commercial rate, commensurate to the risk taken by SG as guarantee issuer. The basis for calculating the cost of the guarantee will be the subject of further analysis.
3.3.6	Early termination	It is envisaged that a beneficiary may withdraw from the scheme and cancel the guarantee early but the guarantee fee will not be refundable. Early exit during any 12-month period would invalidate any potential claims for that period.
3.3.7	Period of guarantee validity	<p>A claim could be made under the guarantee over a maximum period of 3 years from the date that the accommodation first becomes substantially capable of occupation. It is envisaged that the beneficiary may apply for compensation annually, based on the actual revenue compared with the projected revenue for the relevant period. The guarantee claim would be accompanied by independent verification.</p> <p>Please note that this engagement process is seeking views on whether the maximum 3 year period proposed is sufficient or if flexibility should exist to request a longer guarantee period where this is required for developments to proceed.</p> <p>The guarantee could be made available for a period shorter than 3 years if this is considered by the market to be helpful.</p> <p>The guarantee could also be made available on a staged basis to larger projects, if this is considered to be helpful, subject to a minimum stage size, which would probably be equivalent to the minimum qualifying size for a project (see 3.2.1.3).</p>
3.3.8	Indexation	During the term of the guarantee, the rent for relevant units will be subject to indexation based on an agreed index.
3.3.9	Monitoring & reporting	An independently verified report would be provided annually by the landlord, together with a summary update at intervening six-monthly intervals.

3.4 Scheme Availability

- 3.4.1 It is proposed that the scheme will be available on a first come, first served basis, subject to clear qualification criteria (see 3.2.1 above).
- 3.4.2 How the application process is structured in terms of timing and frequency will be reviewed at a later stage according to the expected level of demand.
- 3.4.4 In the event of over-subscription by qualifying applications, SG may consider the introduction of further qualitative evaluation criteria in later rounds.
- 3.4.5 A duration of 5 years is envisaged for the programme, subject to annual review for budget availability and the normal conditions that apply to forward government commitments.

3.5 Scheme Design

The design of the scheme will depend in large measure on the responses to this market engagement exercise and subsequent development of the targeted intervention. However, it is envisaged that following key principles will inform its design:

- 3.5.1 SG recognises that early visibility of a financial support mechanism is an important part of that mechanism's value to the market. It is intended that the criteria for the scheme should be sufficiently transparent for a project developer to be able to predict with reasonable certainty (subject to SG budget availability and the developer meeting the qualification criteria) whether its project will be eligible for the guarantee scheme.
- 3.5.2 In addition, SG expects that there will need to be some level of comfort given about the provision of the guarantee before the development is available for operation. For instance, it needs to be capable of being factored in at the point that a project is raising finance. SG is willing in principle to give some early form of letter of comfort or conditional commitment at a sufficiently early stage to allow it to be taken into account when

arranging finance for the project. This would be subject to a longstop date for availability, for which three years is currently proposed.

- 3.5.3 SG expects that applications may be made on behalf of the future landlord, which may not exist at the time of the application (for instance, if the landlord is an SPV formed specifically for the project). Sufficient information must be provided at the time of application to allow evaluation to be made on the basis of the expected future beneficiary and confirmatory due diligence may be required by SG at a later stage.
- 3.5.4 The process of managing the scheme is likely to be delegated by SG to some suitably qualified and resourced delivery body. SG would welcome views on how this could be structured.
- 3.5.5 Once a formal application for support is made in respect of a project, it is anticipated it would be evaluated and responded to by the designated delivery body within a reasonably short period of time, with turnaround times be embedded in the delivery body's KPIs (Key Performance Indicators).
- 3.5.6 The guarantee would become valid once the agreed building completion trigger is met.

4 Questions

Please provide your feedback on these proposals in the form of responses to the questions below.

	Questions
1	Do you think there is a case for the Scottish Government to take action to support the growth of the BTR PRS sector in Scotland? Please give reasons for your answer.
2	What do you think are the key issues that need to be addressed to encourage the growth of new BTR PRS accommodation in Scotland?
3	Taking into consideration the schemes that are presently available from the UK Government (in particular the Private Rented Sector Guarantee Scheme) do you consider that there are support mechanisms other than a rental income guarantee scheme that could be brought forward to support the PRS sectors in Scotland, either alongside it or as an alternative?
4	Have you applied for or considered applying for support under the UK Private Rented Sector Guarantee Scheme?
5	If so, to what extent is the UK PRS Guarantee Scheme suited to your requirements?
6	In principle, do you believe that a rental income guarantee as a general concept is likely to have a materially positive impact on the growth of BTR PRS?
7	If the response to Question 6 is “yes”, what benefits do you think such a guarantee could create (e.g. lower cost of capital, greater liquidity in the market, greater investor confidence, accelerated development, freeing up sites for development, etc.)
8	If the response to Question 6 is “no”, why do you think this is the case?
9	What do you think the appropriate reference area should be for determining comparable rents?

10	What do you think might be an appropriate data source for comparable rental income?
11	Do the outline terms presented in this document for the RIGS represent an appropriate balance of risk between the market and government?
12	Does the RIGS proposal address the right risks – in other words, those that investors and developers finds difficult to manage at present? Please give reasons for your answer.
13	Do the qualification criteria for the RIGS scheme proposed in this document seem broadly reasonable and achievable?
14	Do the information requirements for the RIGS scheme proposed in this document seem broadly reasonable and achievable?
15	Do you think that the proposed risk-sharing percentages represent an appropriate balance of risk between the project owner and the Scottish Government? Please give reasons for your answer.
16	Do you think the proposed period of guarantee validity of the first 3 years of operation is sufficient to address the perceived early phase risk during the “stabilisation phase” and thus enable developments to proceed? Please give reasons for your answer.
17	Do the proposals for providing some form of conditional support or letter of comfort at the time that financing arrangements are being made for the project, with the guarantee itself becoming valid once the development is occupied, seem reasonable?
18	What do you think would need to be covered in the letter of comfort to be attractive to investors and developers?
19	Does the proposal of a longstop date of three years from the issue of conditional support or a letter of comfort seem reasonable?
20	Are there any other comments or suggestions that you would like to make in respect of this market engagement document?

Handling your response

The Scottish Government will not publish information provided through the consultation which can be attributed to an individual or organisation and we will treat it as confidential.

As the Scottish Government is subject to the provisions of the Freedom of Information (Scotland) Act 2002 and the Data Protection Act 1998 any request made to it relating to the responses will be considered in terms of the appropriate legislation.

Following the closing date, all responses will be analysed and considered along with any other available evidence before a decision is made on the precise terms of any resulting order.

Comments

If you have any queries or comments about this consultation exercise please contact Lynsey Thomson via email at Lynsey.thomson@gov.scot or via telephone on 0300 020 1226.

This document is for market engagement purposes only. It does not bind Scottish Ministers in any way to any future course of action, including proceeding to implement the RIGS Scheme or any similar scheme or as to the contents of any future RIGS Scheme/scheme. No expectation can arise from this market engagement as to future actions of the Scottish Ministers, in terms of implementation of the RIGS Scheme or any similar scheme or the contents of any future RIGS Scheme/scheme.

ANNEX B: RESPONDENT INFORMATION FORM

1. Name / Organisation

Title (Please tick as appropriate)

Mr Ms Mrs Miss Dr

Forename

Surname

Organisation (If applicable)

2. Contact Details

Address

Postcode

Phone

Email

3. Consultation Response