# Senate Inquiry Submission – Affordable Housing

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**Submitted by:**

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## Focus of submission

This submission addresses specific Terms of Reference of the Senate Inquiry into Affordable Housing, being:

a) the role of all levels of government in facilitating affordable home ownership and affordable private rental, including:
   iii the effect of policies designed to increase housing supply,
   v. the regulatory structures governing the roles of financial institutions and superannuation funds in the home lending and property sectors, and

l) the role of innovative and responsible funding mechanisms used in other countries, including the United Kingdom, United States of America, France, Canada, Austria and the Netherlands, that provide a stable and cost effective way of funding affordable rental and social housing, such as affordable housing supply bonds and an affordable housing finance corporation; and

m) the role and contribution of the community housing sector in delivering social and affordable renting housing;

## Summary of Submission

Australia is facing a developing housing affordability crisis. Falling home ownership rates and a declining public housing sector are resulting in rising demand for private rented housing. However, existing market failure in the private rented sector means that increasing numbers of lower income and otherwise disadvantaged households are struggling to access housing suitable to their needs and resources. There is developing a structural shortage of low rent dwellings in Australia's cities and regions This has adverse implications for the living standards of affected households, and broader negative impacts on the productivity and competitiveness of the Australian economy.

This situation has evolved over decades in which the fruits of economic growth have been increasingly unequally distributed; housing markets have reflected and reinforced these inequalities of income and wealth. Current and past policy settings have ameliorated to a degree the full force of rising inequalities but ruling government taxation, spending, planning, infrastructure and environmental policies have collectively failed to adequately reverse existing housing market trends. To the extent that governments have intervened it has generally been to pump up demand-side measures – e.g. first home owners grants – or use housing as a macroeconomic tool to boost aggregate economic activity – e.g. during the global financial crisis. Efforts to date to stimulate the growth of a robust, expanding non-profit housing association sector based on attracting large, continuing flows of private investment have had only modest success. This, in our view, stems from an inadequate understanding of what is needed to bridge the gap between what professional and institutional investors require by way of risk-adjusted returns and the capacity of well managed and regulated non-profit housing associations to fund sustainable affordable rental provision, while ensuring that rents charged are affordable by those currently priced out of the market.

In this submission we:

(a) Outline the current context in which housing affordability has deteriorated in Australia;

(b) Describe existing policies aimed at dealing with the resulting problems – and their inadequacy;

(c) Outline the many successful approaches implemented in other advanced countries to improve affordability outcomes;

(d) Explore the significant interest of and potential for Australia's superannuation funds to invest in a suitable security designed to expand the supply of housing available at sub-market rents to eligible households in need;

(e) Outline two models for such a security – i.e. housing bond – drawing on the best features of models that have been successful elsewhere in the developed world.

In order to successfully bridge the gap between institutional investors and affordable housing providers it is necessary to create a new debt class that provides low risk returns to the former and a low interest or coupon rate to the latter. This requires creation of an institutional structure that delivers a regular pipeline of AAA-rated bonds to investors. A central component of this structure is provided by a carefully crafted, capped government guarantee that operates as a “last call” or backstop reassuring investors that they will receive all entitlements. However, in order to minimise the likelihood that the guarantee will be called upon, a series of “first-call” reserve mechanisms must be put in place to protect the taxpayer. These elements are described in the preferred model presented in the final section of our submission, based on schemes now operating successfully in the UK and Switzerland. This approach requires the creation of an independent, non-profit financial intermediary – the **Affordable Housing Finance Corporation** – governed by a professional board to which directors are appointed, drawn from the financial and legal sectors, government and the non-profit housing sector. This body would report regularly to Parliament to ensure that the taxpayers’ interests are protected.

IN SUMMARY, It *is* possible to design and implement a new policy regime and institutional mechanism able to substantially boost private (notably, institutional) investment in expanding the supply of affordable housing in contemporary Australia. However, strong, strategic government leadership is required. International experience over decades has demonstrated this fact. Government can get “more bang for its buck” in this field by sensibly leveraging its strong credit rating in the way the AHFC approach entails but it must also ensure that the growing non-profit housing sector is able to make use of the low-cost debt provided through this mechanism by way of matching capital and revenue support, as outlined in the preferred model.

# A proposal to increase appropriate long term investment in affordable rental housing in Australia[1]

Dr Julie Lawson, Hon. Assoc. Professor and Professor Mike Berry, Centre for Urban Research, RMIT University.

## Context

Few material concerns are more important to Australians than the homes they live in.[2] Secure, affordable housing contributes to our sense of security, individual wellbeing, health and supports family stability. Affordable housing provides households with the capacity to access other life needs such as education, recreation and access to employment opportunities. It is not only important to overall community well-being but also economic stability.

Despite the importance of housing, regrettably the lack of affordable housing continues to be one of the most persistent and corrosive problems eroding the quality of life amongst Australian households over the last quarter of a century. The work by the Australian Housing and Research Institute (AHURI) and the National Housing Supply Council (NHSC) tells us that the great Australian dream of secure, affordable home ownership is now fading for many households. Today, almost one third of all children are part of a household that rents their home (Hulse et al, 2011:37-39). The implications of this trend are multiple. While families with children have borne the brunt of housing stress and involuntary mobility, couples without children are also having difficulty moving out of rental accommodation and maintaining home purchase obligations in order to advance their housing aspirations (Hulse et al, 2011, Wood and Ong, 2012)[3].

As Australian society ages, older households will increasingly meet the cost of aged care by drawing on their accumulated housing wealth (Productivity Commission, 2011). Obviously this is not possible for renters. Outright ownership amongst over 65s is anticipated to decline by 10% by 2046 (Yates and Bradbury, 2010 in Wood and Ong, 2012; see Table 1). Hence, sub-standard care and poverty looms close for many elderly private renters (Morris, 2009) and those with outstanding mortgage debt on retirement. Clearly, keeping down the costs of rental housing amongst low income tenants and building bridges to affordable home ownership reduces their chances of living in poverty in old age.

This submission to the Senate Inquiry is about how to grow an appropriate and responsible range of housing choices for Australians by better utilising the tools at government's disposal and harnessing circuits of savings and investment via the superannuation sector, to benefit our housing futures.

[1] This submission is based on research carried out over many years by the authors and others, supported by the Australian Housing and Urban Research Institute. A list of relevant reports is appended as Attachment 1. This research and other sources are cited throughout the text of the submission. The "Guarantee" report on which our preferred model (see final section of submission) is drawn from (Lawson et.al, 2014) will be released by AHURI Ltd. on 15 April 2014.

[2] Senate Enquiry into http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Former_Committees/hsaf/report/c02#c02f8

[3] A list of relevant research documents is included as Attachment 1. All references cited in the text are detailed in the Bibliography.

Table 1 Declining rates of ownerships across Australian households

| Home ownership rates by age of household reference person, Australia 1961-2011 | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Age** | 1961 | 1966 | 1971 | 1976 | 1981 | 1986 | 1991 | 1996 | 2001 | 2006 | 2011 |
| **15 - 24 years** | 34 | 30 | 26 | 25 | 25 | 26 | 24 | 22 | 24 | 24 | 25 |
| **25 - 34 years** | 60 | 58 | 56 | 60 | 61 | 58 | 56 | 52 | 51 | 51 | 47 |
| **35 - 44 years** | 72 | 71 | 71 | 73 | 75 | 74 | 74 | 70 | 69 | 69 | 64 |
| **45 - 54 years** | 75 | 76 | 76 | 76 | 79 | 79 | 81 | 79 | 78 | 78 | 73 |
| **55 - 64 years** | 78 | 78 | 79 | 78 | 81 | 82 | 84 | 83 | 82 | 82 | 79 |
| **65 years and over** | 81 | 80 | 80 | 75 | 78 | 80 | 84 | 82 | 82 | 82 | 79 |
| **All households** | 72 | 70 | 69 | 68 | 70 | 70 | 72 | 69 | 70 | 70 | 67 |

Source: Yates 2011 (for 1981 to 2006 data); data for 2011 provided by Yates (based on the ABS most recent 2011 Census).

Research by AHURI and the NHSC confirms that:

- House prices are rising faster than incomes
- Home ownership is declining amongst young and established pre-retirement households
- There is a falling share of social housing available
- There is increasing pressure on rental markets
- Affordability problems are stubbornly persistent
- Cities are becoming more socially polarised
- The market is not responding
- There are growing and well documented shortages of housing, particularly at the affordable end of the rental market.

Existing market processes are having a negative impact on Australia's ability to adequately house not only its current population but also future generations of households. The benefits of rising house prices have not been shared evenly and the trickling upwards of housing wealth is diminishing social and inter-generational equality. Driving housing stress and social polarisation is the lack of support for a well-focused supply strategy and continuing reliance on tax incentives that fuel over-investment in existing housing. Reform of these market defining tools is well within the grasp of good government policy. National leadership can promote more beneficial market processes and more socially inclusive, sustainable and productive housing outcomes for all.

The rental market has the potential to provide important a refuge, oasis and stepping stone for an increasing number of households. However, compared other advanced economies Australia's rental housing is the least secure and most neglected pillar of our housing system (Hulse et al, 2011). Clear recommendations in this research have been made for Australian governments to strengthen the choices available for tenants in this important and necessary part of the Australian housing system.

A modernised Australian housing policy would support and expand housing choices for a range of households. It would be implemented and co-ordinated across relevant government agencies responsible for implementing urban plans, social welfare policies, as well as improving labour market productivity, economic stability and environmental sustainability.

It is now well recognised that current provisions, such as the negative gearing of existing rental properties, entice small scale investors to make highly geared, speculative investments in existing dwellings. This has fuelled price rises in established areas and undermined the secure occupancy of tenants they house (Wood and Ong, 2010). The risk posed by speculative investment by self-managed superannuation funds has also been raised as a cause for concern by the Reserve Bank (RBA, 2013).

Alongside taxation conditions fuelling investment in *existing* housing are the high development costs of new housing on a constrained urban fringe, where revenue strapped local governments lack the capacity to develop infrastructure in advance. Upfront development fees directly impact 'first generation' purchasers, rather than being shared across a wider spatial area and longer time frame. The relatively high cost of new housing in less established or accessible locations compared with existing homes, coupled with high transport costs, has in turn influenced the pace of new construction on the fringe. In advertently, metropolitan strategies prioritise expansion of housing development in job poor areas (Rawnsley and Spiller, 2012:135).

Increasingly the design and focus of these measures are being questioned by experts (see Wood and Ong, 2010, 2012, Milligan et al, 2012, Berry and Williams, 2011, Yates, 2012, Rawnsley and Spiller, 2012, Gleeson, Dodson and Spiller, 2012 amongst many other experts) and given critical attention by media commentators (Gittens, Kohler, Joye, etc). As in the 1980s, housing issues have led to the formation of numerous stakeholder alliances such as Australian's for Affordable Housing, Housing Summit, Urban Alliance and generated numerous parliamentary Inquiries.

However, the Australian government is yet to develop a comprehensive response to these conflicting pressures.

Before its abolition, Australia's National Housing Supply Council found that up to 20,000 new social and affordable dwellings are needed each year for the next 10 years just to retain a modest five per cent share of the social and affordable stock in Australia (Australian Government, 2009 see also subsequent updates to 2013 now online).[4] The cost of meeting this would amount to around $7 billion per year, based on a median cost of $350,000 per dwelling (Lawson et al, 2012).

With no likelihood of significant direct public financing being allocated for housing, it is essential to attract private finance to expand supply overall in the rental housing sector and in particular guide lower cost investment towards new affordable rental housing provided by landlords with a mission to provide secure descent quality, affordable rental housing. This requires much more carefully designed public measures and mechanisms to ensure that investment reaches landlords which share this commitment, such as community housing organisations (CHOs) that serve a range of households from young people at risk of homelessness, to people with disabilities and key workers in high cost urban locations.

**National leadership, with a long term commitment to expanding affordable rental supply is needed to expand and secure long term and appropriate investor interest in affordable rental housing.**

[4] The estimates are based on combining projections of future household growth with the increases in dwellings that would be needed to address the estimated current shortfall over a 10 year period (Australian Government 2010: 89).

Recent efforts have been welcome but are not sufficient on their own. The social housing initiative (SHI) directly lifted affordable rental output by 20,000 dwellings but has now ceased. The National Rental Affordability Scheme (NRAS) offering tax credits for below market rent dwellings for 10 years has generated interest in investment in new supply from individual investors but is yet to attract large scale institutional investment. What is now required are sustained policy enhancements that recognise the taxation regime and investment portfolio needs of institutional investors in order to unlock much greater volumes of investment and channel these towards appropriate and well regulated housing managers, such as not for profit community housing organisations.

National leadership can be demonstrated by governments acting as both an enabler and investment partner. In housing this could entail tax incentives for additional affordable and sustainable housing (via the continuation of a refined NRAS) plus government guarantees backing investment to reduce perceived risk, and equity contributions in the form of subordinated public loans or government land. Strategic actions such as these would channel lower cost institutional investment to appropriately regulated landlords serving the housing needs of those households not met by current market processes.

IN SUMMARY, well-founded, evidence-based research shows that Australia lags European and North American countries in recognising the scale and severity of housing affordability problems. Governments in Australia have begun to address the complex issues entailed but have, to date, lacked the leadership and policy innovation necessary to make a significant positive impact. Rental housing markets in Australia are failing to deliver acceptable social and economic outcomes, putting at risk the wellbeing of current and future generations. This state of affairs has not arisen because of a lack of sensible options; successful approaches are in place and working on other countries. Indeed, Australia is an outlier in the group of OECD countries in this respect. The impact of the global financial crisis has made governments everywhere sensitive to the impact that poorly regulated housing markets can have on national economic performance. Organisations like the International Monetary Fund and the World Economic Forum have stressed the need for national governments to monitor and, where necessary, intervene in housing and financial markets in order to prevent those markets from failing in ways that would undermine the growth and stability of their economies and exacerbate inequality.

The remainder of this submission concentrates on what governments can do to facilitate desirable outcomes from the housing system.

## Policies to increase affordable rental supply

The private rental housing sector in Australia has been sizeable (around 20–25% or more of occupied dwellings) since the 1960s but it has operated in policy and market contexts that have favoured individual rather than large-scale, long term investors. Typical investors in private rental housing are individuals or families owning their own home and renting out one or two further properties.

Traditionally, social housing in Australia was funded through public grants and public loans to State Housing Authorities and Community Housing Organisations. However, investment through these means has been in long term decline, resulting in new supply levels falling below household formation rates. Today, Australia has one of the lowest rates of social housing amongst Advanced Economies, including the US.

In the past, under a social housing subsidy program, the Commonwealth government has determined to:

> subsidise efforts by Eligible Providers to raise additional funds, through gearing, for the provision of an increased level and range of housing services for low and moderate income households. (Department of Housing and Regional Development, undated) [5]

Programs such as the Local Government Community Housing Program (LGCHP) played a catalysing role, supporting partnerships between key stakeholders and promoting innovative responses to local needs. A brief return to supply policy in 2009-2012 generated 19,700 dwellings and repaired or maintained a further 81,000 dwellings as part of the successful Social Housing Initiative under the National Partnership Agreement on the Building and Jobs Plan. Housing supply subsidies directly addressed homelessness and built accommodation for people with disabilities, the elderly, Indigenous households and those fleeing domestic violence. Subsidising supply directly also had a strong economic multiplier (1:1.3) generating up to 14,000 jobs (9,000 in construction) and boosting Australian Gross Domestic Product (GDP) by an estimated 10 basis points during 2011-2012 (KPMG, 2012).

The LGCHP program and the recent Social Housing Initiative (SHI) stimulus, both of which gave a strong impulse to supply, no longer exist. The National Rental Affordability Scheme (NRAS), while a very important new tool for attracting investment, has not yet generated suitable levels of interest from long-term institutional investors in the wake of the GFC and ongoing uncertainty of policy support.

Unlike many European and US schemes established over the past 25 years, Australian efforts orchestrated by various governments to attract institutional investment into rental housing have been ‘piecemeal and fragmented’ or have lacked essential policy support. Milligan et al. (2009) argued that growth in affordable housing necessarily requires a long term investment path involving a substantial commitment of dedicated public funds coupled to forms of cost-effective private financing. Since 1996 disinvestment in social housing has occurred (Australian Government 2009, p.135). The previous Rudd Government, as noted, made positive moves to address the identified shortfall in affordable rental housing in Australia via the successful Social Housing Initiative and the National Rental Affordability Scheme (NRAS). However, many organisations with NRAS allocations have been unable to obtain private finance at any cost (Lawson, et al 2014). Additional measures are required to channel and sustain adequate levels of private finance to achieve adequate supply targets.

[5] See National Partnership Affordable Housing, Social Housing Subsidy program http://www.federalfinancialrelations.gov.au/content/npa/housing/social_housing_subsidy_program/NP.pdf

The vast bulk of Australia's social housing is public housing developed in the period 1945-1980. Provided by state and territory governments, this was financed through long-term low-cost loans via the Commonwealth Government. However, to the limited extent that new social and affordable housing has been developed over the past 10-15 years, it has increasingly involved not for profit providers rather than state governments themselves. At the same time, there has been an assumption that private financing (or 'leveraging') will form a component of the package. This may take place either:

- directly – e.g. private finance secured by a community housing organisation to match public funding in underwriting a particular scheme, or
- indirectly – e.g. community housing organisation raises finance to underwrite wholly privately funded affordable housing as a complement to, and condition of, receiving wholly publicly funded housing.

The first of the above approaches is exemplified by the Victoria State Government program committed in the 2007/08 State Budget, whereby $300 million was earmarked for not-for-profit organisations to build 1,550 new dwellings predicated on the CHO contributing 25% of capital costs (Victoria Auditor General, 2010).

The second of the above models is demonstrated by the 2008 Social Housing Initiative (SHI) as implemented in NSW. Here, the state government directly constructed 6,000 dwellings under the stimulus program, with these wholly publicly funded dwellings being subsequently transferred into not-for-profit CHO ownership in return for a commitment that recipient landlords would then borrow new funds based on the transferred units' cash flow. The borrowed funds would then be used to construct or purchase privately funded dwellings approximating to 20% of those originally received (KPMG, 2012). The asset transfer aspect of this policy was predicated on the assumption that with a larger balance sheet, CHOs would become more attractive to lenders. Further, the cash flow from the transferred Nation Building dwellings could support debt that could be used to purchase or construct the leveraged dwellings.

The only national funding program for affordable housing currently ongoing is the National Rental Affordability Scheme as initiated in 2008 to stimulate the development of 50,000 dwellings by 2016. Given that NRAS support comes via (time limited) annual payments rather than capital subsidy, there is again a requirement for privately raised development funding. The recurrent NRAS subsidy, which is paid in cash to not-for-profits, is in this way designed to be leveraged as the basis for private bank lending.

Given the policy context outlined above, access to private finance is essential to not-for-profit housing agencies aspiring to develop (or, indeed, acquire) new stock. In doing so, they will be looking to minimise costs through achieving the lowest possible interest rate with favourable terms attached by the lender.

However, encouraging an adequate flow of investment into the supply of affordable housing in Australia remains a major challenge for CHOs and concerned governments (Berry and Williams, 2011, Milligan et al, 2013, Lawson, et al, 2014).

An appropriate balance of supply and demand side subsidies will be required on a long term basis, with the balance to be adjusted over time to reflect dynamic housing needs and market conditions. The following section of this submission concerns the type of mechanisms successfully employed in other countries, such as housing bonds and specialist financial intermediaries and guarantees. A later section adapts aspects of some of these approaches to Australian institutional and market conditions.

## Established funding mechanisms internationally

AHURI research[6] has examined growing international experience in steering private investment towards affordable rental housing through well designed government regulations tax incentives and subsidies. The tools used by governments are summarised in Table 2 below:

**Table 2: Financing mechanisms for affordable housing**

| ***Mechanism*** | ***Brief outline*** |
|---|---|
| Grants | Directly able to influence housing supply, but limited to available funds and political commitment to housing. Often used to lever and secure other sources of funds. |
| Discounted land price | Traditionally a key vehicle to manage urban development outcomes, where governments are major land holders. Can be applied specifically to affordable housing goals. Subject to land availability and market conditions and public asset sale regulations. |
| Public loans | Traditionally the primary financing strategy for social / affordable housing. Cost-effective fund-raising. Revolving liquidity (through loan repayments) can offer longer-term reinvestment potential. Recently, curtailed by public sector borrowing limits and the attractiveness of low private mortgage rates. So-called 'soft' loans, may not require same security as for private finance. |
| Protected circuits of savings for specified investments | Used to achieve a dedicated flow of affordable credit for affordable housing programs. Sustained in some countries, while others have dismantled them to improve competitiveness of local banks amid foreign competition. |
| Bank loans | Increasingly play a role in financing affordable housing, either partially or entirely. Vulnerable to changing financial conditions and alternative investments. National approaches vary in cost-effectiveness and the appropriateness of the fund-raising and distribution mechanisms. |
| Interest rate subsidies | Useful in the early phase of a mortgage to reduce higher relative costs. Containing the cost to government over time relies on steadily rising wages and house prices and stable interest rates. |
| Tax privileged private investment | Used to channel investment towards affordable housing and to compensate investors for lower rates of return and profit restrictions. |
| Government-secured private investment | Government-backed guarantees to reduce risks to financial institutions investing in affordable housing, passed on at a lower cost of finance to affordable housing providers. |
| Tax privileges for | Many countries provide various tax privileges to registered organisations, for example income and investment deductions, |

[6] Lawson, 2013, Lawson Gilmour and Milligan, 2010, Lawson, Milligan and Yates, 2012, Gilmour, Washer and Lawson, 2013 and Deutsch and Lawson, 2013, Lawson and Milligan, 2007

| | |
|---|---|
| providers of affordable housing | depreciation allowances, reduced sales and property taxes, exemptions from income tax, fringe benefit tax and capital gains tax. These allowances compensate the efforts of the preferred providers towards achieving the social/economic policy objectives of governments, such as housing low-income households or meeting high environmental standards. |
| Use of own reserves and surpluses | Mature housing organisations can leverage their balance sheets, reserves and surpluses to invest in additional housing. Funds raised may be pooled to support weaker organisations or to promote innovation and competition. |
| Use of tenants' equity | Some funding models incorporate a small tenant equity contribution. Governments may assist low-income tenants to make this contribution. Larger contributions may lead ultimately to tenant purchase of dwellings. |

Source: Adapted from Milligan *et al.*, (2009) p.28 in Lawson et al, 2010.

Typically, these tools are used together to form a mechanism to channel investment towards particular segments of the housing market. In 2009, RMIT/AHURI conducted research[7] '*International measures to channel investment towards affordable rental housing'* describing established contemporary financing mechanisms that employ a variety of subsidies and incentives to attract large-scale commercial finance.

Alongside a six country comparison of the UK, France, the Netherlands, Austria, Switzerland and the US (Lawson et al., 2010), two detailed field work studies were also completed, on the UK's Housing Finance Corporation (Gilmour, Washer and Lawson, 2012) and Austria's Housing Construction Convertible Bonds (Deutsch and Lawson 2012) and later an update of European social housing policies was completed in 2011 (Pawson, Lawson, and Milligan, 2011)[8].The financial models covered by this body of work are summarised in Table 3 below:

**Table 3: Social housing financing models, selected countries**

| *Selected country* | *Financial model* | *Brief outline* |
|---|---|---|
| Austria | 'Structured finance model' | Long term low interest public loans and grants, combined with commercial loans raised via HCC Bonds and developer/tenant equity sustains tightly regulated form of cost rent limited profit housing. Promotion supported by municipal land policy and land banking. |
| Denmark | 'Mortgage loan model' | Bulk of funding derived from private mortgage loan (84%) complemented by local government grant (14% of building expenses) and guarantee and tenant contribution (2%). Recently National Building fund for Social Housing has partly financed new dwellings (Scanlon and Vestergaard, 2007). |

[7] Commissioned by the Western Australian Government, published on AHURI Ltd.website.

[8] Commissioned by the NSW Government, unpublished

| | | |
|---|---|---|
| England | 'Mixed funding model' | Since 1989 the financing of housing association development has involved capital grants from central government matched by bank loan or bond finance supported by rental income streams. Latterly, effective (or explicit) subsidies have also been provided by developer contributions secured through the planning system). However, this system was substantially modified in 2011 under the coalition government's new 'affordable rent' regime which reduces government grant per dwelling and entails newly built homes being let at quasi-market rents. A guarantee was introduced in 2013 to secure scarce private funding (Lawson, 2013). |
| France | 'Protected circuit model' | Tax free household savings scheme (CDC) finances off market loans to HLM providers along side state and local subsidies, tax incentives and other loans. Land provided by local authorities and development contributions. All CDC loans are guaranteed by the central government. |
| Netherlands | 'Capital market and revolving fund model' | Replaced direct loans and subsidies with guaranteed capital market loans and rent assistance. Dutch guarantee fund (WSW) and Central Fund (CFV) provide security and assist to reduce financing costs. Associations are free to determine own investment strategy, asset base and surpluses are intended to be used as a revolving fund to achieve social policy outcomes. A structured guarantee on private loans is shared by government and the non-profit housing sector. |
| Germany | 'Demand assistance model' | Federal government has withdrawn from direct supply support and shifted towards demand side subsidies. Municipalities develop own programs and housing companies are private entities, with a variety of shareholders. Private investment in social housing is promoted via tax concessions and economy of scale and privatisation has been very rapid. Rents and eligibility depends on level and duration of public subsidy. Production levels declined and foreign investors are selling better quality stock (Droste and Knorr-Siedow (2007). |
| Scotland | 'Mixed funding model' | Since 1989 the financing of housing association development has involved capital grants from government matched by loan finance supported by rental income streams. In 2009 Government initiated the capital grant-funding of local authority housebuilding, supported by cross-subsidy drawn from the entire local authority rent base. To stretch public subsidy further, housing associations have subsequently been required to adopt a similar financial |

| | | |
|---|---|---|
| | | model and to observe a target for public funding per dwelling at no more than £40,000 – drastically lower than the £75,000 being recorded under the traditional funding model. Public funding will also be stretched further by a shift towards a 'mid-market rent' (80% of market) product targeted towards low income working households and delivered by housing association non-charitable business subsidiaries. |
| Sweden | 'Capital market model' | Corporate tax exempt Municipal housing companies have always been financed by capital market loans which were sometimes backed by municipal guarantees, grants as well the MOH own resources. In the past interest rates subsidies were provided by the central government but these have ceased. |
| United States | 'Private equity model' | The LIHTC has been the main mechanism for attracting private investors to affordable housing since 1986, underpinned by legal obligations for financial institutions to invest in 'poorly served' areas (the Community Reinvestment Act). For-profit and non-profit developers compete for tax credits allocated by states on different terms and priorities within broad national rules. The equity finance raised by syndicated sales of credits is complemented by various other project subsidies – soft state loans, allocations from state block grants, planning contributions ─ and by mortgage finance. A tax-exempt bond program complements the LIHTC. Targeting to the lowest income households is assisted where links to the Housing Choice Voucher Program operate ─ however vouchers are severely rationed (Schwartz, 2010; 2011). A variety of guarantees exist on private finance for affordable housing investment (Lawson, 2013). |

Source: Pawson, Lawson and Milligan, 2011

Further, a more detailed report (Lawson et al, 2010) contextualizes the following mechanisms within their local market and institutional settings:

1. dedicated and tax-privileged savings deposit system for affordable housing in France
2. housing tax credits in the US
3. specialist financial intermediary with public guarantees in Switzerland (Bond Issuing Co-operative)
4. specialist financial intermediary (the Housing Finance Corporation) in the UK
5. social housing mortgage guarantee scheme in the Netherlands
6. housing construction convertible bonds instrument in Austria.

The mix of public and private funding that is being used in each of the examples above has helped to create and sustain a diversified housing delivery system, supplying a range of housing services from emergency accommodation and affordable rent to rent to buy. While most international systems use non-profit housing organisations as their main providers of affordable and social rental housing, public and private companies also play a key role in delivery.

More recently, AHURI research has described in some detail the features of some of the most successful mechanisms identified: the Austrian Housing Construction Convertible Bond (HCCB) (Deutsch and Lawson 2013), Swiss Bond Issuing Co-operative (SBIC) and UK Housing Finance Corporation (Lawson, 2013), which for more than two decades have helped to deliver adequate, affordable and secure rental housing. In the case of Austria, long term support for affordable rental housing supply has ensured more stable housing and construction markets, lower rental housing costs and promoted economic and financial stability in that country.

Austria, a federation with nine regional governments, has sustained low cost investment in its well regulated affordable rental housing sector via the use of tax exempt Housing Construction Convertible Bonds issued by several participating banks, which are of potential relevance to Australian conditions. Austria's experience suggests that an appropriate bond instrument, sufficiently backed by government, can establish a robust and competitive investor market for affordable rental housing. Beyond the tax exemption, governments play a key role in co-financing developments with long term loans and provide a clear legislative framework for cost rent limited profit housing.

The key message from the Austrian model specifically (and from the international experience generally) is that low cost private finance for affordable rental housing needs to be coupled with risk reducing measures such as public collateral, repayment guarantees, adequate levels of assistance and well regulated providers. Government involvement is critical.

For example, the Swiss Bond Issuing Co-operative is a joint venture of the non-profit sector and the Federal Government Housing Office, established in 1991. It pools the financial demands of its members, being limited profit housing providers and meets these demands by issuing five to 15-year fixed bonds covered by a federal government joint guarantee. This process allows smaller providers to access long-term, low cost finance from pension funds for affordable rental housing at typically 1-1.5% below comparable market rates and just above Swiss Government Bonds. Beyond the guarantee, the federal government contributes to a revolving fund, which provides low cost loans, which is administered by two umbrella organisations of housing co-operatives.

In the UK, the Housing Finance Corporation was established under the stewardship of the National Housing Federation in 1987 to pool the borrowing demands of smaller housing associations and raise long term (20 to 35-year) debt finance from pension and annuity funds at very competitive rates (1-2% above UK treasury bonds). The UK system has been strongly underpinned by subordinated grants and rent assistance (housing benefit) paid direct to the landlord, as well as appropriate sector regulation and secured financing.

These examples demonstrate that lower gross yield can be achieved via a modest tax incentive and/or a guarantee coupled with equity, increasing effective returns to investors and providing a pool of cheaper funds to be passed on to the affordable housing sector. **An important outcome of these programs is that there has been a zero default rate on the bonds sold to investors.** Funds raised by private bonds can meet clearly defined policy targets if loans are made available only for publicly approved projects to permitted regulated providers. In this way, under appropriate intergovernmental arrangements, Australian states and territories can continue to play an important role designing programs to respond to regional needs, national economic imperatives and market conditions.

## Regulatory structures governing financial institutions and superannuation funds

Well regulated, professionally audited and transparently managed not for profit housing associations, are, as noted, the Australian government's preferred delivery mechanism for affordable rental and social housing. This is evidenced by their central role in the SHI, the NRAS, stock transfers and the establishment of the robust National Regulatory System in 2013. However, without long-term commitment in the form of defined co-financing arrangements and appropriate enhancement for private investment, they are unlikely to be able to fulfil their mission as providers of affordable rental housing at sufficient scale to address the emerging affordability crisis.

A robust commercial lending market for CHOs has not emerged and remains immature with a limited number of engaged lenders. Evidence gathered from CHOs (Lawson et al, 2014) reveals considerable variation in their financing terms. For private financing conditions to improve, much more stable and substantial assistance in the form of government backing and intermediation is required.

Promising research has identified the potential of superannuation funds to invest in this sector, and found strong support for investments with a structured government guarantee. (Milligan et al, 2013, Lawson et al, 2012, interviews with fund managers, 2013, Lawson et al., 2014). The forthcoming AHURI report (Lawson et al, 2014) goes into considerable detail on the investment needs and experience of managed funds, learning from their role in infrastructure and fixed income investments.

Unlike the case in Europe, larger Australian institutional investors, such as superannuation funds and insurance companies, have little experience of investing in affordable rental housing directly. In order to reduce the cost, increase leverage and broaden access to finance, Australian governments need to establish a clear program of long term co-financing affordable rental projects to provide starting equity and secondly, a structured guarantee to attract long term private investment in them.

The following paragraphs consider the role of Australia's large and rapidly growing managed funds in more detail and their potential as investors in affordable rental housing.

## Superannuation funds as a positive circuit of Australian savings and investment.

Twenty years ago the Commonwealth government created a new circuit of savings and investment known as superannuation.[9] In just two decades, broad based compulsory contributions by employees and employers have generated one of the fastest growing

[9] A circuit of compulsory savings underpinning Australia's pension system was legally established in 1992 by the Superannuation Guarantee (Administration) Act 1992. Funds which managed these compulsory savings are regulated under the *Superannuation Industry (Supervision) Act 1993* known as the *SIS Act* and the *Financial Services Reform Act 2002*.

pension schemes amongst advanced economies (Towers Watson, 2013).[10] Today, several Australian funds: Australian Super, QSuper and First Super are amongst the largest 100 pension funds in the world.[11] By 2013, the value of funds accumulated and invested in Australian superannuation was $1.62 trillion (APRA, 2014), greater than the nation's GDP for the same year.

Superannuation funds aim to generate sufficient incomes for policy holders' retirement, to reduce their reliance on and supplement the Aged Care Pension. During both the accumulation and payout phase, fund managers invest to meet specific portfolio goals. Despite the global economic downturn, Australian's largest funds were able to provide strong returns (13.7%) in 2013 (APRA, 2014).

**A circuit to benefit for members and responsible to the wider community**

Australia's fast growing 'super' funds play an important role in household welfare on retirement and simultaneously in the nation's infrastructure development. In this space, affordable housing can be considered alongside infrastructure, as generating returns not only for members, but also for the wider Australian community.

While it is anticipated that Australian super funds will play an important role as investors in goods and services of national economic significance (Infrastructure Partnerships Australia, 2010), so far their infrastructure investments tend to be found outside Australia, in countries as diverse as China and Poland (Vamos, 2013). Funds argue that Australian infrastructure investment poses too many obstacles in terms of liquidity, strategy alignment, and high risk Greenfield projects, with complex and expensive bidding processes. They also contend that Australian infrastructure often lacks a consistent pipeline of investments, and furthermore, funds lack in house expertise to assess dynamic risks adequately (FSC/EY, 2011). In order to justify the risk of investment, liquidity constraints, and complexity, the required rates of return are high (IPA, 2010).

Learning form these insights, housing researchers have proposed appropriate measures to enhance the attractiveness of investment in completed, ready-to-tenant affordable rental housing provided by well-regulated housing providers. Revolving public loans would be required to finance initial construction, prior to long term institutional take out (Berry and Williams, 2011, Lawson, et al, 2012, Milligan et al, 2013).

It is widely considered that private investment, as with any mortgage-backed product, must be supported by adequate equity and revenue streams. Non-profit financial intermediation and government guarantees have been the tried and proven tools of the many European models reviewed and summarised above (Lawson, 2013) and have enjoyed growing government support and financial sector interest since the global financial crisis (GFC).

In Australia, pooling and vetting by a professional not for profit financial intermediary under government stewardship at a distance combined with a guarantee, could effectively address

[10] Australian funds grew by 11.2% 2002-2012, compared with 8.9% during the same period for the 13 largest funds worldwide (Towers Watson, 2013:15).

[11] Followed closely by Start Super, Uni Super and Commonwealth Superannuation Corporation, Retail Employees Superannuation Trust, Hesta and Sun Super (OECD, 2013:13) http://www.oecd.org/pensions/PensionFundInfrastructureAustraliaCanada2013.pdf

the inefficiencies and high costs of fragmented commercial borrowing, one off financing costs and for profit intermediation.

For governments, a guarantee can be justified on the basis that affordable and social housing is a form of social and economic infrastructure which contributes to urban productivity, liveability and environmental sustainability of Australian cities and regions. For funders, investment in completed, turnkey projects can provide a relatively low risk form of investment when compared with other infrastructure developments. This is particularly the case where completed, tenanted properties are of good quality, well located and efficiently managed by not for profit landlords.

Investment based on secure rent revenue can also be supported by rent assistance and voids minimised by lengthy waiting lists (since there exists a permanent excess demand for sub-market rental housing), which in turn support stable revenue flows to support moderate returns from low risk mortgage-backed bonds.

Pension and insurance funds clearly have the potential to invest in this fixed income asset class, which could be offered by pooling borrowing demands of numerous regulated rental housing providers and bonds issued by a specialist intermediary with vetting and monitoring powers over participating borrowers.

Well-rated securities are increasingly sought by managed investment funds, especially by defined contribution pension funds and annuity schemes, or in response to policyholder requirements. New international banking regulations also require the holding of higher quality assets such as AAA rated bonds.

Attracting pension funds to a new asset class such as affordable rental housing requires a solid business case justification, long-term policy commitment and much more active facilitation than currently exists by key stakeholders, notably housing providers and co-financing governments.

Once a business case has been provided and in order to help establish a market for investments, governments need to guarantee investments in co-financed, appropriately regulated not-for-profit landlords. This enables sound long-term rental housing providers to attract lower cost, longer term private funds.

As in Switzerland and the UK, governments and providers can also help to facilitate the establishment of a specialist financial intermediary, in order to identify, aggregate and assess borrowing demands in order to issue a suitable scale, risk/return and pipeline of guaranteed bonds for investors. As noted above, related discussions are already taking place in Australia, with regards to the establishment of a financial intermediary to facilitate infrastructure investment (Crowe, 2013, Coalition, 2013, SMART, 2014, RAI/EY, 2012).

The following sections develop this potential further, by proposing to providers, governments and investors, suitable instruments and mechanisms channelling investment towards affordable rental housing. It focuses on the design of a debt instrument and intermediary appropriate to the long term investment needs of affordable rental housing providers, outlining the implementation requirements to substantially grow Australia's supply of long term rental housing via investment from the managed funds sector.

## Housing Supply Bonds Model[12]

There has been growing Australian interest in the development of a financial instrument and intermediary to attract investment to the not-for-profit sector more broadly, and in reforms to expand the corporate bond market in Australia and provide greater access to retail investors. In 2010, the Productivity Commission highlighted the lack of access to capital by not-for-profits and the need for a specialist financial intermediary to raise funds for the sector. In 2011, the Senate Economics References Committee recommended that the Australian Government examine ways to create incentives for investment in the social bond market, via enhancements such as tax credits, government guarantees and/or a top-up on social bond coupons. Specific proposals have also been put forward by charitable organisations, such as the Benevolent Society, who have argued that franking credits should be applied to social bonds (Lawson et al, 2012:2).

The primary purpose of any financing instrument should be to attract larger volumes of appropriate investment, under improved terms and conditions to those that exist currently to ensure the supply of decent quality, secure and affordable rental housing. International research demonstrates that raising funds at this scale will require a dedicated financial mechanism and appropriate institutions that are fit for purpose to raise and distribute funding.

The Housing Supply Bonds HSB proposal[13] was developed with funding from AHURI Ltd.by Lawson Milligan and Yates in 2012, working with industry specialists both in Australia and Europe. It has attracted considerable interest from key stakeholders, in particular pension funds.[14] Industry requirements for a bond instrument are summarised below in Table 4.

[12] For full details see, Lawson et.al. 2012.

[13] The final report, presentations and media coverage can be accessed here http://www.ahuri.edu.au/publications/p30652/

[14] Australia’s largest industry superannuation fund, Australian Super, has backed a proposal for government-guaranteed housing supply bonds which it says could bring billions of dollars into the ailing not-for-profit social housing sector.” reported in Australian Financial Review, 31 May 2012, see http://afr.com/p/business/property/super_funds_could_back_cheap_homes_FHNta4F2w7uHhec8DfjmGN

**Table 4: Requirements for a financing instrument to support investment in affordable rental housing**

| | |
|---|---|
| Terms and conditions of housing supply bond? | ✓ A straight forward, low risk, low yield and long term instrument required to provide cheapest funds<br>✓ Enhancement required to reduce risk and enhance low yield<br>✓ Tax incentives need to be devised so they are equally valuable to those with high and low tax rates<br>✓ Guarantees are very interesting for low risk long term investors - insurance funds, certain portfolios of super funds, banks, retail investors |
| Financial intermediary? | ✓ To pool funds for scale<br>✓ Specialist knowledge of sector<br>✓ SPV to issue bonds, linked to provider loan obligations<br>✓ Optional forms: Public, not-for-profit, for-profit |
| Regulatory requirements? | ✓ Beyond benchmarks, ensure sector regulation meets investor standards<br>✓ Strengthen financial capacity of providers and reduce risks to lenders<br>✓ Use to promote innovation, collaboration and solutions rather than impede growth |
| Related requirements? | ✓ Capacity to repay based on revenue stream<br>✓ Rent assistance and eligibility policy critical<br>✓ Long term and consistent policy vision by governments<br>✓ Facilitative planning and land supply to reduce development risk |

Source: Lawson et al. 2012

Following this consultation, a suite of housing supply bonds was designed to reflect the management, taxation and yield requirements that were identified through the research. This suite of instruments comprises 1) public loans as equity; 2) tax exempt coupons on special purpose retail bonds providing mezzanine finance; and 3) guaranteed (AAA equivalent) bonds suitable for fixed income portfolios of super funds, to provide senior loans.

In summary:

- public bond issues (NAHA Growth Bonds) which will provide for equity via conditional revolving public loans (a long term loan asset attracting low or zero interest);
- a tax incentive (e.g. 6% tax free coupon) on mezzanine investment in social housing retail bonds (Tax Smart Housing Supply Bonds) and
- a guarantee on bonds linked to senior loans in approved co-financed projects (supported by NAHA growth bonds). More detail on the structure of this guarantee

and related financial intermediary is provided in sections below and developed further in Lawson et al, 2014)

**Cost to governments**

The costing presented below is based on raising $7 billion to finance 20,000 affordable rental dwellings, and is intended as an ongoing national program, with state and local governments and importantly SHAs and CHOs as key partners. Given the well-established shortage of affordable rental housing accessible to low to middle income households and experience from the latest NRAS round, 20,000 dwellings is considered a responsible and feasible target. It could of course be piloted on a smaller scale in particular States and Territories with ready capacity and commitment.

The AAA Housing Supply Bonds' cost to government is predicated upon an assumed 0.5% default rate based on settings in the UK for senior term debt for community-managed affordable housing. If these bonds are to provide 70 per cent of the $7 billion required, then $4.9 billion is to be financed with AAA HSBs. The cost of a 0.5% default rate equals $24.5 million each year for 10 years (or $245m if provided as an up-front contribution) for each $7 billion tranche issued.

The Tax Smart bond costs are based on the assumption of a tax free 6% coupon rate. This provides individual investors on the top marginal tax rate of 46.5% with the equivalent of a before tax yield of 11.2% and corporate investors on a 30% tax rate with the equivalent of a before tax yield of just under 8.6%, seen as being approximately that needed to attract retail investors to such bonds. The cost to government, therefore, is the amount of tax foregone by making the coupon tax free. Assuming 20% of funds are raised through Tax Smart bonds, and a 40% tax rate as a hybrid of corporate and personal tax rates, this cost equals $7 billion x 20% x 6% x 40% = $33.6 million per year (or $336 million over 10 years for each tranche).

The third instrument is the revolving NAHA Growth Fund equity component that funds the first 10% of project costs. The annual cost to government each year for 10 years is the interest foregone on the $700 million. Assuming the borrowing cost for government is 5%, then the annual cost to government for the NAHA growth bonds equals $700million x 10% x 5% = $35 million or, if provided as an upfront cost, $700m for each tranche.

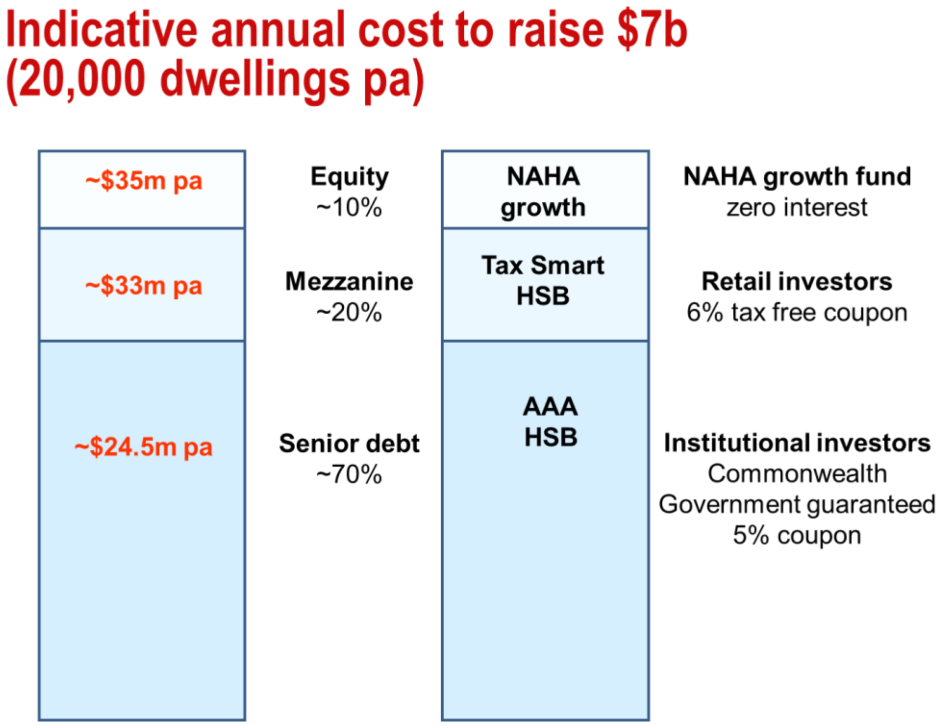


**Figure 1 Indicative cost of HSBs**

**What are the issues to be addressed?**

A prudent first step would be to provide a robust, long term costing and market testing of the bonds proposal, refining proposed yields, the nature of enhancements and their cost to government. Such a process should be expert and independent, and involve key stakeholders. Another important issue concerns the design of a suitable financial intermediary and the structure, terms and potential cost of any government guarantee backing housing supply bonds.

Very recently, research has been completed by AHURI towards an appropriate model for a financial intermediary and guarantee for Australian conditions, following extensive industry consultation and exchange of international expertise and the Final Report will be published in April. A preview of results of this study is provided below. This model is simpler than the HSB approach, focusing on the critical role of the way that the government guarantee meshes with the overall structure of financing rental housing provision. It is also likely to be cheaper for government in the longer run and most attractive for institutional rather than retail investors.

## Affordable Housing Finance Corporation Model[15]

The AHURI Final Report Enhancing Affordable Rental Housing Investment via an Intermediary and Guarantee (Lawson et.al. 2014) offers a feasible proposal for a private investment mechanism for affordable rental housing, to be underpinned by government and operate across all participating states and territories. It combines the aggregated investment demands of the affordable housing sector, in order to provide a suitable scale of and pipeline demand for bond issues targeted at Australia's growing superannuation sector. Further, the proposal manages risks through appropriate regulation, sufficient revenue, subordinated debt and specialist financial intermediation.

This proposed financial intermediary adapts the established Swiss and (recent) UK approaches outlined in Lawson (2013) to the needs and market conditions present in Australia. Figure 2 below provides a schematic representation of the key elements and linkages, which are outlined in more detail below.

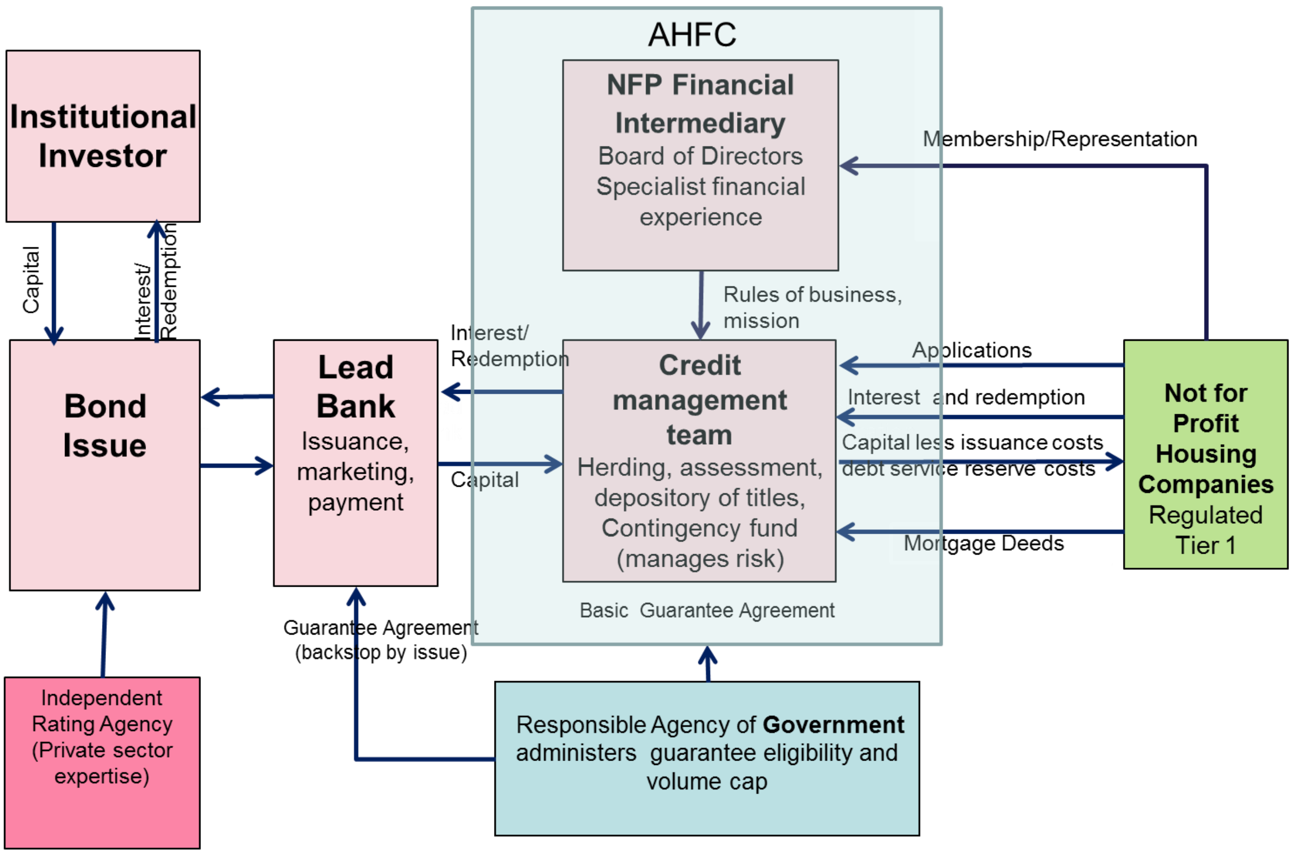


**Figure 2 - Affordable Housing Finance Corporation (AHFC) Model**

[15] For full details see Lawson et.al. 2014.

**Implementation requirements**

The first step is the creation of an independent non-profit entity (“NFP Financial Intermediary” box) comprising an expert Board of Directors the majority of which are to be drawn from the financial sector. Government and the non-profit sector would each appoint Directors as well. A possible composition could be: two Directors appointed from government, two Directors from the non-profit sector and five Directors from the business, finance and legal sectors. The organization and board would be independent of government but be accountable through requiring borrower compliance with the National Regulatory System and monitoring the robust reporting requirements imposed on the borrowing non-profit housing providers. The Board would report annually to Parliament, detailing the lending eligibility criteria, the volume of loans allocated, the addition to the affordable rental stock achieved, the incidence of any default events (actual or avoided) and the actions to take in mitigation or enforcement.

This Board would require directors with extensive experience and expertise in financial management and credit assessment in order to oversee the professional management of the borrowing process (“Credit Management” box). The latter would be responsible for aggregating borrowers in the non-profit housing sector; in Australia this would initially be restricted to those organisations eligible for Tier 1 status under the National Regulatory System.

The Commonwealth would sign an overarching agreement with the Financial Intermediary guaranteeing the payments due to bond purchasers if non-profit providers default on payments; this guarantee would be structured and provided separately on each issue up to an agreed total cap for an agreed period. International experience indicates that each bond tranche should be separately guaranteed and each borrower’s default risk managed separately (this view was strongly put by our international visiting experts, Piers Williamson and Peter Gurtner, respectively CEO of the UK Housing Finance corporation and Chair of the Swiss bond issuing agency). This approach maximizes the incentives for individual borrowers to meet all their debt obligations, since it will be clear to all parties that an individual borrower’s default will not be bailed out by other compliant borrowers.

For each issue Management would assess loan applications from providers and recommend borrowers to the credit committee of the Board. Once the successful borrowers have been identified, the “lead Bank” issues and markets the bonds the duration of which would need to be tested for investor appetite. The bonds would be rated by a major ratings agency. The rating would depend on: the credit rating of the government providing the guarantee; the limitations or other structuring characteristics of the guarantee, the rating of the (Tier 1and Tier 2) non-profit housing sector in Australia[16]; the quality of the Financial Intermediary (The Board); and the value of the individual properties backing the bonds. AFHC Management would hold the title deeds to the properties purchased by the providers as collateral for the loans financed by the bond purchase. Alternatively, title deeds could be passed to and held by a commercial trustee. The Lead Bank (which could be in-house) would manage the payments to investors.

[16] Tier 1 and tier 2 housing provider meet a range of criteria enshrined in the National Regulatory System. Both these classes of organization have established a track record of delivering significant rental stock to the market and have well developed financial and managerial systems in place. The main difference between tier 1 and tier 2 is that the former have also successfully developed new affordable housing in addition to acquiring existing stock. See Chapter 4 for more information on the non-profit housing sector in Australia.

In this model the investors' interests are protected by the government guarantee. From the government's viewpoint, the guarantee is a final backstop to be drawn upon only if:

a) a borrower defaults after other procedures and processes fail, and:
b) the reserves held by AFHC Management are insufficient to meet loan payments when due.

With respect to the second point above, there are two reserve funds that stand between borrower default and a call on the guarantee.

1. *Specific Reserve*: When passing through the capital loan to the borrower, Management retains the equivalent of one year's interest payment on the bond principal.[17] This can only be drawn upon to make payments to the lender if and when the borrower misses a payment milestone. The borrower pays interest on the full face value of the bond while actually receiving the discounted capital sum to invest in housing. If all payments are made on time for the duration of the bond, then the borrower is credited with the intact reserve at redemption.
2. *General Reserve*. A small premium (e.g. 10-15 basis points) is added to the coupon rate paid by the borrower and held by AFHC Management as a general reserve to cover unexpected contingencies ("unknown unknowns"). This is not returned to borrowers and accumulates as a further fund from which to manage possible but unforeseeable default threats. [18]

The role of the reserves is to ensure continuity and certainty of payments due to bond holders during the period that Management moves to resolve the problems causing an individual borrower to miss repayment deadlines. The overarching agreement with government will specify the trigger points and steps to be taken for AFHC Management to step-in in this manner; these details will be harmonised with the procedures laid down in the National Regulatory System for Tier 1 and 2 non-profit housing providers.

In summary, the probability of the government guarantee being invoked in this model is very small due to:

1. The quality of credit assessment and management
2. The comfort provided by the independent credit rating agency
3. The level of maturity and experience of the Tier 1 borrowers
4. The monitoring and step-in powers over borrowers exercised through the National Regulatory System
5. The reserve funds held and accumulated by AFHC Management to maintain continuity of payments to bond holders

Moreover, further comfort is provided by noting the zero-default experience of the Swiss guarantee scheme during its ten years of operation and the introduction during 2013 of a similar scheme in the UK.

Clearly government plays a key role in this approach, with the last-resort guarantee crucial in achieving a high rating and therefore affordable interest rate for each bond issue. However,

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[17] Such a reserve was used by the UK's THFC to convince HM Treasury of the very low risk of the guarantee to government.

[18] This simple to administer reserve has ensured that the Swiss Guarantee has not been called on for over a decade. It has enabled the accumulation of a healthy reserve fund by the Bond Issuing Co-operative and negated any need to rely on government support.

government also ensures the appropriateness and robustness of the regulatory system (and has a direct and powerful incentive to do so). Beyond that, in order for non-profit providers to achieve financially sustainable access to the housing bonds issued, government will need to continue to provide both capital subsidies and recurrent subsidies, the latter in the form of CRA and NRAS. British and Swiss experience suggests that providers will need to contribute at least 20 per cent equity leveraged by bonds to acquire dwellings that can be rented at affordable (sub-market or cost rent) rents, as required by current ATO and NRAS rules. In Australia's housing market, decent affordable housing close to employment opportunities is simply not possible without subsidy or market intervention.

The necessary equity slice could be generated in the longer term from CHO balance sheets, though at the current stage of sector development, this avenue is limited. There are a range of other strategies to provide this equity. Government capital grants (in cash or land), planning gains through rezoning land or increasing densities or a revolving low-or-no-interest public loan could assist in meeting this contribution. The latter option also provides opportunities for revenue generation (where the government lends to borrowers at higher interest than it raises funds, as in WA).

Lawson et.al. (2012; outlined in previous section) propose a mechanism by which no-interest government loans substitute for a proportion of the equity required. Co-financing provides certainty of delivery, targeting in compliance with government objectives and is more beneficial to institutional investors than a tax offset from their income. Box 1 presents an example using both capital grants, no-interest loan leveraged by high grade bond finance.

**Box 1 Example of Capital grant, no-interest loan leveraged by high grade bond finance**

Cost of dwelling: $300,000

Financed by:

Grant (10%) $30,000

No-interest loan (20%) $60,000

10-year Bond loan (70%) $210,000

Assumptions:

Interest foregone at 4% p.a.

Default rate on guaranteed bonds = 0.5% (in line with international experience)

Default on no-interest loan = 0.5%

Cost to Government:

$30,000 + interest foregone on loan = $2,400 p.a. for 10 years

+ $1,050 expected bond default

+ $300 expected no-interest loan default

= $55,350 over ten years (= $50,816 present value at 4% social discount rate)

Scaling up the example presented above, 10,000 dwellings, worth $3 billion would cost government $553,500,000 over 10 years ($55,300 per year). The grant component could be provided as a cash outlay or through land transfer.

However, as the analysis in Lawson et al, 2014 demonstrates, the capacity of providers to take on debt is constrained by tight free cash flows characteristic of the sector. The cost to non-profit providers in the above example would be interest payments on the bond, say $10,500 per dwelling acquired at 5% coupon rate plus amortised repayment of the no-interest loan by government over the 10 year period (it could be longer). Given that the providers would be charging sub-market rents, they would need to continue attracting CRA and NRAS-type subsidies in order to meet the level of financing commitments identified in the above example.

The UK model that informs this approach has been introduced after intensive modelling by the Department of Communities and Local Government and demonstrated the very low probability of the government guarantee being called; Piers Williamson, the CEO of the UK Housing Finance Corporation, underscored this point at the project Think Tank.

The proposed Affordable Housing Finance Corporation Model provides, in our view, the best way forward in current Australian circumstances for the following reasons:

- ✓ It is relatively simple and transparent and can be harmonised with the new National Regulatory System and state based Regulatory Systems for non-profit housing providers.
- ✓ It focuses on the untapped source of funds from institutional investors and meets the growing demand of superannuation funds for AAA-rated bonds.
- ✓ It fits well with existing government subsidy policies, notably CRA and NRAS and leverages the extent to which current sector competencies and strategies are progressing.
- ✓ It minimises the impact on government budgets.
- ✓ It provides lower cost of finance to providers, compared to other approaches, including the current reliance of CHOs on bank finance and, hence over the medium to long run is likely to maximise the sustainable expansion in the stock of affordable rental housing.
- ✓ Properly structured and managed, the Model reduces to negligible levels the probability of the government guarantee being called
- ✓ Australia can draw on the successful experience and expertise of other countries.

This AHFC proposal, grounded in extensive national research of industry stakeholders and successful international experience, forges a new funding pathway to institutional investment in affordable rental housing. The AHFC will have the expertise to issue rated bonds with a government guarantee for well-targeted rental housing developments.

**The proposal overcomes many of the barriers cited by institutional investors, by offering suitable investment opportunities at an appropriate scale, simplicity and risk weighted return. It would fulfil the Australian government's commitment to increase private investment in rental housing, bridging the gap between Australia's affordable housing investment needs and the risk/return strategies of our large and rapidly growing super funds as they enter the pension phase of operation.**.

The proposal also aligns with the government's aim to develop deeper, longer term bond markets in general and specifically can inform efforts to grow investment in infrastructure. With strong government leadership and expert and adequately resourced implementation, the AHFC approach can strengthen Australia's housing choices and build a stronger, more secure, more equitable and more efficient rental housing market.

**In conclusion - what are the benefits of channelling investment towards affordable rental housing in Australia?**

Government efforts to stimulate private investment in new affordable rental housing can be justified as contributing towards:

- ✓ a tangible and substantial contribution towards expanding housing supply, progressively building Australia's long term assets in affordable rental housing;
- ✓ addressing a clear and unmet need for rental housing which is accessible and available for low income households as a refuge, oasis and stepping stone;
- ✓ ensuring that the housing supported by government incentives and subsidies is both affordable and secure, generating lasting benefits to family functioning, child development, individual health and economic and social participation;
- ✓ making more efficient use of limited public resources, exploiting government credit worthiness to full effect; by guaranteeing bonds investing in completed, approved developments;
- ✓ improving productivity by: promoting new medium density rental housing in well serviced areas, reducing the distance between affordable housing and employment opportunities, generating sustainable employment in the construction sector, supporting local economies and lifting regional and national GDPs;
- ✓ ensuring financial continuity and growth of well-regulated non-profit housing providers, strengthening the governments preferred suppliers of social housing by providing a pipeline for investment;
- ✓ bridging the financial demands of institutional investors and affordable housing providers, by aggregating borrowing requirements, financial intermediation and risk reduction;
- ✓ Provide a suitable vehicle for superannuation funds to meet both the risk-adjusted yields required by policy holders (and regulators) and their own social, economic and environmental corporate responsibilities to the wider community;
- ✓ strengthening economic competitiveness through improved access to the rental market by low income households, enabling a more flexible and productive workforce;
- ✓ enhancing national cohesion and social inclusion, sharing the benefits of secure affordable housing more fairly across the community and assisting those not served adequately by existing market and government processes;

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# Attachment 1: Relevant Research

The submission draws on relevant published research, which is listed below and can mostly be accessed in full online:

Berry, M. & Williams P. (2011) *Investigative Panel on a socially sustainable housing system for Australia*, AHURI Final Report No.169. Melbourne: Australian Housing and Urban Research Institute.

Lawson, J, Berry, M, Hamilton, C and H Pawson (2014) *Enhancing Affordable Rental Housing Investment via an Intermediary and Guarantee*, RMIT AHURI Research Centre, Melbourne: AHURI

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Deutsch, E and Lawson, J (2013) *International measures to channel investment towards affordable housing: Austrian Case study* for RMIT AHURI, commissioned by Department of Housing, WA Government pp. 1-70

Gilmour, T, Washer, M and Lawson, J (2013) *International measures to channel investment towards affordable housing: England Case study* for RMIT AHURI, commissioned by Department of Housing, WA Government pp. 1-40

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