Banking & Payments Federation Ireland

How can the Irish banking sector continue to contribute effectively to the financing of housing?

September 2024

Executive Summary

It is widely expected that the Government will formally increase its **housing targets** to **50,000 units each year**, which the Department of Finance estimates will require approximately **€20bn development capital annually** to finance.

The funding challenge to deliver the increased levels of housing output required is significant. The **State's investment in housing is at historically high levels**. However, this level of investment may become unsustainable if the currently strong public finances deteriorated, and therefore additional funding will be required from private sources.

The banks are already providing significant finance to the housing market. BPFI has undertaken this report to assess if the lending capacity of the banking sector is being fully utilised and to understand the key issues, if any, impacting the banks' ability to deploy increased levels of development finance effectively.

The inability of many smaller developers to secure development finance due to a **lack of equity is a major concern**. There is an opportunity for the banks to make an increased contribution by exploring ways to increase lending through innovation such as a **tailored credit guarantee scheme**, and minor amendments to existing support schemes (e.g. making Croí Conaithe more effective to unlock increased levels of apartment development activity).

This consultation also highlights the **increasing role of the State** in the provision of development funding currently limiting the banks' ability to lend for affordable housing. The banks are uniquely positioned, to act as a **conduit to attract additional international capital**, but to do this effectively the banks must be seen to be active lenders in all aspects of the development market where appropriate.

Introduction

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There is a general consensus that a significant increase in medium-term housing demand projections will result in an upward revision of the Government's *Housing for All* housing output targets later this year. This is likely to see a minimum housing requirement of 50,000 residential units p.a., refocusing the discussion on the amount and the sources of the development finance required to deliver the increased output. The recently published **Report of The Housing Commission** reinforces this view, presenting a detailed analysis for the banking sector to evaluate and to assess the implications for the residential lending market in the medium-term.

Housing for All is driving increasing state activity on the supply side through initiatives such as Croí Conaithe and Project Tosaigh etc. Notwithstanding the significant counter-cyclical support that this direct intervention is having on housing output, there is a recognition that the government needs a "new housing model" that can attract private capital at significant scale to meet targets of 50,000 and beyond.

The **objective of this paper** is to **explore further opportunities** that the Irish banking sector may have as it strives to continue to play an optimal role in the development funding landscape. It also looks at the **key blockages** that could inhibit future growth of the banks' residential development lending as well as what **actions, policies or risk-sharing mechanisms** could be introduced to ensure that the banks can scale risk-adjusted lending appropriately in line with market growth.

BPFI has consulted with a selection of its members and some external stakeholders in order to understand some of the main issues impacting the banks' ability to deploy development finance effectively in the housing market. This paper outlines an extract of the issues raised, emphasising the key strategic challenges that we believe could be addressed through a combination of actions.

There is significant demand for housing

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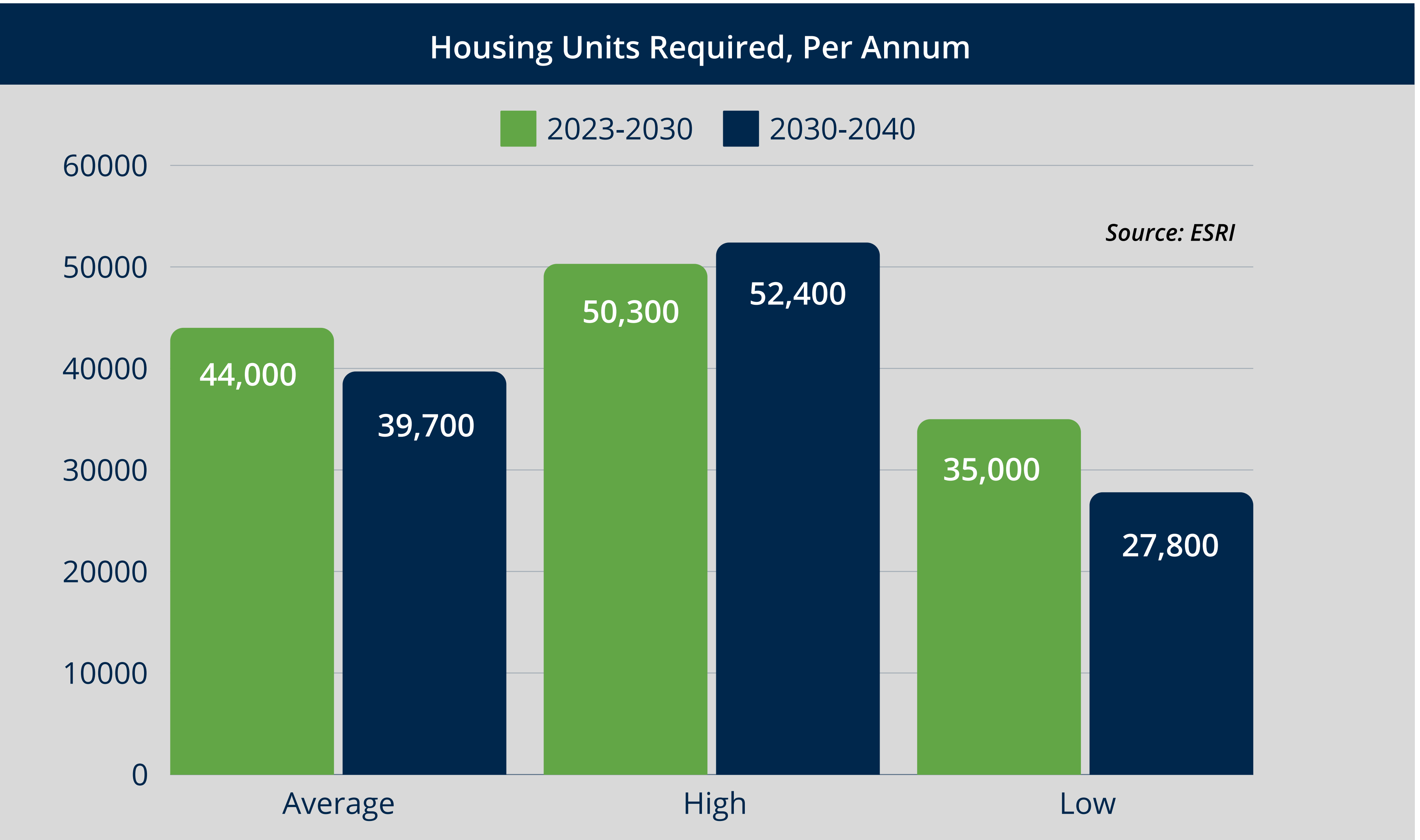
There are several factors driving structural demand for housing. A recent ESRI report provided estimates of housing demand using three main factors:

- Population growth
- Household size
- Rate of housing obsolescence



The ESRI report estimates annual housing requirements with different assumptions under these three factors resulting in 12 different scenarios.

Using the average of 12 different scenarios, it is estimated that 44,000 units will be needed in the period 2023-2030 and around 39,700 units between 2030 and 2040.

The ESRI analysis also points out that their estimates are for future housing demand and do not necessarily capture "pent-up" demand.

In their recent report, the Housing Commission estimated this pent-up demand to be between 212,500 to 256,000 units.

Hence it is important to take account of this pent-up demand while trying to estimate future annual structural demand for housing.

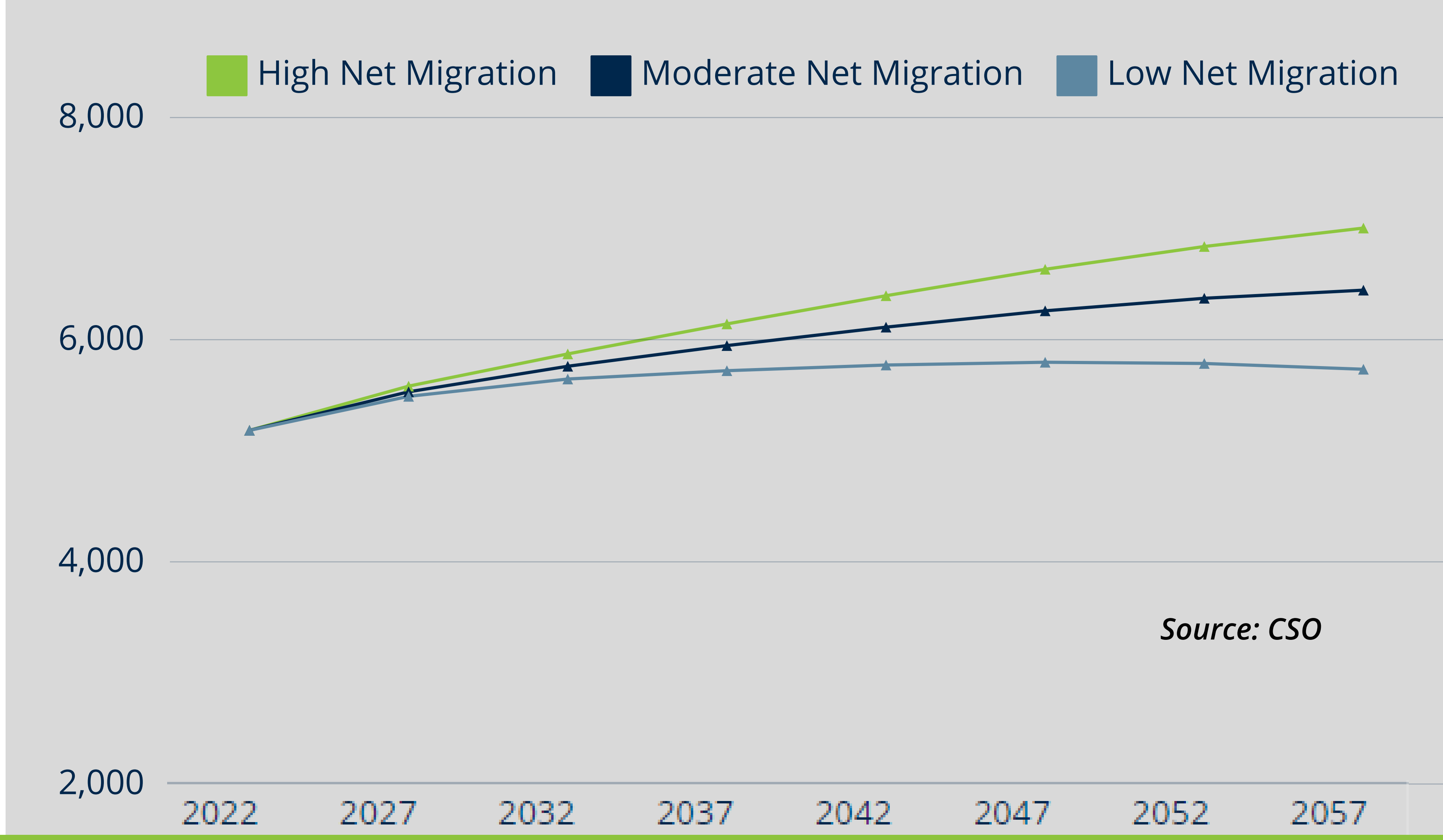
Structural reasons underpinning demand for housing

Ireland's population is projected to rise at an average rate of 5.3% per decade to 2060. Additionally, one of the key findings of the Housing Commission's analysis is that current household size is artificially elevated due to housing scarcity.

- In the coming decades, **higher population growth** will drive demand for more housing units in total each year.
- If Ireland, which currently has a **household size** of 2.6 converges to the Eurozone average household size of 2.3, more housing units will be required even if the population remained unchanged.

It should also be noted that between 2011 and 2022, the share of young adults aged 18 to 34 years living with their parents increased from 32% to 41% according to the latest CSO research, which is one of the main indicators of pent-up demand.

CSO Population Projections 2022 - 2057



Housing targets to be increased

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It seems increasingly likely that national housing targets will be revised to the mid-range of the Housing Commission estimates, or approximately 50,000 units p.a., from the current target output of 33,000 units annually in *Housing for All*.

The two *main factors* impacting the housing requirement are population growth and average household size. If we assume the mid-point of population projections of 6.75m in 2050, and an average household size of 2.2 persons, there would be a requirement to build 51,800 new housing units each year.

For a population of 7.0m in 2050, the projected requirement for housing units to accommodate either 1 or 2 persons, ranges from 56% to 62%. This indicates that apartments may form more than 50% of new housing units in the medium-term, an increase over the approximately 40% evidenced in recent years. Apartments require disproportionately more development finance to construct, with all finance fully committed upfront before any income can be realised from the development.

50,000 units annually Min 50% apartments

TOTAL HOUSING REQUIREMENT

Average annual housing requirement 2024-2050 under alternative scenarios, assuming 0.5% obsolescence, including any housing deficit

Household size 2050	6.25 million	6.5 million	6.75 million	7 million	7.25 million
2.4 persons	33,400	37,600	41,700	45,800	49,900
2.3 persons	37,900	42,200	46,500	50,800	55,100
2.2 persons	42,800	47,300	51,800	56,300	60,800
2.1 persons	48,200	52,900	57,600	62,300	67,000
2 persons	54,100	59,000	64,000	68,900	73,800
1.9 persons	60,600	65,800	71,000	76,200	81,400

Source: Housing Commission

INCREASIING REQUIREMENT FOR APARTMENTS

Distribution of additional households by size, with population of 7.0m

Average household size	1 person	2 persons	3 persons	4 persons	5+ persons
2.3	23%	33%	19%	16%	9%
2.1	25%	35%	19%	15%	7%
1.9	32%	30%	15%	16%	8%

Source: Housing Commission

The funding challenge to build 50,000 residential units

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The Department of Finance estimates that approximately **€20bn of development finance will be required to deliver 50,000 residential units.** With State capital investment projected at €3.5bn, this means more than 80% of the total finance will be required from private capital sources.

As targets increase, the State will need to attract and retain capital from many sources. In this context, **it is vital that the lending capacity of the banking sector is fully utilised**, while enabling it to act as a promoter and conduit of international capital into the housing market.

Estimated Development Funding Requirements (€ bn)

Source: Department of Finance

Funding delivery of 50,000 units

In a recent report on the financing of residential development the Department of Finance sets out the following funding requirements:

State Funding €3.52bn (17%): to fund public sector development (social housing) through phased payments i.e. forward funding arrangements. This funding will be deployed primarily by the Housing Finance Agency and the Land Development Agency.

Private Funding €16.86bn (83%): the balance of funding for private sector development for sale and for rent, including an element of development for public sector clients e.g. units acquired by an Affordable Housing Body on a turnkey basis. This private funding includes equity and debt, from both domestic and international sources.

***Note:** these figures represent the gross development capital required each year, with no account taken for the revolving nature of development funding*.

The funding challenge and the role of the state

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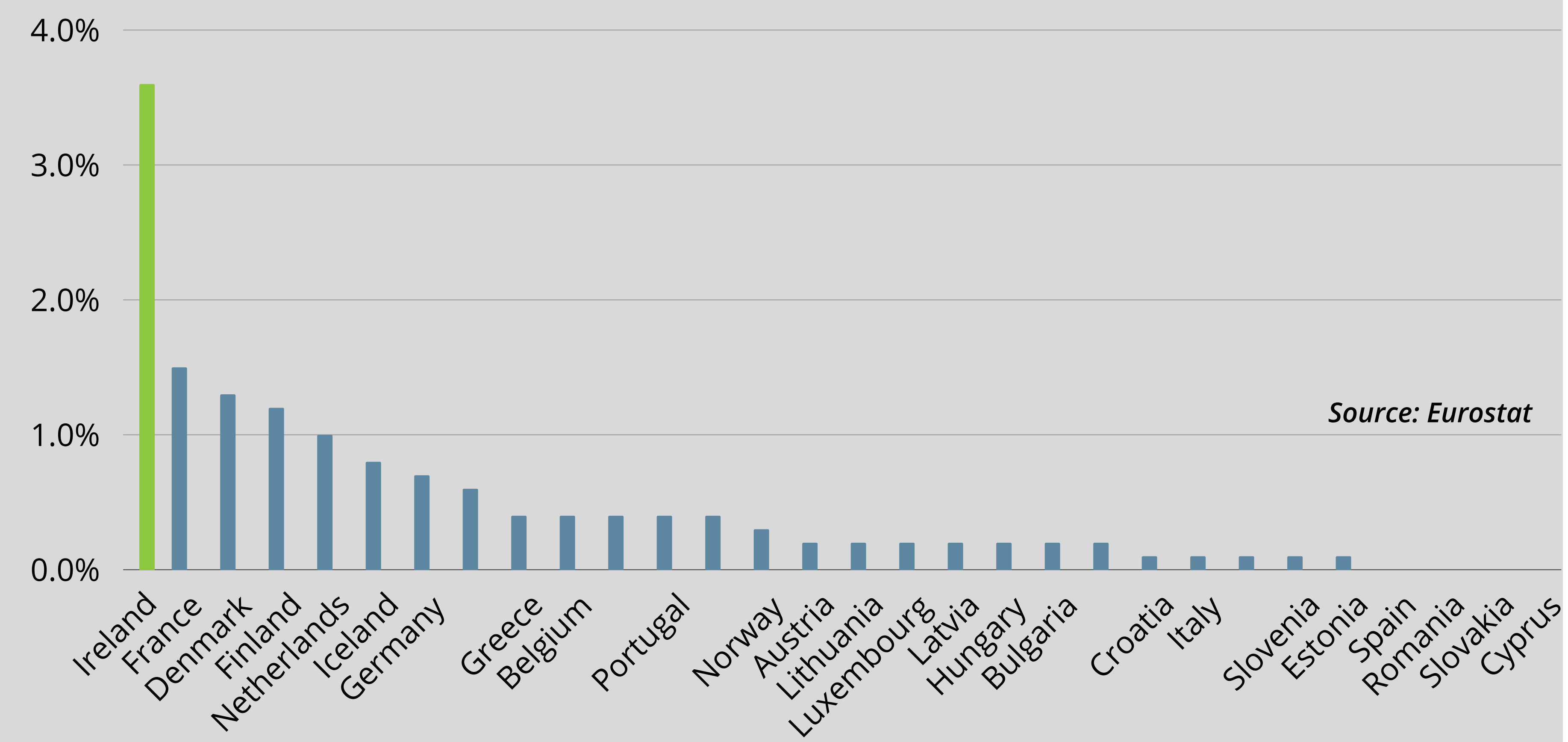
State Investment

In the context of strong exchequer surpluses, the current level of State investment in housing is at an unprecedentedly high level. This level of investment may not necessarily be sustainable in the future if the public finances were to deteriorate.

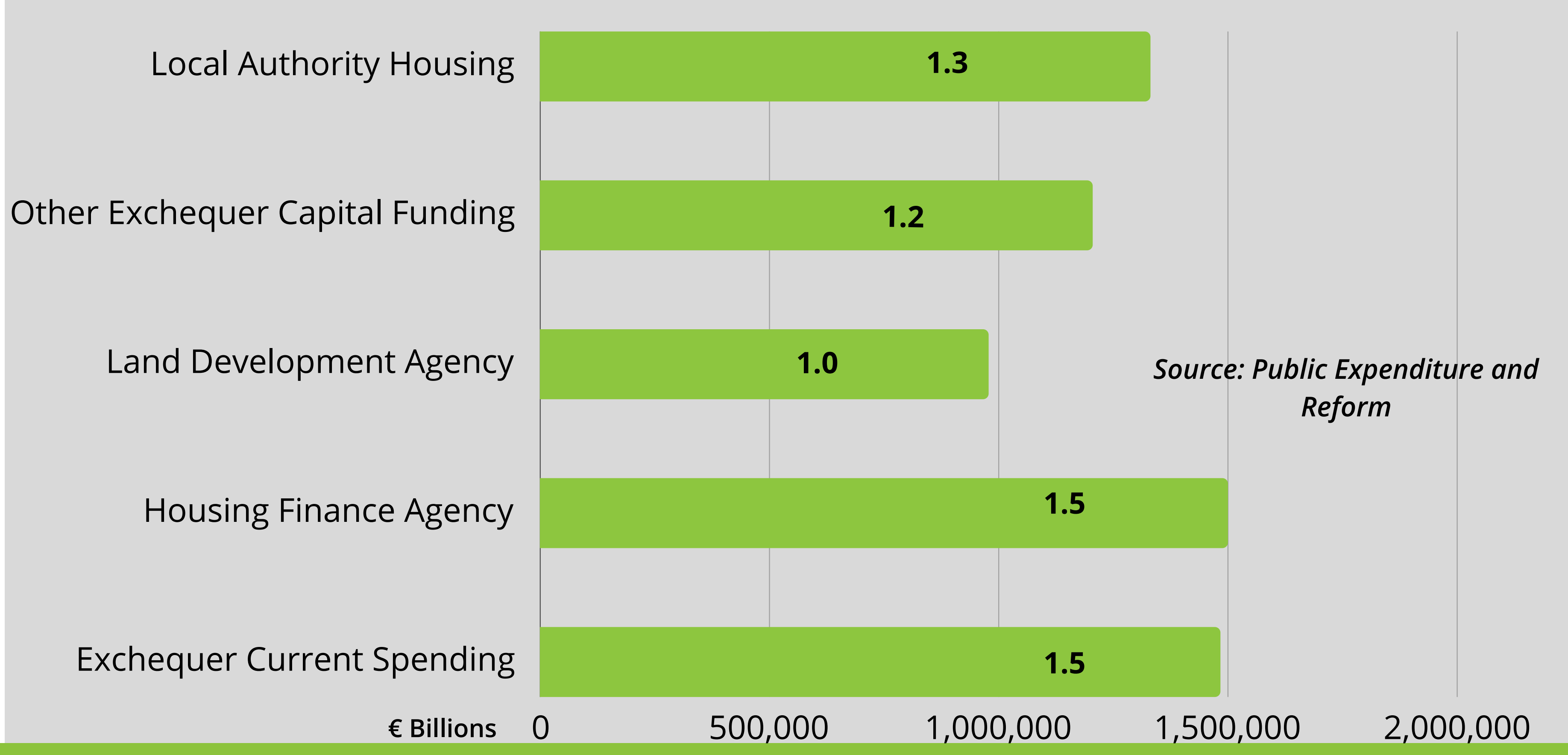
In terms of spending on housing as a percentage of national income, Ireland's spend is much higher than that of any other country in the EU. In addition to ongoing current expenditure, and taxation incentives, the State has committed €5.6bn of capital spend to housing in 2024. *Firstly*, the capital spend is allocated directly through Local Authorities and Approved Housing Bodies (AHB).

Secondly, and increasingly, capital is being directed through the Housing Finance Agency (HFA) and the Land Development Agency (LDA) to provide forward funding to developers to deliver housing for public sector clients – the LDA itself and the AHB sector. Home Building Finance Ireland (HBFI) is also providing significant funding to developers, to deliver units to both the public and private sectors.

Housing Share of General Government Expenditure (2019)



State Support for Housing (2024)



Significant State activity in funding housing

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As part of this research, we consulted various stakeholders including banks, direct lenders, state agencies and industry bodies.

Overall, the range of government funding initiatives are viewed in a broadly positive manner. In the challenging macro environment, notably the significant reduction in investment in the Private Rental Sector (PRS) market, this countercyclical funding has underpinned housing output in 2023 and into 2024. However, there are several issues:

The implementation of both the **STAR** (*cost rental* apartment development) and **Croí Conaithe (Cities) Scheme** (*for sale* apartment development) schemes have been slower than expected, with specific refinements under consideration. The effectiveness of these schemes are central to the ability of developers to deliver large numbers of apartments with private funding to the market.

The extent of **forward funding** being advanced by the Housing Finance Agency and the Land Development Agency is significant. Whilst the aim of State funded entities "avoiding" market finance costs is understandable, it must be stated that the cost of development risk may not always be included or appropriately priced.

The extent to which current output is skewed towards social and affordable tenures is again understandable, but the comparative low percentage of private output reflects insufficient levels of sustainable mixed tenure development.

The scope and role of each State entity operating in the housing market is evolving, through innovation and out of necessity. It is imperative that the complementary roles of private market participants are recognised and not "crowded out", to ensure the optimum delivery of funding to the housing market.

In this context, we believe that state investment should be targeted to unlock the optimum level of private development finance, as follows:

Social Housing – direct forward funding arrangements transfers some risk from the developer to the state funding entity, and limits lending opportunities for private capital. This must be matched with a corresponding investment in resources and expertise in these state entities.

Affordable Housing – in addition to existing state demand-side supports (e.g. Help to Buy), all state supply-side supports should be allocated as subsidies for each unit delivered. This will enable the delivery of affordable housing units to be funded primarily by private capital.

The use of the banking sector to fund affordable development, with additional collocated mixed-tenure development, should always be evaluated. This will ensure that state funding can attract and leverage available private capital to the fullest extent.

Developer access to finance

The stakeholder consultation also highlighted the concentrated nature of the developer/contractor market in Ireland. It is well documented[1] that outside of the top tier of developers, the strength of many developer's balance sheets is constrained. This directly impacts their ability to secure development finance.

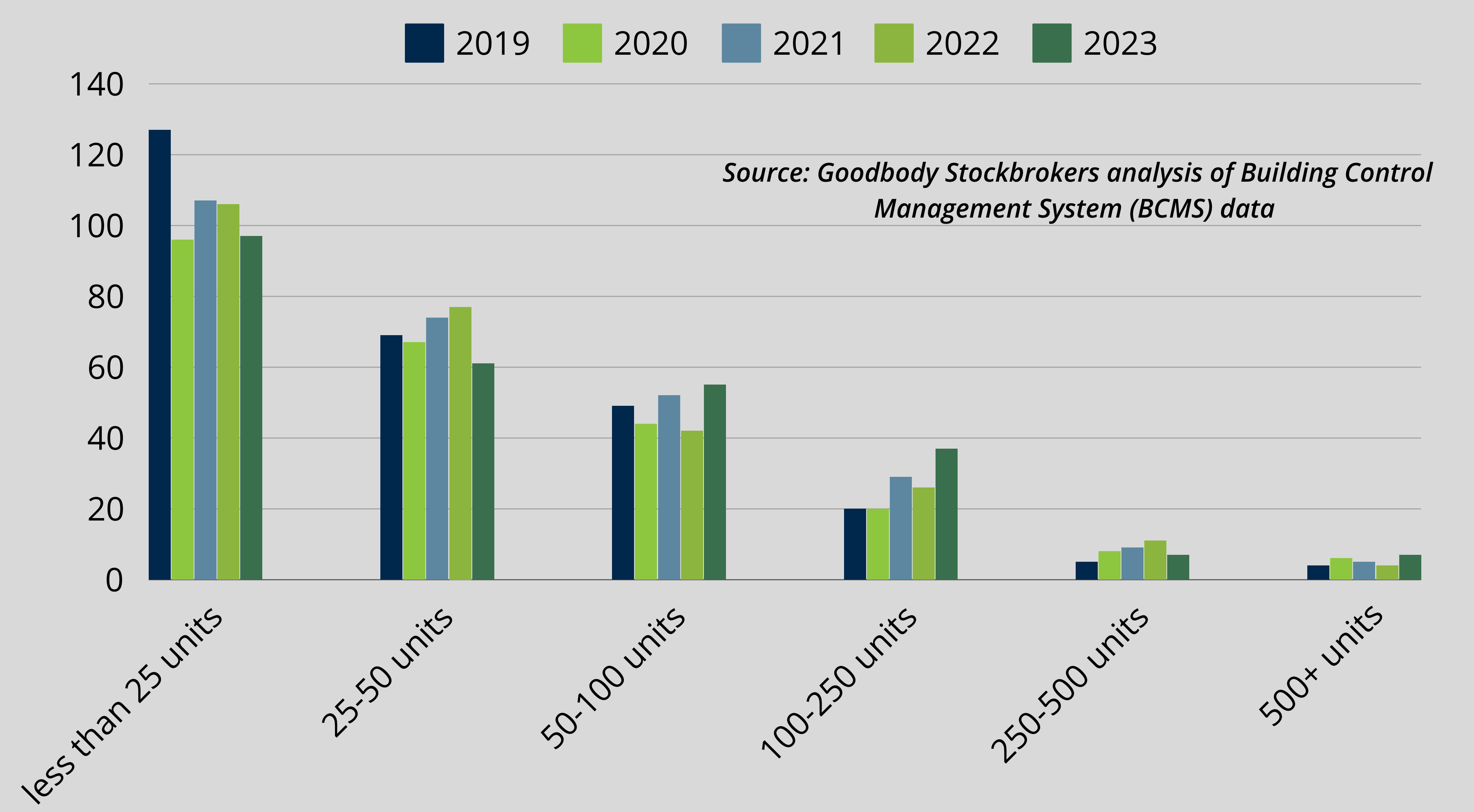
- Where the banks are not in a position to lend more than 65% loan-to-cost on viable projects due to risk assessment frameworks, many developers have insufficient equity to secure debt funding. The bulk of loan requests to the banks are within this risk scope, however lending to some smaller developers where collateral is considered insufficient, would be outside existing risk tolerance limits.

- The lack of equity also prohibits many developers from acquiring/owning more than one site at a time, limiting developers' ability to scale their business. A limited number of developer platforms are seen to be investible (governance, processes, financial strength etc.) by institutional capital providers.

- This current level of concentration will be a significant barrier to achieving sustained higher levels of housing output. It also impacts the ability of the banks to lend, and the attractiveness of the residential development market to international capital.

- Most developers have commenced less than 100 units p.a. in recent years. Only a few have managed to deliver more than 250 commencements each year.

Number of builders by annual commencement volumes



1 |Who's building in Ireland? A census of the Irish Homebuilding Industry. Dermot O'Leary, February 2024.

Addressing the equity gap

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Stakeholder consultation indicates that there is a large cohort of capable developers, with viable projects, who struggle to secure bank funding due to a lack of equity. Where banks may advance up to 65% on a loan-to-cost basis, the developer needs to bridge the gap with own funds or with reasonably expensive mezzanine finance[2]. This has several negative consequences:

- The mezzanine finance reduces residual development returns, which in turn limits the ability to strengthen the developer's balance sheet – a cycle that is hard to break.
- It is very difficult to fund more than one site/development at a time and consequently to scale up a business and residential delivery pipeline. If higher levels of housing output is to be achieved, it is essential that this cohort of developers can deliver more units each year than they are currently able to do.

In the context of this more volatile collateral, and the banks' risk assessment frameworks, it is understandable that the banks are constrained. The Housing Commission calls for a review of the capacity of the domestic banking system to identify measures that could be taken to increase the scale of financing, while minimising the risks involved.

Potential Solution

There is a compelling rationale for some form of credit guarantee scheme for SME builders to be put in place, partially underwritten by the state, to advance finance to developers with viable projects but insufficient equity. This would enable the banks to advance finance to additional clients/developments, without compromising credit underwriting standards.

		Developer Equity	
Bank Debt	+	**Credit Guaranteed**	**Balance Sheet / Equity**
65%		**15%**	**20%**

2|**Mezzanine Finance** is a form of debt, sometimes called "quasi-equity", that ranks below senior debt and is invariably secured at levels of interest well more than senior debt lending rates.

Banking activity & attracting additional international capital

There were several additional observations from the stakeholder consultation process:

In general, **debt financing is available for viable housing projects.**

The banks have lending capacity available and invariably, it is the inability of developers to secure zoned, serviced land that is the key constraint to new lending.

By actively engaging with international investors and offering them access to the domestic real estate market through their banking services, banks can effectively attract international capital and contribute to the growth and development of the real estate sector. With the requirement for additional sources of development finance, this role as a **conduit for international capital**, is particularly important and is currently manifested in and number of ways. For example:

- Providing expertise and advisory services on local market conditions, regulations, and potential investment risks to international investors.
- Offering foreign exchange services and tailored financial products to facilitate international transactions and investments in the domestic real estate sector.
- Ensuring transparency, stability, and adherence to best practices in banking and real estate transactions to instil confidence in international investors.
- Collaborating with international financial institutions and participating in real estate investment forums to promote opportunities in the investment market.

However, to fulfil this role effectively, the banks must be seen to be active lenders in all aspects of the development market. The current level of intervention by the state in the funding of affordable housing, whilst providing a welcome counter-cyclical stimulus to the housing market, is curtailing most private lending activity in this space. This impacts on the banks' ability to promote opportunities effectively, e.g. in context of financial structures - AHB bonds, PPPs, infrastructure funding – that can act as a channel for new international investment in due course.

Funding apartment development for sale to individuals

Several stakeholders raised the challenges in funding the development of apartments for sale, noting issues with the existing Croí Conaithe scheme.

The **viability of for sale apartment development** is marginal, and only for the top developers and in very few locations. This is primarily due to the comparatively high development costs of apartments.

The amount of **development finance required for apartment development is significant**, and needs to be fully committed and drawdown, before any income from sales can be secured. This makes it a higher risk proposition for any lending institution. Most of the apartment development in the last 5 years has been "de-risked" by being forward sold either to private institutions (private rental sector development) or more recently to the Land Development Agency or to Affordable Housing Bodies.

Making Croí Conaithe more effective

We believe that consideration should be given to **reducing the minimum threshold** below the current 40 units, to further unlock brownfield/infill development opportunities. As the market for apartments for sale is still relatively untested, it might also be worth exploring if some form of **"sales backstop"** or insurance could be procured, where **unsold units would be purchased by the LDA or AHBs.**

Summary

Housing Challenge

Housing targets will likely be increased to 50K units annually

Apartments likely to reflect a larger share of output

Approximately €20bn development finance required

Funding Challenge

Leverage state capital to fullest extent

Make STAR and Croí Conaithe schemes more effective

Evolving roles of state entities to be reviewed and refined as market evolves

The role of the Irish banking sector

Lack of equity is key issue in the finance market, and consideration should be given to a credit guarantee scheme to underwrite an element of developer equity

Sufficient lending capacity to lend more within existing risk assessment scheme limits

Can also play a vital role as a conduit for international capital into the residential development market

About the report

Banking & Payments Federation Ireland

Banking & Payments Federation Ireland (BPFI) is the voice of banking and payments in Ireland. Representing over 110 domestic and international member institutions, we mobilise the sector's collective resources and insights to deliver value and benefit to members, enabling them to build competitive sustainable businesses which support customers, the economy and society.

Verannott is an independent provider of real estate capital markets analysis for the Irish property sector. It specialises in providing analysis of the Irish development finance market, with a particular emphasis on residential development finance. It has recently produced several substantive reports on the sources of residential development finance in Ireland, and the role played by international capital, for a private client.

The report was commissioned by BPFI to examine and understand some of the main issues impacting the Irish banking sector's ability to deploy development finance effectively in the housing market.

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