PAPER 12

DOES DEFERRED OWNERSHIP BRIDGE THE GAP?

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ABSTRACT

GAP Housing represent households earning within the First Home Finance brackets of R3 500 to R22 000 (Refer to Annexure P of the National Housing Project (NHP), Finance-linked Individual Subsidy Programme) monthly combined income. The unfortunate truth for this market segment is that a lack of discretionary income and poor credit record prevent the majority of families from getting a bond. Cape Agulhas Municipality requested their Implementing Agent to propose an alternative strategy that will enable a greater number of families to get access to GAP Housing as part of a larger development catering for BNG as well as GAP housing opportunities.

A proposal under the heading of 'Deferred Ownership' was submitted in 2018 to the Department of Human Settlements/Infrastructure (Department) for consideration. It was requested in 2018 that the Department considers a pilot project at Area F in Bredasdorp. Funding is provided by the Department to construct housing opportunities which will be offered to prospective purchasers to sign an option to buy the property, rent the property for 5 years and when the rental period is complete buy the property at the initial offered price.

Funding from the Department de-risks the capital investment for the developer, the 5-year period of rental is used to get the purchaser financially fit to get a bond at the end of the period and inflation adjusted income over the period assists the purchaser to afford the bond and associated down-payments. Community rental does not cater for income above R3 500 and social housing is not feasible in all areas. The Department agreed to the pilot and provided R10 million seed funding.

The project proposal was refined ensuring that rental payments are proxied on bond re-payment amounts, a proxy amount for utilities, the purchaser builds a deposit as incentive and the time value of money is accommodated over a 3-year period. The property remains a municipal asset until transfer to the purchaser, however the purchaser assumes full responsibility for the house's upkeep during the rental phase similar to a normal rental agreement. The pilot proceeded in 2022 and 26 housing opportunities are now occupied on the basis of Deferred Ownership. Though the project is still ongoing the paper will outline the approach, assess the outcomes to date, critically evaluate the success and explore alternatives.

1. INTRODUCTION

Cape Agulhas Municipality was preparing to implement a large housing development consisting of 676 opportunities in Area F Bredasdorp. Bredasdorp is the biggest town in the Municipality housing amongst other the Municipal offices and several large business concerns. During the planning phase of the project the Municipality was confronted with the challenge to include provision for the First Home Finance (originally known as FLISP) income bracket rather than fully subsidised housing only. Due to the substantial demand database for housing in the Municipality the vast majority of units were used for fully subsidised housing and 106 erven were set aside for GAP and affordable. The Municipality wanted to help people earning from R3500 upward on the GAP and Affordable erven.

This objective is not unique as many Municipalities are desirous to create housing opportunities to people earning above the R3 500 a month income bracket. The planning process in these Municipalities are similar with the fully subsidised share of units being the catalyst for the project and the GAP and Affordable erven being dispersed strategically on the peripheral.

GAP and Affordable housing are broad references generally associated with housing provided to first time home purchasers and more specifically, due to the Finance Linked Individual Subsidy (now First Home Finance) band, is associated with an income category from R3 500 per month to R22 000 per month. The cost associated with the provision of GAP and Affordable housing to this income band is important but not the only determinant due to the fact that people at the lower spectrum generally do not earn sufficiently to be considered for a bond and people across the entire income bracket struggle with creditworthiness.

Cape Agulhas Municipality was determined to use the erven earmarked for GAP and Affordable housing in the Area F development as a 'sandbox' to test product types in an effort to ensure greater access to prospective purchasers falling in the First Home Finance income band. The Municipality employed, as part of their housing delivery strategy, an Implementing Agent and tasked the Implementing Agent (IA) to propose strategies for implementation.

The first consideration was called "Deferred Ownership". This strategy was proposed with the primary objective to assist people to access bond finance and secondary to test how comprehensive the income bracket (R3 500-R22 000) can be assisted.

2. THE DEFERRED OWNERSHIP PROPOSAL

Initial engagement with the Department was positive and confirmed their willingness to receive a proposal for a pilot even if the approach may not be supported by existing policies. Housing policy permits ownership for fully subsidised products (up to R3 500 monthly income) a sliding-scale of assistance to home purchasers under the Finance Linked subsidies, rental options within social housing (up to R15 000 monthly income) and community rental (up to R3 500 monthly income).

Assisting beneficiaries in the income bracket above R3 500 per month with a 'rent to own' option does not exist. Social Housing is not an option since ownership is not a possibility through Social Housing. GAP and affordable housing provide ownership, however the cost of the housing product and access to finance was a challenge. It was clear that a new concept had to be packaged and submitted to the Department for their approval.

The concept presented to the Department in 2018 combined elements of an existing rent to own concept and relied on a de-risked approach with the Department injecting the funding required to build housing stock. Essentially it was a public private partnership whereby the Municipality provides the land, the Implementing Agent (Private Sector) develops the units based on commercial principles and Provincial Government provides bridge funding.

The Implementing Agent was appointed by the Municipality on a turnkey basis for a number of Human Settlement projects, hence the basis for partnership already existed and did not require a new procurement process nor did it take the form of an unsolicited bid. The Implementing Agent packaged the proposal on behalf of its client, the Municipality, and the funding made available by the Provincial Department was per agreement between the two spheres of Government. There was no direct contractual relationship between the IA and the Provincial Government proposed.

To address the challenge experienced by many prospective purchasers pertaining to bond qualification, at the time of purchase, it was proposed that the sale price of a property is fixed for a period of 5 years, during which period the purchaser will be occupying the property, pay rent and receive financial mentorship with the ultimate objective to purchase the property, at the original price. The fact that the sale price remains unchanged, the purchasers receive the benefit of inflationary adjustments in remuneration over the rental period, whilst receiving financial guidance, and the property price escalates meant that much better fundamentals are in place to assist with bond approval at the end of the rent to own period, hence the term 'Deferred Ownership'.

The concept was dependant on Provincial Government making available capital to build the housing units after a successful sale and prior to occupation. This was in the form of bridge funding, at zero interest, as the intent is that once the house is sold, either through a direct sale or through Deferred Ownership, the funds flow back to the initial capital pool. If the upfront capital was a commercial loan whereby the developer builds the houses albeit for a direct sale or deferred ownership, the interest cost and risk would be priced into the product which would create a far less favourable environment for bond qualification.

Until such time that the transfer of a unit takes place, and since the house was built on Municipal land, the Municipality will be the landlord. Since there was little success with Community Rental programmes where the Municipality is the landlord, it was expected that there would be reservation about a renewed role for the Municipality as landlord in Deferred Ownership.

There are distinct differences between a pure rental model and a rent to own model:

1. The tenant is participating in a programme whereby the successful completion of the program will yield home ownership in a rent to own model.
2. The tenant stays in his/her future home.
3. Rental collection and financial fitness are managed by private sector.

Both the Municipality and the Department was willing to test the concept and monitor potential defaults during the rental period preceding ownership. The Department requested that the 5-year rental period be reduced to 3 years but other than that provided the in-principal support for the proposal and requested that implementation commences as soon as possible.

Figure 1 provides a picture of the fund flow in the concept. The Department provides funding to create the infrastructure through the Integrated Residential Development Program. The funds must be recovered from the sale of the property and go into the SOA, Special Operating Account (SOA) of the Municipality once recovered. With the erven created the Department provides funding for the houses through the Asset Finance Reserve (AFR), a fund created by the Western Cape Department with the aim to assist with the roll-out of affordable housing. The intent here is also that the funds must be returned, since the AFR is not a grant.

3. REFINEMENT AND IMPLEMENTATION

Following the approval of the concept by the Department, the IA met with the Department to refine the concept for presentation and acceptance by the Municipality. It is worthwhile to note that the IA onboarded a transferring attorney that has several years' experience with the rent-to-own concept, albeit in a different market segment.

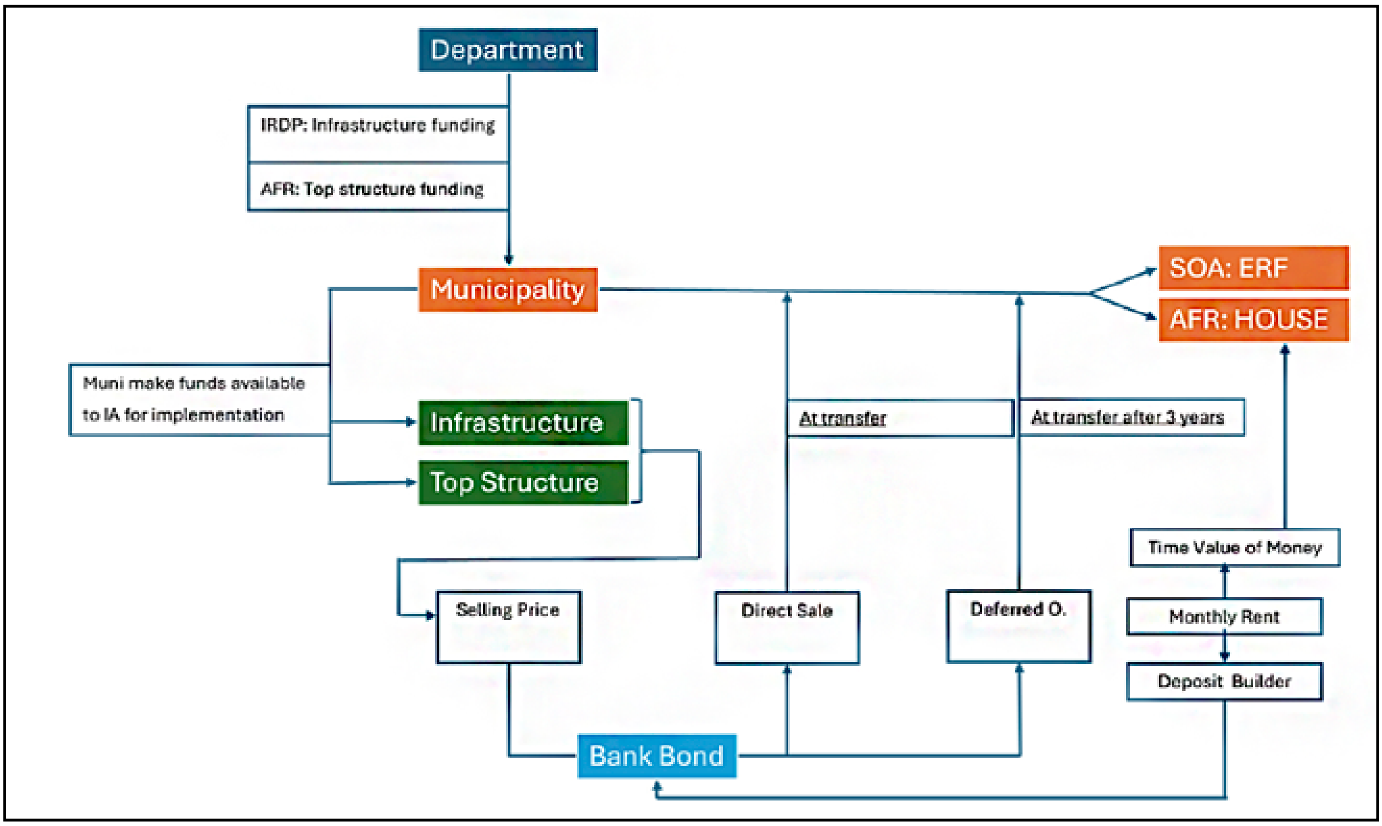

FIGURE 1: *Fund flows*

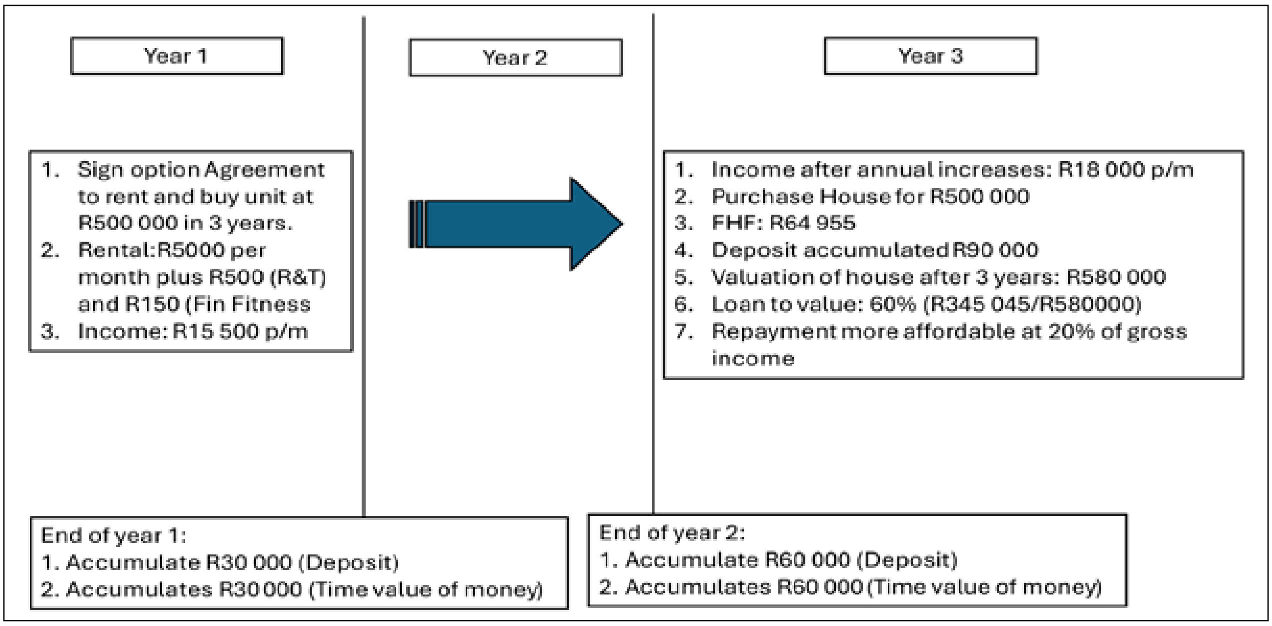

FIGURE 2: *Benefits of Deferred Ownership through Rent to Own to Beneficiary*

The following was agreed by the team:

1. The project is not limited to Deferred Ownership. It is an affordable housing project with the objective to sell houses to first time homeowners. The combined income of these new homeowners may exceed the upper bracket of the FHF but purchasers in the FHF income category will be assisted through the FHF subsidy. Deferred Ownership will augment this objective by providing purchasers a softer entry into the market.
2. The prospective purchaser that participates will be screened in a similar manner that banks screen prospective purchasers, evaluating their credit history and discretionary income. Purchasers that qualify outright for a bond (green) will be candidates for a straight sale, purchasers that do not qualify for a bond due to a technical reason, but their current circumstance indicate that they will be able to afford the monthly rental (orange) will be considered for participation in Deferred Ownership. Prospective purchasers that, amongst other, do not have sufficient discretionary income to afford the monthly rental (red) will not be able to participate.
3. Monthly rental will be determined on the basis of the product cost and prevailing interest rate at the time of signing the option agreement. This is to instil financial discipline during the rental period.
4. The rental period will be three years.
5. The rental will include provision for the following:
    a. A levy amount for rates and taxes. It remains a Municipal property over the rental period, so there is no rates and taxes, however the amount will be made available to the Municipality to fund insurance on the building.
    b. A levy amount to fund the financial mentor. The mentor connects with the purchaser on a monthly basis and monitors the financial health of the purchaser working towards the objective of qualifying for a bond at the end of the rental period.
    c. The monthly rental is split in half, with one half flowing back to the capital pool to address the time value of money and the other half to accumulate against the name of the purchaser for several purposes:
        i. The benefit of the purchaser as a deposit on the property if the rental period is concluded successfully and the purchaser qualifies for the bond.
        ii. Assistance should the purchaser experience short term difficulty with rental affordability.
        iii. Funding the legal process to evict the purchaser should it be required.
6. The full contribution including rental, utility payment and financial fitness is payable with commencement of occupation.
7. The funds to be paid to the Municipality, including the rates and taxes amount and the accommodation for the time value of money accumulates in the trust account of the transferring attorney until such time that the Municipality has set up the appropriate accounts.
8. The transferring attorney will open an account in the name of each purchaser to accumulate the funds that may be used towards a deposit, financial assistance or legal costs. Authority for this account remains with the transferring attorney during the rental term.
9. The product cost was based on the following:
    a. The pilot must be commercially viable to ensure a broader future application of the concept.
    b. Two typology plans were proposed, a 43m^2 two-bedroom unit and a 55m^2 three-bedroom unit. The units have an affordable housing specification, built with 140mm concrete blocks and concrete panel walling at the back and on the sides.
    c. To mitigate costs no allowance was made for land cost, service connection fees, plan approval fees and interest.
10. The purchaser will be able to apply for FHF after the rental term is concluded, if the purchaser complies with all requirements at the time.

The concept unit-types were costed and presented to the Municipal Council. This was done to get Municipal approval for concessions including waiving water, sewer and electrical connection fees as well as plan approval fees. The cost of electrical reticulation was incurred by the Municipality as part of the larger project and there was no recovery of electrical reticulation from the sales required. The land price was zero, though the costing of the units made provision to recover the subsidy made available to service the site as required by Human Settlements policy.

The benefit to the purchaser was explained as per Diagram B. The purchaser will develop the financial discipline over the 3-year period, have

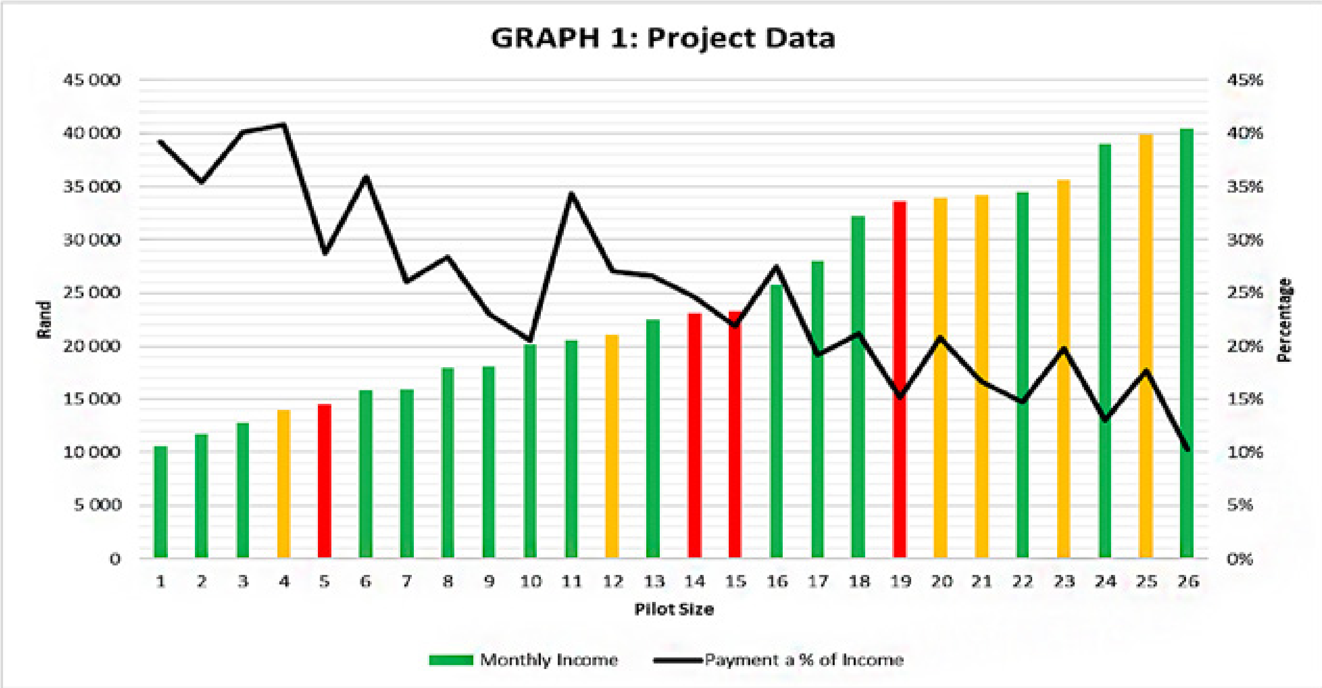

FIGURE 3: *Project Data*

the benefit of accumulating a deposit and the house price will remain the same over the period. The Municipality agreed to the proposed concessions, accepted the proposed typologies and confirmed support for the pilot.

Project implementation commenced and the following provides an overview:

1. The Department transferred R10 million to the Municipality.
2. A sod turning was held on 21 June 2022 and sales commenced with a 43m^2 two-bedroom units (R467 600) and a 55m^2 three-bedroom unit (R590 950).
3. A 2-bedroom 43m^2 showhouse was built and opened on 9 September 2022.
4. The first top structure phase commenced 24 October 2022.
5. Houses sold through Deferred Ownership were handed over from June 2023.
   a. Phase 1a, 14 houses, phase 1b, 2 houses.
   b. Phase 2a, 4 houses, commenced January 2024 with handover in April 2024
   c. Phase 2b, 6 houses, handover scheduled for July 2024.
6. A total of 39 units (including the showhouse) is part of the pilot of which 26 are Deferred Ownership units (14 two bedroom and 12 three bedroom).
7. Prices of the units were adjusted on a six-monthly basis to accommodate for building inflation.
8. The pilot closed for new sales/deferred ownership offerings in March 2024.
9. Upon completion the Department would have transferred a total of R25 million of which R18 million will be spent on the project of 39 houses.

Herewith facts regarding the status quo of the project up to June 2024 (also see Graph 1):

1. Twenty units are occupied (red and green bars, Graph 1). Fourteen units for at least 11 months, two units for at least 6 months and four units for at least two months. Six units (orange bars, Graph 1) are committed and will be handed over August 2024.
2. The average (combined monthly) income of participants is R24 594, the median is R22 815. The lowest income is R10 620 and the highest income is R40 464.
3. There are 12 participants in total that fall within the FHF income bracket up to R22 000 (combined income per month).
4. The average total monthly payment (rent plus rates and financial fitness) expressed as a percentage of gross income across the 26 participants is 25%, the highest percentage is 41% and the lowest 10%.
5. There are four participants (red bars, Graph 1) who did not pay full rent over the period and for which an arrangement had to be made.

4. CONCLUSIONS

To assess the success of the pilot project one has to delve deeper into the data at the hand of certain project objectives.

1. Did the public private joint effort yield a more affordable product:

The Municipal concessions pertaining to connection fees, plan approval fees and electricity reticulation as well as the Departments upfront contribution made the product more affordable. There would have been a potential additional cost of 15% after VAT on the selling rate (R539 000 instead of R467 000 in 2022) if the aforementioned concessions and contributions were not made. This does not take zero cost for land into consideration since it is assumed that a project of this nature will be executed on public land approved by Council for the intended purpose. Should this not be the case land cost will further exacerbate the product cost.

A key element of the pilot was that the project must be replicable elsewhere therefore based on economic principles that can be applied by other Municipalities with different service providers. It is unlikely though to assume that all Municipalities will be in a position to contribute to the electrical reticulation and therefore this cost will be recovered from the end user.

It is clear though that the joint effort led to a lower product cost through concessions and de-risking of the project. Despite the various concessions and de-risking, a conventional product offering remains too expensive.

Though a price of R467 600 could be achieved, and even if that price was R400 000, people with a gross income between R3 500 and R10 000 cannot access such housing. Serious consideration must be given to the notion of incremental housing as an enabler since the only way to reduce cost is to provide less but still sufficient to address aspiration.

2. Was it possible to assist people that would otherwise not have qualified for a bond?

To answer this question a particular case study of one of the participants will be used. Unit 1 on Graph 1 reflects a green bar, hence up to date payment of rent of R3 513 per month as well as R650 (R500 rates and R150 financial fitness) over an 11-month rental period (up to June 2024). Over the 11 months, Unit 1 has accumulated R19 322 towards a deposit.

The product cost of R467 600 at a 100% bond and interest rate of 9% (at the time) would require a repayment of R4 200 per month, at 40% of gross income. Subsequent interest rate increases up to 11.75% would have made it difficult for this purchaser to maintain affordability and convince a bank of that fact.

An assessment of the purchaser's bank account, outstanding debts and discretionary income showed that the purchaser is a candidate for Deferred Ownership. The total monthly repayment would be set at 39% of gross income, however the purchaser will be cushioned against interest rate increases since the rental will not be adjusted in line with future interest rate increases.

The likely scenario will be the following in three years for the purchaser in terms of the Deferred Ownership approach:

- Income (of R10 620) with three years inflationary adjustment: R12 648
- First Home Finance at the time: R104 071 (current FHF schedule)
- Deposit saver over three years: R 63 234
- The purchase price in three years R467 600
- The amount for which a bond will be required: R299 695 (R467 600 minus R63 234 and minus R104 071)
- At 11.75 interest the repayment will be R3 274 (26% of gross income).

In the example it is clear to note a much more favourable set of circumstances that will assist the participant to navigate the transition into homeownership than what would have been the case if the participant wanted to purchase upfront through a bond.

The combined effect of lower product price and the impact of the Deferred Ownership approach using rent to own principles over three years, the availability of First Home Finance and the accumulation of a deposit over the period creates an environment substantially more conducive to precipitate home ownership.

There is a caveat to this example and that is the requirement of sufficient discretionary income upfront to confirm affordability of the rental commitment. Even though someone with an income as low as R10 620 could be assisted, Deferred Ownership would face the same challenges related to lack of discretionary income.

The concept is therefore not a panacea that will solve the problem of home ownership to a broad spectrum of applicants that do not qualify for a bond. There was a 46% hit rate with 26 out of 56 serious applicants that qualified for the pilot. It is therefore based on the same fundamentals as a bond application; however, it creates room for a slightly more lenient approach, and it presents a set of circumstances that allows the purchaser to navigate the risks associated with purchasing a new house much better.

3. Did the pilot make it possible for people in the FHF bracket to be assisted?

The pilot consists of 26 units and 12 of these units have purchasers with a combined income of R22 000 or less. The pilot therefore created opportunity for people in the FHF income bracket, but it failed to reach people between R3 500 and R10 000. (Refer to the Banking Association South Africa, Financial Sector Code (SFC) Affordable Housing Standards, 2023).

It stands to reason though that the upper limit of R22 000 is outdated as the Financial Services Charter publication by the Banking Association of South Africa sets the benchmark for affordable housing at an inflation adjusted income of R29 600 per month for 2023. This is a more accurate reflection and in this bracket the pilot achieved 17 out of the 26 participants (65%).

4. Is there a major risk of payment default, creating a liability for the Municipality?

The possibility of default and the potential liability it creates for the Municipality is a fair concern that must be evaluated as part of the pilot. Out of the 20 units occupied, there are 4 flagged cases:

- Unit 5 (Graph 1) has been renting for 11 months and paid half of the rent for three months. Unit 5 has built up a deposit of R14 052 over the period and the part of rent not paid has reduced the accumulated deposit, but there has been no default on the part of the rent that go towards rates and taxes (proxy amount to Municipality), financial fitness (R150) and the contribution towards the time value of money (R1 756.5 per month).
- Unit 14 (Graph 1) rented for 2 months and did not pay the second month. There is no accumulation of a deposit saver. The client will pay the outstanding amount over three months and normal payment from 1 July. This will be monitored.
- Unit 15 (Graph 1) presents a recurring payment issue over the 11-month rental period and after all commitments excluding the deposit contribution, only accumulated R2 446 towards a deposit. This is a potentially problematic scenario.
- Unit 19 (Graph 1) paid short in one month and do not pay for the financial fitness (R150). The unit has accumulated R24 420 as a deposit contribution, so there are sufficient funds accumulated to recover short payments.

The argument for lower default is that a purchaser is renting towards owning their own house and builds a deposit from rent paid. The accumulated funds are used to mitigate certain risks and act as incentive since it will be used as a deposit towards the house, once the purchaser completed the three years as originally committed. Except for one purchaser all occupied units have accumulated funds towards a deposit. Two out of twenty occupied units are flagged as a potential risk. It seems therefore at this point that the risk of default is being managed.

5. RECOMMENDATIONS

In the pilot 54% of benefactors were above the First Home Finance upper bracket of R22 000. This is most likely symptomatic of the fact that the upper value of this bracket has not changed for some years and therefore due to inflation more and more people fall outside the upper limit. The First Home Finance income band cannot be based on idealistic parameters that is divorced from reality.

Municipalities should not view the First Home Finance income bracket as the only parameter that determines if someone should be assisted with home ownership. Many people with a combined income above R22 000 per month would like to access home ownership for the first time and therefore benefits provided by the Municipality should not be limited to R22 000.

The initial objective to help people that earn between R3 500 and R22 000 was not achieved through Deferred Ownership. Not a single beneficiary that participated earned a combined income less than R10 000 per month. People earning between R3 500 and R10 000 is the true GAP and alternative thinking which includes unsecured lending in an incremental manner is required to reach deep enough down the income band.

Deferred ownership works where the product is bondable. To have greater impact lower down the income bracket, above R10 000, a combination of the Deferred Ownership approach in tandem with incremental housing products that test the boundaries of what banks will bond, may be the only way to address the affordability challenge.

Even though the replicability of the project was flagged, the project was executed in a manner that may not be feasible to other Municipalities. The concessions made by Cape Agulhas in an effort to achieve their desired outcome may not be acceptable to other Municipalities, which will have a direct impact on product cost. Municipalities must consider the concessions and possibly the introduction of a two-step approach whereby the costs will not be subsidised above a particular income threshold, but the benefits of the programme at large should apply.

This is a rental scheme that can work but it is essential that the management of the rental is done by private sector. Prevent political interference. It is a rental programme with a particular goal, namely homeownership and the programme must be managed to achieve this outcome, however people that do not honour their commitment and remain in default must be removed from the programme.

The Western Cape Department of Infrastructure took the bold step to commit funding to the pilot, thereby galvanising a joint effort by private and public sector. There must be serious consideration to develop proper policy in this regard as it propagates the role of Government as catalyst rather than the provider of housing in last resort.

Deferred Ownership effectively draws in public and private sector and combines variables i.e. the cost of the product, the discretionary income of the purchaser, the prevailing interest rate and arrange it favourably using rent to own principles and inflationary movement over three years to create an outcome whereby the purchaser can transition into ownership. The current variables are not yet a 'bridge over the GAP', but it is a promising concept.

6. REFERENCES

1. National Housing Projects Act, Annexure P, Finance-linked Individual Subsidy Programme
2. The Banking Association South Africa, Financial Sector Code (SFC) Affordable Housing Standards