



*Final Report*

# Enhancing affordable rental housing investment via an intermediary and guarantee

authored by

**Julie Lawson, Mike Berry, Carrie Hamilton and Hal Pawson**

for the

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at the University of New South Wales

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<b>Authors</b>	Lawson, Julie Berry, Mike Hamilton, Carrie Pawson, Hal	RMIT University RMIT University Housing Action Network University of New South Wales
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A list acknowledging all contributors can be found in Appendix 1.

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## ACRONYMS

AAA, AA+, BBB	Credit rating evaluation by Standard & Poor's
ACT	Australian Capital Territory
AFI	Australian Financial Institutions
AFR	Australian Financial Review
ADI	Authorised Deposit taking Institutions
AHFC	Affordable Housing Finance Corporation
AHURI	Australian Housing and Urban Research Institute Limited
ANZ	Australian New Zealand Bank
ANAO	Australian National Audit Office
AOFM	Australian Office of Financial Management
APRA	Australian Prudential Regulation Authority
ASFA	Association of Super Funds of Australia
ASIC	Australian Securities and Investments Commission
ASF	Australian Securitisation Forum
ATO	Australian Taxation Office
AUD	Australian Dollar
BBSY	Bank Bill Swap Bid Rate (Reuters)
BBSW	Bank Bill Swap Rate (mid-rate)
BIC	Swiss Bond Issuing Co-operative
BIS	Bank of International Settlements
BP	Basis Points
CBA	Commonwealth Bank of Australia
CBH Act	Charter of Budget Honesty Act 1998 (Australia)
CECODHAS	Federation of Public, Co-operative and Social Housing (Europe)
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CGLLS	Caisse de Garantie du Logement Locatif Social
CGS	Commonwealth Government Securities
CHO	Community Housing Organisation, often known as Community Housing
CHF	Swiss Franc
CoA	Commonwealth of Australia
COAG	Council of Australian Governments
CP	Conditions Precedent
CPI	Consumer Price Index

CRA	Commonwealth Rental Assistance
CSB	Community Sector Banking
DB	Defined Benefit pension scheme
DC	Defined Contribution pension scheme
DCR	Debt Cover Ratio
DF	Department of Finance (Commonwealth Government)
DSCR	Debt Service Coverage Ratio
DSS	Department of Social Services
EC	European Commission
EFIC	Export Finance and Insurance Corporation
EGW	Emissionszentrale für Gemeinnützige Wohnbauträger (Swiss Bond Issuing Co-operative)
EIB	European Investment Bank
EPEC	European PPP Expertise Centre
ESA95	European System of Accounts 95
EU	European Union
Eurostat	European Statistical Office
EY	Ernst and Young
FaHCSIA	Australian Government Department of Families, Housing, Community Services and Indigenous Affairs
FFC	Fixed and Floating Charges
FIIG	Fixed Income Investors
FoH	Federal Office of Housing (Switzerland)
FSC	Financial Services Council
GDP	Gross Domestic Product
GFC	global financial crisis
GSE	Government Sponsored Enterprises
HSB	Housing Supply Bonds
HUD	Department of Housing and Urban Development (HUD)
IAS	International Accounting Standards
ICR	Interest Cover Ratio
IFM	IFM Investors
IFR	Infrastructure Finance Working Group
IP	AHURI Investigative Panel
IPA	Infrastructure Partnerships Australia
IRR	Internal Rate of Return
LAH	Local Authority Housing

LGCHP	Local Government Community Housing Program
LIBOR	London Interbank Offer Rate
LVR	Loan to Value Ratio
MBS	Mortgage Backed Securities
ME Bank	Member's Equity Bank
MECU	An Australian Financial Co-operative, formerly Members and Educational Credit Union
NBN	National Broadband Network
NAB	National Australia Bank
NAHA	National Affordability Housing Agreement
NDIS	National Disability Insurance Scheme
NFP	Not-for-profit entity
NPV	Net present value
NRAS	National Rental Affordability Scheme
NRS	National Regulatory System
NSW	New South Wales
OECD	Organisation for Economic Co-operation and Development
PPP	Public Private Partnership
PRS	Private Rental Sector
PV	Present Value
RAI	Regional Australia Institute
RBA	Reserve Bank of Australia
RF	Revolving Fund
RMBS	Residential Mortgage Backed Securities
SA	South Australia
SBB	Social Benefit Bonds (NSW)
SCAP	Stand Alone Credit Profile
SIB	Social Impact Bonds (UK)
S&P	Standard and Poor's, credit rating agency
SCOTI	Standing Council on Transport Infrastructure
SHA	State Housing Authorities
SIB	Social Impact Bonds (UK)
SIS Act	Superannuation Industry (Supervision) Act 1993
SFI	Specialist Financial Intermediary
SGB	State Government Bonds
SHG	Social Housing Guarantee
SHI	Social Housing Initiative

SPV	Special Purpose Vehicle
SVA	Social Ventures Australia
SMSF	Self-Managed Super Fund
THFC	The Housing Finance Corporation (UK)
VHB	Voluntary Housing Body (Ireland)
WA	Western Australia
WAB	Waratah Annuity Bonds (NSW)
WB	Waratah Bonds (NSW)
WSW	Dutch Guarantee Fund Social Housing (NL)

## EXECUTIVE SUMMARY

As home ownership rates decline across all age cohorts, the suboptimal quantity, allocation, and security of housing opportunities in the rental market has received increasing policy attention. To date, fiscal strategies for attracting investment towards rental housing have had limited success, especially in attracting institutional investors to this sector. Renewed policy ambitions aim to channel private investment more efficiently and effectively towards *new* dwellings in the *affordable* rental housing market targeted to *low and middle* income households and provided by third sector Community Housing Organisations (CHOs).

This Final Report on Social Housing Guarantees follows an international Positioning Paper (Lawson 2013) that detailed relevant and established mechanisms operating overseas. It recognises the context dependent nature of these market mechanisms and thoroughly reviews prevailing Australian conditions. In detail, the report offers a locally grounded and feasible proposal to lift investment in affordable rental supply in order to boost Australian economic productivity, and promote social inclusion and innovation in medium density housing provision. The report presents two options for increasing institutional investment targeted towards new development managed by not-for-profit community housing providers and puts forward a recommended model for implementation.

This chosen model learns from international best practice, adapting this knowledge to Australian market conditions, in order to address Australian housing policy goals to increase private investment in affordable rental housing to ensure appropriate and sufficient supply outcomes. The model acknowledges the substantial body of research that has already identified the barriers to investment (Investigative Panels; Berry & Williams 2011; Milligan et al. 2013) and advances their recommendations for more appropriate and attractive instruments (Lawson et al. 2012).

The research thoroughly analyses contemporary evidence of inefficient and mismatched commercial borrowing conditions, which underscores the imperative for a new investment pathway for CHOs. It examines the potential of superannuation funds to 'fill the gap' and draws on a wide and deep range of stakeholder views on suitable investment reforms through interviews, strategic literature review and deliberations of an industry Think Tank on investment in affordable rental housing.

The report offers a feasible proposal for a institutional 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.

### Rationale for action

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

- 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.
- Bridging the financial demands of investors and housing providers, by aggregating borrowing requirements, financial intermediation and risk reduction.

- Strengthening economic competitiveness through improved access to the rental market by low income households, enabling a more flexible and productive workforce.
- Making more efficient use of limited public resources, exploiting government credit worthiness to full effect; by guaranteeing bonds investing in completed, approved developments.
- Enhancing national cohesion and social inclusion, sharing the benefits of secure affordable housing more fairly across the community and assisting those not served by existing market and government processes.
- 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 financial continuity and growth of well-regulated non-profit housing providers, strengthening the government's preferred suppliers of social housing by providing a pipeline for investment.

### **Australian CHO debt demand, capacity and market context**

The experience of Community Housing Organisations (CHOs) in borrowing funds from commercial banks in Australia has expanded considerably in the past five years. However, evidence gathered for this project reveals considerable variation in terms offered and the length of the debt-raising process. This suggests that CHO lending is still immature in the Australian commercial banking sector with a limited number of engaged lenders.

Positive (tick) and negative (cross) findings on the current debt market for the community housing sector include:

- × Loan tenures are extremely short, three to five years, creating significant refinancing risk and inefficient mismatch with asset life.
- × Loans are predominantly entity-wide lines of credit, rather than project-specific.
- × Limited number of banks in the field, key person risk high.
- ✓ Debt Cover Ratio (DCR) is more of a driver of terms and conditions than Loan to Value Ratio (LVR).
- × Many facilities are interest-only, even in the operating phase, suggesting an impermanent financing solution.
- × Without exception, lenders require security well beyond the assets being financed by the debt.
- ✓ Some CHOs report improved relations have led to the disappearance of the requirement for fixed and floating charges.
- × CHOs report that their security assets are under-valued, as a result of offering income-related rents.
- ✓ Even with the shallow history of CHO bank borrowing, there are already many examples of refinancing.

Many of these key findings represent limitations for the CHO sector in accessing debt finance, which indicates required assistance in the form of government backing and intermediation for conditions to improve and potential to be achieved.

## Potential of Australian superannuation funds

In view of the limitations seen in current commercial lending identified above, the potential for institutional investment via superannuation funds is examined in the report. This section takes a more macro view before zeroing in on the alignment of fund and CHO investment needs.

By mid-2013, the value of funds accumulated in Australian superannuation was \$1.62 trillion (APRA 2014), surpassing the nation's Gross Domestic Product (GDP) and growing rapidly. This 'super' system, based on defined compulsory contributions, has greatly influenced the flow of domestic savings. With the Global Financial Crisis (GFC) and Basel III reducing banks' propensity for corporate lending, attention has turned to the role of superannuation funds in supporting corporate growth, property, infrastructure and (potentially) affordable rental housing.

However, unique in the world, Australian funds are offered little guidance by governments concerning their allocation requirements. Free to determine their own strategy, Australian super funds have invested a significant proportion of their assets in higher risk/yield equities rather than debt securities or property (compared with 13 countries reviewed by the OECD 2011). Australia's bond markets are relatively small, shallow and short term. Banks have traditionally serviced corporate lending needs. Enticed by the strong performance of equities and their preferential tax treatment, Australian super funds have institutionalised a bias against fixed-income securities (Deloitte 2012).

Yet, this strong reliance on equities has raised concerns about the risks posed for policy holders (especially in the payout phase) and the limited role super funds will play in a post GFC/Basel III world in supporting economic development and growth. Since the GFC, Australian banks have been unable to supply sufficient credit to meet local investment needs, forcing corporations to rely on international capital markets. There have been numerous efforts by the Commonwealth (Treasury and ASIC) to expand Australia's corporate bond market and enable retail investors to participate, but while corporate bond markets have grown, progress in this area has been slow.

Fixed income securities do provide an appropriate vehicle for investments in mortgage assets with a long-term and predictable revenue stream, such as rental housing. Pension funds do maintain a small proportion of fixed income assets (5–15%), to meet specific risk/return and liquidity norms for specific portfolios and to meet overall strategic objectives for diversity, policy holder demographics, longevity and hedging. Investors of bonds are concerned about the tradability of their assets. They are less interested in bonds traded by few investors, in small positions (less than \$500 000), or securities that are infrequently issued and/or have a declining credit rating (NAB n.d.). Investors are also wary of 'orphaned assets,' meaning securities that are highly customised and one-off rather than recurrent, requiring extensive research and underwriting prior to investment and therefore not 'worth the effort' (Interview Investment Manager 2013; Milligan et al. 2013).

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 often involve 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 from 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 & 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 (Lawson 2013) and have enjoyed additional government support and financial sector interest since the 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 the inefficiencies and high costs of fragmented commercial borrowing, one off financing costs and for profit intermediation.

## **Views of Australian stakeholders**

The research revealed widespread support for such a mechanism to channel funds towards affordable rental housing among investors, asset consultants, affordable housing providers and housing policy and finance market experts.

Specific insights on the desired instrument, financial intermediary and enhancement, were obtained during extensive interviews in several states (27 industry stakeholders), a full-day Think Tank hosted by Australian Super (24 participants) and numerous consultation meetings. These views are detailed in Chapter 4.

## **Australian policy and experience in the use of guarantees**

In the context of shrinking government budgets and increased reliance on private investment, governments around the world use guarantees in the housing sector for a range of reasons: to address market failure causing undersupply in segments of housing market, to increase investor comfort and familiarity with new assets, to bolster the credibility of investment in order to reduce cost and increase leverage, and to broaden access to finance. Experience has shown that a well-managed guarantee has little or no implications for government budgets (Lawson 2013).

Guarantees are increasingly used by governments more widely to speed up economic activity and ensure the provision of necessary infrastructure at minimal government cost (Irwin 2007). Such guarantees unlock sources of credit, improve borrowing terms and maximise the benefit of any contributing government subsidy. For these and many other reasons, guarantees are a growing tool of government policy following the GFC.

Informed by a review of six international housing guarantee schemes (Lawson 2013), the Final Report gives critical attention to Australia's experience in this field.

While Australia has an established policy with regard to the use of guarantees, it has been applied in a limited and selective manner. So far, it has not been used to enhance investment in affordable rental housing.

Australian guarantees have been structured in a variety of ways, on a case-by-case basis, influencing contingent liabilities and their reporting requirements. Chapter 5 provides a number of examples where Australian governments, at both state and Commonwealth level, provide either an explicit or implicit guarantee to investors (or



could do so). Cases relate to export finance, the Residential Mortgage Backed Securities (RMBS) market, infrastructure and social services. Experience suggests that Australian policy-makers, while reluctant and cautious, are prepared to provide different forms of credit enhancement where they can be tied to specific, well-established economic or, more rarely, social policy commitments.

The impact of such guarantees on the existence, cost and stability of markets for investment can be very significant, as illustrated by the Commonwealth Government's role in supporting the Australian financial system when bolstering RMBS markets and securing deposits during the GFC. The stance of the Productivity Commission: that guarantees are inefficient by definition is clearly not supportable, either in theory or in policy practice.

A persuasive public good argument, based on enhanced productivity and economic stability, can be used to legitimate the use of guarantees in the field of affordable housing. But this argument has yet to be advanced by housing policy-makers. The argument could be two-fold: (1) cost savings to government in dealing with homelessness and its follow-on costs for government, and (2) the labour productivity gains created by better quality and located housing for workers, including those currently effectively excluded from workforce participation, in the context of an increasing dependency ratio as Australia's population ages. Similar arguments can be advanced for creating a funding flow into the non-profit sector to expand the supply of housing suitable for people with a range of disabilities that will progressively be able to draw on the new opportunities provided by National Disability Insurance Scheme (NDIS). The current unfolding debate on the (un)sustainability of Budget increases in social security payments and the need to reduce welfare dependence by enhancing workforce participation and productivity, add to the case for more strategic use of government guarantees to expand the supply of affordable, appropriately located housing.

A framework to progress the design of a guarantee suitable for affordable rental housing is provided in Chapter 5, drawing on the work of the World Bank (Irwin 2007) and recommendations from the *International Review* (Positioning Paper, Lawson 2013). The basic rules that governments should follow include:

1. Each guarantee opportunity should be evaluated on a case-by-case basis. There are no general rules of thumb to fall back on. By implication (as noted above), the blanket dismissal of guarantees by government is invalid, since it is likely to prevent efficient projects from proceeding.
2. Modern accrual accounting, rather than cash accounting, methods are vital to ensuring that the long-term costs and benefits of guarantees are considered and properly included in the public accounts. Even the best practice public accounting systems may inadequately value these impacts and require appropriate notes to the public accounts.
3. Government departments providing guarantees may be required to pay the estimated cost of the guarantee into a special fund to help manage the future cash flow risks of the guarantee. The private investor and/or borrower may also be required to contribute to this fund which is first drawn upon before the guarantee is called upon.

A number of key principles, drawing on international experience, have been identified to inform the development of an appropriate Australian social housing guarantee scheme. These principles and their related practices are summarised in the following Table 1.

**Table 1: Principles and practice**

<b>Principles</b>	<b>What this means in practice</b>
Boundaries	Defined characteristics of eligible projects for guarantee, overall and project-related borrowing volume cap (and hence contingent liability for government), competitive allocation process for guarantee certificates, long-term policy commitment to sustainable business model by all stakeholders, including equity and revenue support arrangements.
Lowering risk	Expert management and regular professional reports, appropriate regulation and enforceable compliance, sufficient equity and revenue base, back stop role of government.
Transparency and commitment	Clear mission, professional financial management and accounting standards, commitment to a sustainable business model by relevant stakeholders, appropriate information for investors, governing guarantee agreement and joint marketing strategy.
Expert intermediary	Vetting and aggregating CHO investment needs, independent and expert management, skill base to assess proposals, risks and enforce regulatory compliance among borrowers.
Scale and frequency	Pool multiple smaller borrowing demands to achieve efficient scale, regular bond issues to sustain market interest, involvement of lead bank with investor liaison.
Adequate structure	Clear and agreed structure including targets, volume cap, contestable allocation, on-going compliance process and 'trigger points', practical lines of defence against default, mechanism to build up contingency reserves, agreed loss sharing arrangements.

## **Proposed model and implementation requirements**

All stakeholders noted that direct government bond issue would be the most cost-effective means of raising finance to fund housing production. However, in the absence of government appetite for direct public debt, the report analyses the means by which government can induce institutional private sector investment. Following a summary of the policy rationale for action, two options for an affordable rental housing finance intermediary with enhancement are outlined in Chapter 6.

The first option, called the Affordable Housing Finance Corporation model (AHFC) adapts key learnings from the established Swiss and UK approach outlined in the accompanying Positioning Paper (Lawson 2013). It involves the establishment of an expert financial intermediary to assess and aggregate the borrowing demands of registered community housing providers and issue bonds with a carefully structured and targeted guarantee. This guarantee is designed to minimise any potential call that could require a government transfer.

The second option, called Securitisation, draws more centrally on the leadership of the financial sector in securing a large flow of private investment into highly rated housing bonds, using the established tool of securitisation. A guarantee by government is not required<sup>1</sup> in this instance but is replaced by direct equity and cash contributions to the scheme.

A comparison of the two schemes (Table 2) made on the basis of simplicity, appropriateness to sector capacity, proven feasibility of implementation, costs of

<sup>1</sup> However, specific, partial guarantees could be included in order to reduce the required interest (coupon) rate on the AAA-rated bonds.

implementation and volume of finance generated, led to our a preference for the first Affordable Housing Finance Corporation model.

**Table 2: Comparison of two schemes: Affordable Housing Finance Corporation and Securitisation**

	<b>Model A AHFC</b>	<b>Model B Securitisation</b>
<b>Borrower-CHO</b>		
Advantages	Lower interest (coupon) cost Transparent Works elsewhere	Magnification generates more debt funds therefore more housing built Financial sector accustomed to structure (via RMBS)
Disadvantages	Requires new agency Delay as financial sector becomes aware of structure Reluctance of government to supply guarantee	Necessity of structuring leads to higher transaction cost adding to the higher coupon rate
<b>Lender/investor</b>		
Advantages	Comfort with government guarantee to address perception of risk Uncomplicated	Familiarity with product
Disadvantages	Sovereign risk	Unfamiliarity with rental sector High transaction costs
<b>Government</b>		
Advantages	Minimal impact on Budget with careful guarantee structure Expanded supply of affordable housing	Capital market discipline on providers Expanded supply of affordable housing
Disadvantages	Risk of call on guarantee	Greater requirement for government investment

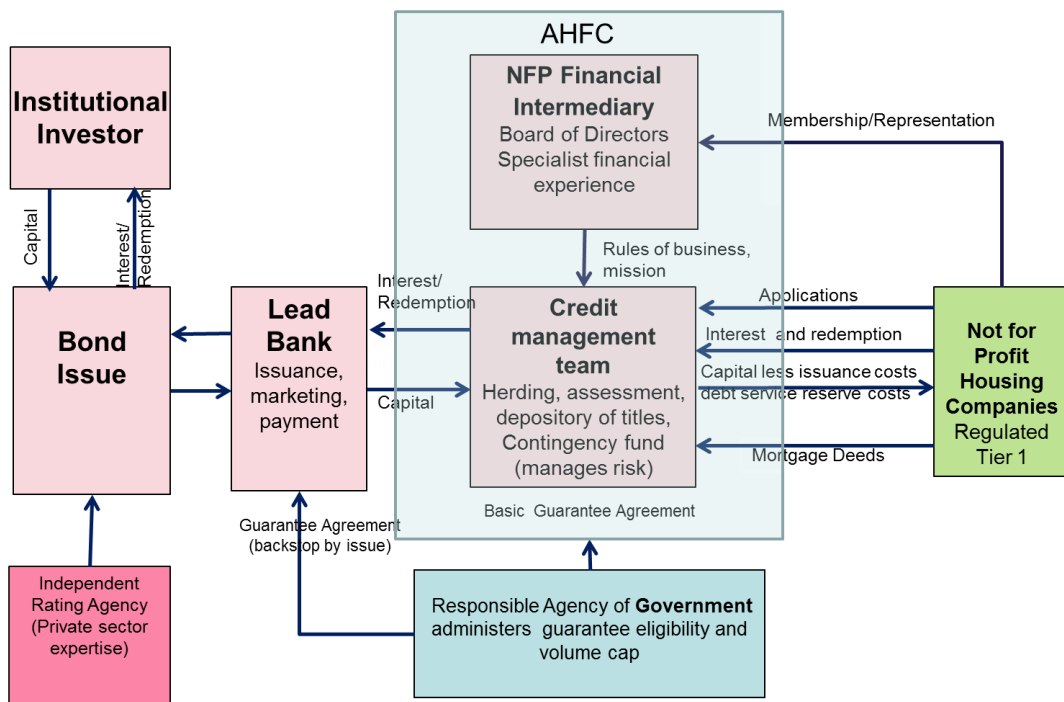
On the basis of the advantages and disadvantages noted above in Table 2 and the input of interviewees and participants at the industry Think Tank, the research team has concluded that Model A—the Affordable Housing Finance Corporation—provides the best way forward in current Australian circumstances 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 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 the likely pricing of Model B and current bank finance and, hence over the medium to long run is likely to maximise the sustainable expansion in the stock of affordable rental housing.

- Following the preceding point, Model B requires a higher equity contribution by project sponsors, increasing the demand for government capital subsidies to non-profit CHOs; the government equity grant to UK providers in the case of conventional bond finance averaged 40 to 50 per cent, falling to 20 per cent on the new guaranteed bond product (CEO, Housing Finance Corporation).
- Properly structured and managed, Model A 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 model is described in detail in the body of the report and summarised in the diagram below:

**Figure 1: Recommended model—Affordable Housing Finance Corporation**



Key steps for the implementation of this model and the key stakeholders responsible are as follows:

**Table 3: Key implementation steps and their responsible stakeholders**

<b>Key stage</b>	<b>Implementation tasks</b>	<b>Responsible stakeholders</b>
1. Creation of AHFC as a financial intermediary	Creation of a taskforce, chaired by a senior financial sector professional, jointly funded by the Commonwealth, industry superannuation sector, ACTU and the residential property sector peak associations. The Taskforce would be charged with creating and funding the corporate entity within the relevant legal form (the Financial Intermediary and Credit Management organisation depicted in Figure 1, hereafter termed 'the Corporation').	Leadership provided by Commonwealth DSS in establishment of Task Force of key financial and legal experts and resourced by relevant stakeholders as identified in tasks.
2. Overarching guarantee agreement	The Corporation would negotiate and sign an overarching agreement with government(s) offering an issue-specific default guarantee on bonds issued by the Agency. Government would need to give a clear commitment to continuity of funding eligible tenants via CRA, etc. and the term of the guarantee, so that potential investors can be confident of a pipeline of future bond issues.	AHFC with Commonwealth DSS and participating SHAs
3. AHFC Board establishes administration	The Corporation would establish its mission and strategic plan and recruit relevant expert and ancillary staff.	AHFC Board
4. Administers market scan	The Corporation would then carry out a market scan, identifying the potential borrower-provider and lender universes.	AHFC staff
5. Aggregates demand and bond rating	The Board of the Corporation would oversee the establishment of procedures for aggregating and assessing borrower demand and establishing procedures for issuing rated bonds.	AHFC Board, staff and Rating Agency
6. Reserve funds	The Corporation would establish internal procedures for creating borrower-specific and general reserve funds, as per the Model structure.	AHFC Board, staff and participating borrowers
7. Bond Issuance	The Corporation would engage specialist assistance (Lead Bank) to market the initial issue and establish a brand presence in investment markets.	AHFC staff with Lead Bank

This AHFC proposal, grounded in extensive national research of industry stakeholders and adapting 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 for well-targeted rental housing developments, attracting investor interest with a well-structured government guarantee.

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 can strengthen Australia's housing choices and build a stronger, more secure, more equitable and more efficient rental housing market.

# 1 INTRODUCTION

This Final Report responds to Australian research, stakeholder views and market capacity regarding a suitable mechanism for enhancing private investment in affordable rental housing. It proposes two options suitable for the Australian affordable housing sector and specifies implementation requirements for a preferred option. It offers feasible recommendations for a government-facilitated private investment mechanism for affordable rental housing to operate across all states and territories, combining the strengths and capacity of Australia's growing superannuation and rapidly professionalising non-profit housing sector.

The conducted research focuses on the role played by Australia's financial services industry, focusing on superannuation, debt securities and banking sectors, investigated via literature review and intensive interviews with fund managers, ratings agencies and borrowers. An industry Think Tank, hosted by Australia's largest superannuation fund, drew on international expertise from the UK and Switzerland, and directly engaged key stakeholders in the Australian financial services and affordable rental sector.

This report outlines the rationale, preferred design and implementation requirements for a mechanism to catalyse institutional investment in affordable rental housing. It also shows how governments can help to establish a robust market for such activity.

## 1.1 Responding to national policy imperatives—an overview

All Australian governments are critically engaged in housing policy reform. The Council of Australian Governments (COAG) provides an important vehicle to achieve it. Via the National Affordability Housing Agreement (NAHA), COAG aspires to ensure that all Australians have access to affordable, safe and sustainable housing which can, in turn, contribute to their improved social and economic participation (COAG 2011).

Of direct relevance to this study, under the NAHA, the Commonwealth Government is responsible for leadership for national housing and homelessness policy including Indigenous housing policy and the financial sector regulations and Commonwealth taxation settings that influence housing affordability (COAG 2011:5). 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 n.d.)<sup>2</sup>

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. 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 given its timing alignment with the GFC and ongoing uncertainty of policy support.

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<sup>2</sup> See National Partnership Affordable Housing, Social Housing Subsidy program [http://www.federalfinancialrelations.gov.au/content/npa/housing/social\\_housing\\_subsidy\\_program/NP.pdf](http://www.federalfinancialrelations.gov.au/content/npa/housing/social_housing_subsidy_program/NP.pdf)

Different state and territory jurisdictions have explored a range of grant, debt and equity models, with varying output. Housing Ministers are aware that the amount of leveraging that can be achieved relies on the interaction of government policy, the economic context and the financial position of social housing providers (HMC/VGDHS 2009, p.29).

A report to COAG on National Housing Reforms (HMC/VGDHS 2009) stressed the need to establish new mechanisms for leveraging private funding and co-financing affordable rental housing, primarily via institutional investment in the not for profit sector:

Reform to funding will need to address the financial and structural barriers in the medium to long term and provide a financial platform that would facilitate leveraging investment through community housing (HMC/VGDHS 2009, p.24).

This remains an important goal for budget-constrained state and Commonwealth governments. In order to facilitate reforms, two AHURI Investigative Panels (IPs) have emphasised the importance of inter-governmental efforts via a renewed COAG agreement and/or joint Commonwealth and state legislation (Milligan et al. 2013; Berry & Williams 2011). Further, the 2013 IP recommended that the Council of Australian Governments (COAG) negotiate and establish minimum annual targets for new affordable dwellings and specify affordable housing requirements for urban plans and land release (p.6). Both the AHURI Investigative Panels (IPs) and the Final Report on Housing Supply Bonds, called for a Task Force to provide leadership to focused policy implementation efforts and re-assure investors of the certainty and continuity of this policy goal (Berry & Williams 2011; Milligan et al. 2013; Lawson et al. 2012).

Recently, the Minister for Social Services has expressed strong support for:

Encouraging a multifaceted approach to increasing private investment across the housing continuum ... investment is an area where the Commonwealth is part of the solution ... We must energise the housing construction sector. We need to leverage private investment. And we need to work across the public, private and community sectors. Unless we do these things, we face a looming social crisis. (Hon. Kevin Andrews, Minister for Social Services, National Housing Conference, 1 November 2013).

In this speech, the Minister called for doubling of efforts to increase private investment in affordable rental housing, alongside a fine-tuned National Rental Affordability Scheme.

Serving these goals, this Final Report aims to inform such a Task Force to channel and increase longer term, lower cost institutional investment towards landlords whose mission is to increase the supply of secure affordable housing. It provides the policy rationale, market evidence, principles and practical necessities for two alternative mechanisms to increase investment in new supply.

## **1.2 Relevant findings of the Investigative Panel and Housing Supply Bonds Study**

This project follows on from the earlier AHURI reports on housing supply bonds (Lawson et al. 2012) and institutional investment in rental housing (Milligan et al. 2013) but concentrates on the role of government guarantees in reducing barriers to and encouraging institutional investment at scale in expanding the supply of affordable housing in Australia. It is taken for granted in this study that earlier research has established the existence of pervasive market failure in the provision of rental



housing affordable by and available to lower income and otherwise disadvantaged Australians; and that current governments recognise and are seeking to overcome these failures through appropriate policy interventions.

The 2013 AHURI Investigative Panel concluded that institutional investment was the most desirable source of finance to achieve long-term growth in the supply of rental housing for a number of reasons:

- Unmet demand is so large that no-one else (including government) has access to sufficient funds to provide the finance needed.
- Institutional investment offers efficiency gains from scale and proportionally lower transaction costs for a small number of large investments rather than a large number of smaller contributions.
- Institutions are likely to view longer-term lettings more favourably and to provide a more stable and predictable source of funds than individual investors.
- Institutional investors represent an alternative source of finance for larger scale rental housing providers currently constrained by costly and limited bank finance. Nevertheless, the goal needs to be substantially increased levels of investment, not just a change in the sources of investment.
- Institutional investment has the capacity to change the structure of the residential construction industry from a potentially inefficient, small scale cottage industry to a more professionalised sector.
- Institutional investment will be needed if a new property asset class focused on income returns rather than speculative gains is to evolve (Milligan et al. 2013, pp.34–35).

One of the main areas of market failure concerns the under-provision of finance—private and public—for rental investment, relative to the growth in demand for rental housing. Although this twin shortage of finance and dwellings affects the entire rental market, it is particularly severe in the low rent segment; in other words, low income and multiply disadvantaged households are pushed to the back of the lengthening queues, in both the public and private sectors. Persistent and rising homelessness is the most serious consequence of this situation, one that ramifies through to other areas of social policy like mental health. Inadequate supply also undercuts the efficiency of urban labour markets and hence productivity growth driving industry competitiveness, while reinforcing welfare dependency and social exclusion.

Private rental investment flows are currently encouraged and constrained by existing market incentives, taxation settings and cultural values, leading to the domination of the sector by small-scale 'petty landlords' (Beer 1999; Berry 2000). Institutional investors are largely absent from the residential rental sector for a host of reasons that are well documented in the literature (Berry 2003; Wood 2001; Yates & Milligan 2007). The IPs investigated current barriers to investment regarding the asymmetry of information, scale of investment required as well as the minimisation of liquidity and (policy) risk (Milligan et al. 2013; Lawson et al. 2012; Berry & Williams 2011).

The primary barrier, yet to be surmounted, is that the rental yields available in Australian markets do not meet the risk-adjusted requirements of the large institutions, including the superannuation funds. The challenge of surmounting the risk-return hurdle is heightened when the policy aim is to include a significant tranche of affordable housing in the rental portfolio, since by definition, rents on that tranche will need to be below market rates. Unfamiliarity with this investment sector further prevents institutional interest, reinforced by distrust of long-term government

commitment. Lack of interest has undermined innovation by the financial sector. As the head of fixed interest at one of the large industry superannuation funds comments:

Certainty around government policy would be a positive. However, until there is an attractive investment structure created, institutional investment will be limited. (*Australian Financial Review*, 4 April 2013)

At least one investment manager at a large industry fund has expressed an optimistic belief that a suitably structured instrument could be developed with the right supports in place. John Hopper, investment manager for Australian Super which manages \$42 billion of funds, said the government guarantee proposed by the 2012 AHURI report would lower the risk profile of an investment by making it appear more like a government bond, lowering the return required.

If structured the right way this could find a logical home in our portfolio, Mr Hopper said. 'This is a pretty good step in that direction. I think now we just need to see more detail so we can make a proper investment assessment.'  
(*Australian Financial Review*, 31 May 2012)

The superannuation funds and their investment managers are ideal targets because of their need to match the long-term pension liabilities of their members with the potential steady returns delivered by well-managed secure tenancies, underpinned by adequate government support, provided sufficient scale and liquidity can be generated.

Government support can come through a range of ways, notably by way of financial incentives—in cash or via tax relief—and through measures of credit enhancement. Both avenues work to reduce the yield gap, either by increasing the net effective yield or reducing risk. In order to develop a deep market meeting the scale and liquidity requirements of institutions, total annual investment of around \$500 million would be necessary, as confirmed by the investigative panel (Milligan et al. 2013, p.3). Debt instruments targeted at the operational end of an expanded rental sector are likely to best meet the investment mandates of the institutions, given that superannuation funds, in particular, are under-weight on relatively low risk-lower return assets. For example, an infrastructure bond-type of product would likely fit the bill, if volatility of return can be reduced.

Because of the need to expand effective opportunities for low-income households to access appropriate housing at affordable rents, it will be necessary to attract private finance to expand supply overall in the rental housing sector. This would allow some existing and new low rent dwellings to be freed for occupation by lower-income households while facilitating cross-subsidisation of those groups by higher income households paying market rents, while still meeting the hurdle rates of return of investors.

Government on-budget support will need to be confirmed over the long run, especially:

- Continuation of key Commonwealth funding streams—Commonwealth Rent Assistance and NRAS, probably more effectively differentiated and targeted and at more generous levels.
- Equity investment in the form of capital outlay grants and land contribution.

Also suggested is the possibility of financing construction (prior to take-out by institutional investors) by establishing a revolving low interest loan fund.

The Housing Supply Bonds Study (Lawson et al. 2012) presented a tripartite tranche structure for bond instruments that would likely attract the appetite of retail,

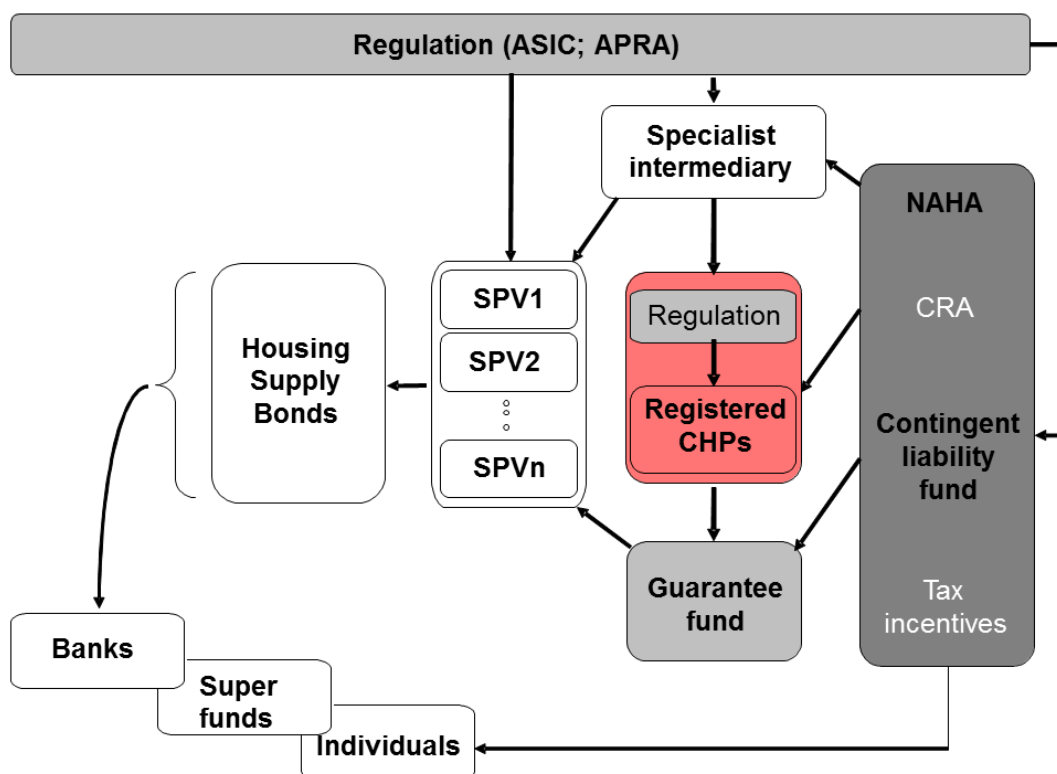
government and institutional investors in Australia and internationally. In each case, some form of credit enhancement will be necessary in order to deliver loan finance at affordable rates to social and affordable housing providers. This is summarised in Table 4 and Figure 2 below, drawn from the study.

**Table 4: Target markets for HSBs and proposed enhancements**

Bond type	Characteristics and enhancements	Investor segment
AAA Housing Supply Bond	A fixed interest, long-term (up to 10 years) AAA-rated bond—implying need for a government guarantee.	Super fund managers (15% tax rate)
Tax Smart Housing Supply Bond	A fixed term, fixed interest (or indexed) lower yield long-term bond with a tax incentive to generate a competitive after-tax yield.	Retail investors (various tax rates)
NAHA Growth Bond	A zero interest bond that converts a direct grant into a long-term revolving loan.	Governments

The Housing Supply Bonds study then outlined, schematically, the overall architecture of such an approach, reproduced below.

**Figure 2: The architecture of the Housing Supply Bonds**



Source: Lawson et al. 2012

### **1.3 Relevant recommendations from the Investigative Panel concerning design of the social housing guarantee**

Hamilton (in Milligan et al. 2013, vol.2, pp.16–19) discusses the various forms that credit enhancement can take in order to craft a product or range of products that are attractive to investment institutions. The argument is made that in the (still) risk-averse shadow of the GFC, commercial credit enhancement remains too costly to significantly reduce finance costs for affordable housing (see relevant evidence summarised later in Chapter 2). Government, on the other hand, could meet this need to counter the risk premium charged on a new asset class of pooled rental housing, especially in the short to medium term, by providing a degree of certainty to potential rental investors via a range of mechanisms. These could include full capital (repayment) guarantees, partial guarantees tailored to specific market segments and/or investor-types, covenants and 'letters of comfort'. Examples of each mechanism have been tried in Australia and other countries; see below for more detail on Australia and the Positioning Paper in relation to international cases (Lawson 2013). Once investors become familiar with these approaches, government support may gradually be wound back as commercial credit enhancement products re-establish their market presence; however, it is highly likely that an appropriate government guarantee mechanism would be needed in periods of volatility in global credit markets, as recent history demonstrates.

Credit enhancement via guarantee in this context could take the following forms:

1. A straight-out guarantee on investors receiving their interest/coupon payments *or* repayment of the principal sum at the end of the agreed period *or* both.
2. A guarantee of specific components impacting on the provider's capacity to meet debt obligations—for example, income support programs like CRA, rental income flows in relation to rental arrears and vacancy rates, etc.
3. Creation of a reserve fund that would pay out to investors holding defaulting debt.

This fund could be fully funded by government or co-funded with, for example, the non-profit housing provider sector. The balance of provider versus government contributions to the fund could evolve with the former increasing relative to the latter as the rental sector matured. A final government guarantee could stand behind the reserve fund that would be called upon only in the event that the fund was exhausted before investor entitlements were met. This two-part structure has the benefit of allowing time for restructuring the debt of defaulting providers—for example, by merging at-risk providers with stronger ones. It may also reduce the cost to government of credit enhancement (see below).

Other forms of back-stop guarantee options could be a government commitment to purchase unsold dwellings at agreed market value upon default or in the event that a newly-developed housing project fails to be taken up fully by private investors.

Specific conditions can be placed on guarantee structures with respect to timing, financial limits, reporting and monitoring, and cascading by level of risk reduction. In the latter context, specific debt instruments can be engineered with different levels of support, enabling the different tranches to be targeted at different investor/stakeholders; the deepest enhancement would be attached to low risk-return instruments sold to the superannuation funds.

In summary, the Investigative Panel research found great variation in the structuring options and thereby government exposure represented by a guarantee. The maximum efficiency for a new asset class, such as pooled affordable rental housing,

is in finding the amount of credit enhancement that soothes investors in a new type of security, while being no 'skin off the nose' of government, who already manages, regulates and provides income supports in this sector.

## **1.4 Relevant findings from the International Review of Guarantees**

Australia is not alone in its aspiration to lower the cost and lengthen the terms of investment in affordable rental housing. For more than 30 years governments in Europe, North America and Asia have attracted investment via land use planning, subordinated grants and loans, rent assistance, intermediaries and guarantees, in order to generate new supply. Comparative discussions and overviews of housing policy developments in these countries can be found in Lawson and Milligan (2007) updated in Pawson et al. (2011), in planning developments in Gurran et al. (2007) and innovations in affordable housing in Milligan et al. (2009).

A review of international best practice provided by the Positioning Paper, *The use of guarantees in affordable housing Investment—a selective international review*, offers a discussion of key concepts and design principles for guarantee mechanisms and intermediary agencies and reviews successful practice which attracts investment towards affordable rental housing in the UK, France, Switzerland, Ireland, the US and the Netherlands (Lawson 2013).

Recently, at the European level, Housing Ministers<sup>3</sup> recommended the expansion of European Structural Funds and European Investment Bank activity in this area. The exchange of expertise between financial intermediaries and guarantee schemes which exist across Europe is being facilitated by peak housing bodies such as the Federation of Public Cooperative and Social Housing (CECODHAS). As reviewed in the Positioning Paper there is much to learn from this international experience and this report explores their relevance and adapts the lessons they provide to the Australian context.

The AHURI Positioning Paper analysed seven schemes in Europe and the US channelling longer term, lower cost private investment to increase the supply of social and affordable housing. It found that guarantees were important in establishing a much more favourable investment market for affordable rental housing and that over time such mechanisms had a minimal impact on government budgets.

From the detailed international review, the Positioning Paper distilled important lessons for Australian policy-makers when designing appropriate investment enhancements.

### *1. Agreed principles, facility agreement, predictable pipeline*

From the outset, agreed principles for investment eligible for government guarantee need to be defined by government and agreed by peak bodies to ensure appropriate targeting of implicit public subsidies and to provide a clear signal of commitment to investors and borrowers for specific housing supply outcomes.

Once these principles are agreed there should follow a clear government mandate for guaranteed obligations. Agreement on the limit should be based on defined supply targets and the current and potential borrowing demands and capacity of the social

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<sup>3</sup> See resolutions of the 19th Informal Meeting of European Housing Ministers, 9–10 December 2013, 'The sustainable financing of housing policies in times of crisis', particularly recommendation 2 and 8b to the European Commission regarding the EIB and use of European Structural Funds, [http://www.housingeurope.eu/www.housingeurope.eu/uploads/file\\_/finalcommuniqu%C3%A9HousingMinisters101213.pdf](http://www.housingeurope.eu/www.housingeurope.eu/uploads/file_/finalcommuniqu%C3%A9HousingMinisters101213.pdf)

housing sector. Such a ceiling and review process would ensure greater market certainty and investor commitment.

## *2. Lowering risk of investment and avoiding any potential call on the guarantee*

It is vital to reduce the likelihood of the guarantee ever being called. First and foremost, the borrowers must be well managed, reporting appropriately and independently monitored. Non-profit providers should be able to demonstrate whether their businesses are stable and critical conditions supportive.

Second, it is important to inform investors of the nature of the guarantee and the 'back stop' role played by the government. This component of the guarantee is the main factor influencing the rating of the bonds.

## *3. Informing investors and marketing the bonds*

Investment in well regulated affordable rental housing with a clearly defined and supported revenue stream differs markedly from investment in more risky infrastructure projects. The lower risk of rental housing, backed by loans with a government guarantee, needs to be reflected in lower anticipated yields by investors. Pro-active, government supported efforts need to inform relevant investors of the nature of risk and related guarantee enhancements. This would require an active marketing strategy or repeated 'road show' among relevant stakeholders.

## *4. Expert financial intermediary*

Investors are unlikely to have specialist technical and legal capacity to service the social housing sector, and hence the establishment of an independent financial intermediary is required. This intermediary should have the capacity to assess risks and ensure the requirements to be eligible for guarantee. Various models are possible, including cooperative buying groups as in Switzerland, non-profit intermediaries as in the UK and the Netherlands, and publicly-owned corporations as in Ireland and France.

## *5. Pooling demands and regularity of bond issues*

The size of the organisations is not definitive for their financial management efficiency and effectiveness, but the size of the bond issue is important to investors. Scale efficiencies can be achieved by pooling multiple smaller borrowing demands with cost of issuance shared between participating borrowers and added as a premium on the loans.

Pooling mechanisms can work effectively, but regularity of issue is also important. Investors require issues to be regular and predictable, thereby developing a liquid market for the bonds. This requirement could dovetail with a long-term housing program with annual supply targets.

In Switzerland since 1991, quarterly pooled bond issues in 5000 lots have varied from CHF 23 million (AUD 26 million) to CHF 123 million (AUD 141 million), attracting strong and sustained interest from large and small investors.

## *6. Structure of the guarantee and accounting requirements*

In the event of any default, loss sharing arrangements need to be clear and agreed in advance. As with the Dutch WSW, the guarantee can be conceived as a series of layers or lines of defence against any default and consequently any call on the government.

First, organisations must be accountable to a body that has real power to intervene and enforce compliance where an organisation is failing to comply or needs assistance or re-organisation to comply. High calibre and professional expertise in the

financial management of not-for-profit organisations is very important, both inside these organisations and those regulating them. This requires adherence to clear and appropriate commercial benchmarks for solvency ratios, interest rate cover and equity to be eligible for any guarantee.

Further, equity or equity-like components of guaranteed schemes are also important and include indefinite public loans or other (tenant, landlord, government provided) equity. Properties that are guaranteed need to be well located, maintained in good condition and be highly rentable. The guarantee may be tied to a mortgage on an unencumbered property. Comfort to investors can be given via a legal agreement, where the bond coupon payments are ranked higher than other financial obligations, and hence these bond investors can claim first call on any repayment.

As in the Netherlands and Switzerland, a guarantee fee can also be used to build up a reserve fund proportional to the obligations guaranteed. It can also be conceived as the government guarantee's second line of defence against being called upon. In Switzerland, the fee is used to cover interest payments for a maximum of one year and is, of course, in addition to any issuance fee.

Alternatively, governments can act as an insurer, by pricing the risk and charging fees; thereby accumulating a fund. Otherwise they must account for this risk in their budgets, as contingent liability and set aside an acceptable proportion of the guarantee obligations. If they intend to regularly support organisations to meet their repayment obligations, the government is in effect taking responsibility for them and they should be accounted as such in the government budgets.

Through appropriate revenue support and regulation, sound business management practices and carefully structured guarantees, there has been a zero default rate among all European guarantee schemes over the past decade including during the GFC and related turbulence in housing markets. (Lawson 2013, pp.14–16)

Table 5 below provides a summary of the schemes reviewed in the Positioning Paper.

**Table 5: Key features of selected affordable housing investment guarantee schemes**

<b>Guarantee scheme</b>	<b>Intermediary</b>	<b>Targeted</b>	<b>Financial impact</b>	<b>Default rate</b>
Dutch Guarantee Fund Social Housing (WSW) backed by the sector, a fund and central and local Dutch governments (1983)	Yes Independent foundation	Yes, new and renovated nominated rental housing, low to middle income, registered and monitored providers	1–1.5% below going market rates for similar mortgages	0%
Swiss Bond Issuing Cooperative for Limited Profit Housing (EGW) backed by the Swiss Federal Government (1991)	Yes Cooperative owned by sector backed by government	Yes, new and renovated cost rental housing, low to middle income, compliant with Charter and government standards monitored providers	Small margin above government borrowing costs	0% since 2003
UK Affordable and Private Rented Housing Guarantee Schemes, backed by UK Government (NEW in development mid-2013)	Yes, THFC non-profit corporation, licenced guarantor	Yes, newly completed below market rental or ownership housing, low to middle income, registered and monitored providers	Aims to provide 30 year finance at small margin above government borrowing costs	0% based on lengthy THFC experience, guarantee introduced 2013
French Mutual Fund for Guarantees of Social Housing (CGLLS), backed by the French Government (2001)	Yes, Publicly owned and administered	Yes, new and renovated nominated rental housing, low to middle income, registered and monitored providers	Market only exists with guarantee	0% since 2008, has been higher 0.04%
Irish Housing Finance Agency backed by the Irish Government (1982 LAHs/2012 VHBs)	Yes Publicly owned company	Yes, new and renovated income related rental and ownership housing, low to middle income, registered and monitored providers	Very limited market without guarantee	0% for LAH, new for VHBs
Scottish Government's National Housing Trust, backed by the Scottish Government (2010)	Yes Publicly owned trust	Yes, newly completed near market rental housing, low to middle income, managed by registered and monitored providers	NA	0% new
US Risk Sharing Scheme between Housing Finance Authorities and HUD, backed by Federal Housing Administration insurance (1992 pilot/2001 permanent)	Yes Publicly owned corporations	Yes, rental or ownership housing, low to middle income, registered and monitored providers	NA	NA



Of the seven mechanisms, the Swiss Bond Issuing Cooperative (BIC) and The Housing Finance Corporation (THFC) established in the UK clearly demonstrate international best practice in terms of the importance of a specialist financial intermediary and effectiveness of government guarantee in improving the financing conditions for affordable housing providers.

The BIC is a joint venture of the Swiss non-profit housing sector and the Federal Housing Office, established in 1991. It pools the borrowing demands of its members and meets these by issuing five to 15-year fixed bonds covered by a federal joint guarantee. This process allows smaller builders access to long-term, low cost finance from pension funds for affordable rental housing at typically 1–1.5 per cent below comparable market rates and just above Swiss Government Bonds. The full faith and credit provided by the Swiss Federal Government is clearly specified in their Guarantee Agreement, translated by BIC for this study with key text provided in Box 1 below.

**Box 1: The Swiss Federal Guarantee for BIC bonds**

The Swiss Confederation shall issue a federal guarantee to back the bond liability, encompassing running and accrued interest, commission, late-payment interest, expenses and costs, including where these are added to the capital. It shall be liable as a joint and several guarantor (pursuant to Section 496 of the Swiss Code of Obligations) alongside BIC up to a maximum amount of CHF 70 700 000. [up to AUS\$89 million] the guarantee relationship being entered into with Zürcher Kantonalbank as the representative of the bond creditors. In this capacity, Zürcher Kantonalbank shall be authorised to enforce all rights arising out of the joint and several guarantee in the names of all the bond creditors.

In the event that BIC is late in meeting a payment obligation in connection with the bond, the joint and several guarantor undertakes to pay to Zürcher Kantonalbank at its first demand in its capacity as representative of the bond creditors the amount owed by BIC, including late-payment interest, up to the maximum amount specified in the joint and several guarantee.

The maximum amount shall be reduced by each payment that the joint and several guarantor makes to Zürcher Kantonalbank in fulfilment of BIC's payment obligations arising out of this bond (Directorate, Swiss Federal Department of Economic Affairs and Swiss Federal Office of Housing 2013).

Beyond the guarantee, the Swiss Federal Government contributes to a revolving fund, which provides low cost loans, that is administered by two umbrella organisations of housing cooperatives.

The Housing Finance Corporation (THFC) was established in Britain 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 paid direct to the landlord, as well as appropriate sector regulation and secured financing.

In October–November 2013, key experts Dr Peter Gurtner, BIC Chair and Piers Williamson, THFC's CEO, shared their experience with key stakeholders in Australia as part of this research project.

**Figure 3: Piers Williamson and Dr Peter Gurtner responding to questions at the National Housing Conference, Australia**



Note: Piers Williamson—CEO, UK Housing Finance Corporation; Dr Peter Gurtner—Chair, Swiss Bond Issuing Cooperative. Photo taken at National Housing Conference, 1 November 2013 in Adelaide, Australia.

Both the UK and Swiss financial intermediation arrangements operate successfully under quite different financing settings and market conditions. No two housing finance systems are alike and there will always be differences between overseas arrangements and those present in Australia. Simply transplanting overseas models to the Australian context is not the approach of this research. Rather, the research identifies the key mechanisms and their contingent circumstances which underlie successful schemes and carefully examines their relevance and adaptability to Australian conditions.

Towards this end, the key principles and practices inherent in successful guarantees are summarised below.

**Table 6: Principles and practices of successful guarantee schemes**

<b>Principles</b>	<b>Practice</b>
Boundaries	Agreed principles, defined characteristics of eligible projects for guarantee, overall and project-related borrowing volume cap (and hence contingent liability for government), competitive allocation process for certificates, long-term policy commitment to co-financing and revenue arrangements.
Lowering risk	Expert management and regular professional reports, appropriate regulation and enforceable compliance, sufficient equity and revenue base, back stop role of government.
Transparency and commitment	Professional audit and accounting, commitment to a sustainable business model (equity and revenue), appropriate joint marketing strategy by stakeholders involved.
Expert intermediary	Vetting and aggregating CHO investment needs, independent and expert, able to assess proposals, risks and enforce compliance among borrowers.
Scale and frequency	Pool multiple smaller borrowing demands to achieve efficient scale, regular bond issues to sustain market interest.
Adequate structure	Clear and agreed structure including compliance process, lines of defence against default, expert resources to assess risk and build up reserves and agreed loss sharing arrangements.

## 1.5 Why bother?

A mechanism designed to stimulate investment in medium density affordable rental housing managed by not-for-profit housing associations can be justified as contributing towards:

- Economic competitiveness through improved access to the rental market by lower-income households, enabling a more flexible and productive workforce.
- More efficient use of limited public resources, exploiting government credit worthiness to full effect; by guaranteeing bonds investing in completed, approved developments.
- Increased productivity through new housing supply, responding to demand and generating sustainable employment in the construction sector, supporting local economies and lifting regional and national GDPs.
- Closing the gap between investor demands and housing provider financing needs, by herding borrowing requirements, financial intermediation and risk reduction.
- National cohesion and social inclusion, sharing the benefits of secure affordable housing more fairly across the community and assisting those not served by existing market processes.
- Social welfare, addressing a clear and unmet need for rental housing which is accessible and available to lower-income households as a refuge, oasis and stepping stone on housing pathways.
- Financial continuity and growth of well-regulated non-profit housing providers, strengthening the government's preferred suppliers of social housing by providing a pipeline for investment.
- Promoting new medium density rental housing in well serviced areas, reducing the distance between affordable housing and employment opportunities, improving the productivity and sustainability of Australian cities.

## 1.6 Strengthening housing choices

There is a well-established shortage of affordable and available housing supply which varies across regions within Australia. This particularly affects Sydney, Melbourne and Brisbane and regional centres of the Sunshine Coast and the Gold Coast (Wulff et al. 2011). Young people and families are particularly affected by the lack of access while poverty among older Australians dependant on fixed incomes, is prevalent.

As access to well-located home ownership narrows, the choices available in the rental market for young people and families with children need to be strengthened considerably to improve their choice of affordable, secure, well located, and suitable quality housing. Access to such housing contributes in a tangible and meaningful way towards social cohesion: by promoting family stability, continuity in education, reducing car dependency, improving labour market productivity and supporting environmental sustainability. A modernised Australian housing policy would support and expand housing choices for a range of households. It would be implemented and coordinated across relevant government agencies responsible for implementing urban plans, social welfare policies, as well as improving labour market productivity, economic stability and environmental sustainability.

Increasingly, Australian housing policy relies on the third sector of not-for-profit community housing organisations as affordable rental providers. To succeed in expanding this provision requires support by treasury, infrastructure, planning and welfare departments.

A return to supply policy was signalled by the introduction of the National Rental Affordability Scheme (NRAS) as well as the Social Housing Initiative in 2008/9. The latter generated 19 700 new dwellings and repaired or maintained a further 81 000 dwellings as part of 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 and those fleeing domestic violence. Subsidising supply directly also had a strong economic multipliers effect (1:1.3) generating up to 14 000 jobs (9000 in construction) and boosting Australian Gross Domestic Product (GDP) by an estimated 10 basis points during 2011–12 (KPMG 2012).

NRAS continues to provide a form of refundable tax offset for investors, and is targeted to new dwellings providing below market rent accommodation for a defined period (10 years). The scheme has attracted growing interest from retail investors and cross party support. Interest from large-scale institutional investors has been slower to emerge. Modifications to the scheme are anticipated following evaluative research (Speech, Hon. K. Andrews, National Housing Conference, 1 November 2013).

However, since 2011 there have been signs that high cost finance as well as limited government support have weakened the growth of the Australian non-profit housing sector (Deloitte Access Economics 2011). NRAS alone, without equity or other enhancements, has not been sufficient to attract large-scale institutional investment.

By 2013, the cessation of SHI generated a gap in the supply and demand subsidies required to attract institutional finance. CHOs had to depend on the limited and shallow interest from the banking sector and have struggled to obtain low cost, long-term funds.

CHO interviews for this research project (see Chapter 2) confirm that commercial lending conditions are currently undermining the potential of the sector to deliver new supply. Providers have experienced weak support from private lenders under tight credit conditions and with limited retail competition. These conditions have led to

inadequate debt terms for CHOs, where lending tenure falls far short of typical commercial mortgage terms for such property assets. These conditions are unlikely to improve without appropriate innovative, long-term policy action.

## **1.7 Designing a mechanism appropriate to Australian conditions**

Promising research has identified the potential of Australian superannuation funds to invest in this sector, and found strong support for quality ‘government like’ securities with a government guarantee (Berry & Williams 2012; Lawson et al. 2012; Milligan et al. 2013). Such interest comes at a time when the current federal government is also keen to develop mechanisms to channel long-term investment towards infrastructure (*Coalition’s policy to deliver infrastructure for the 21st Century*, 2013). Consideration of a government guarantee has also been advanced by both the previous and current governments.<sup>4</sup> The Coalition Government has proposed to establish a Funding and Financing Advisory Unit in order to:

... provide advice on the most efficient financing options to raise capital for a particular project. This will include an analysis of suitability for private, as well as public, financing options. (Coalition Policy 2013, p.10)

An indication of where the Coalition government considers government enhancement necessary was provided by Leader of the National Party Warren Truss, in his speech to the IPA, when referring to the Toowoomba second range crossing:

[The project] will generate some trucking toll revenue, but this is unlikely to cover much more than maintenance costs. This project lends itself more to a PPP, covering construction and maintenance supported by a Commonwealth loan guarantee and availability payments. (Truss 2013)

While Coalition Government infrastructure efforts are currently focused on transportation infrastructure, an investment strategy could easily be broadened to address well established market failures in the rental housing market as recommended by the COAG's National Affordability Housing Agreement. Suitable instruments for investing in affordable rental housing have already been suggested by previous research and several industry panels (Berry & Williams 2011; Lawson et al. 2012; Milligan et al. 2013) and this Final Report provides more details on their implementation requirements.

While they have not been major investors in rental housing, superannuation funds and other larger institutional investors are increasingly aware of this potential asset class (Milligan et al. 2013). Fund managers are researching opportunities for involvement in this area, as confirmed through interviews for this study and by the active participation of leading funds in the Think Tank meeting conducted for this research. A list of participating organisations is provided in Appendix 1.

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<sup>4</sup> Both the Abbott and Gillard Governments suggested the use of bonds and guarantees to advance Australia’s infrastructure investment needs. See Crowe 2013, 2013a; Coalition Policy 2013 and also Truss 2013 with regards to projects where revenue does not cover costs: ‘This project lends itself more to a PPP, covering construction and maintenance supported by a Commonwealth loan guarantee and availability payments.’

**Figure 4: Think Tank meeting on Affordable Rental Housing Investment, hosted by Australian Super**



Note: photo taken at Think Tank meeting, 29 October 2013.

## **1.8 Research objectives and methods**

With the aim of facilitating the supply of affordable rental housing in Australia, the primary goal of the research is to develop a social housing guarantee model appropriate to Australian conditions. Towards this goal, the project tackles three key research questions:

1. How are existing social housing guarantee (SHG) frameworks capitalised, structured and accounted for in established social housing systems and what are their costs and benefits for relevant stakeholders?
2. Given international experience, local financial conditions and provider characteristics, what model of SHG would most cost effectively enhance the cost-effective availability of social housing finance in Australia?
3. What are the key implementation issues and how could they be addressed?

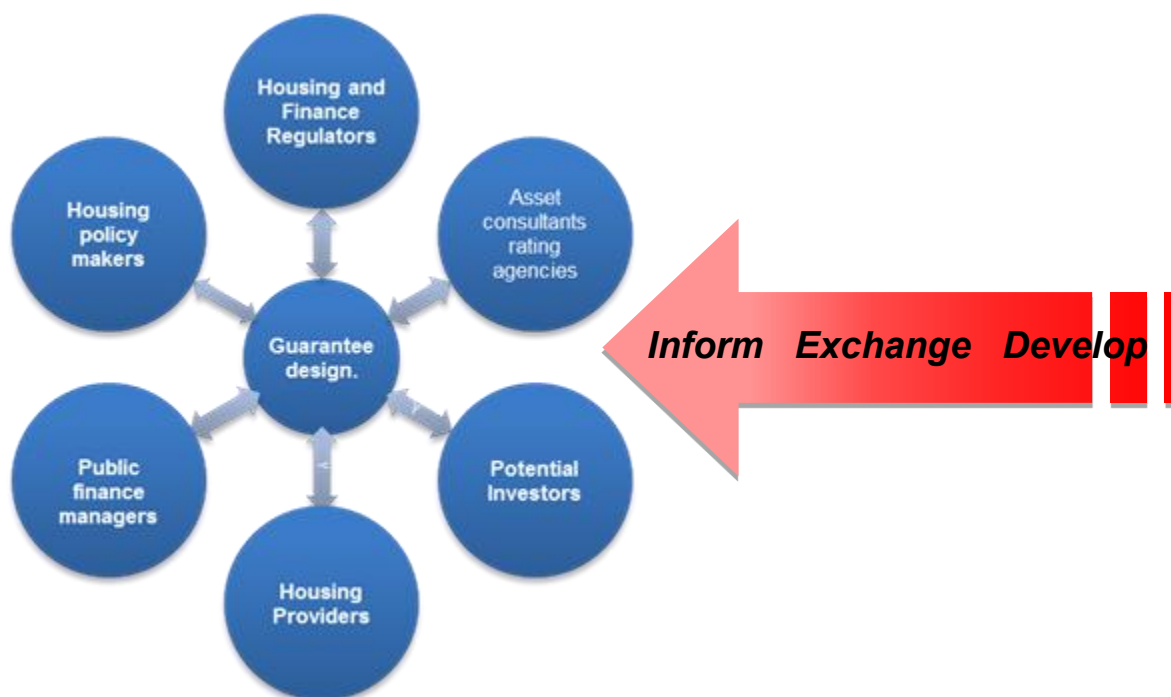
The first question has been addressed by the international review provided by the Positioning Paper (Lawson 2013). The second and third questions are the focus of this Final Report.

### **1.8.1 Methodology and research process**

This research necessarily engages key industry stakeholders and international experts in order to design an appropriate mechanism to promote investment in affordable rental housing. Key stakeholders have been identified in Figure 5 below: housing policy-makers inside governments and advisors in treasury departments, regulators of housing providers and financial institutions; potential institutional

investors such as managed funds and their asset consultants and providers of affordable rental housing.

**Figure 5: Stakeholders in the research process**



The first phase of the research involved strategic learning by the research team via focused literature reviews of:

1. International experience in the use of intermediaries and guarantees (Positioning Paper).
2. Australian housing provider borrowing needs, capacity and experience of financing environment (informing Chapter 2).
3. Australian policy, views and practice with regard to government guarantees (informing Chapter 5).

The second phase involved a number of semi-structured interviews with key stakeholders (detailed in Appendix 1). In addition to 11 interviews in Europe, an additional 21 semi-structured stakeholder interviews were conducted in New South Wales, Victoria, and the ACT. Beyond this, telephone interviews were conducted with nine larger community housing providers based in New South Wales and Victoria and selected on the basis that (as reported by other industry experts) they had recent experience of securing bank debt. It should be noted that even among larger providers, such experience is far from universal because—especially in New South Wales—CHOs have generally been limited to the management rather than the ownership or development of social housing. Until recently (e.g. as necessitated by the requirement to honour ‘leverage commitments’ under the Social Housing Initiative) very few New South Wales providers have had any need for large-scale loan finance. Resulting findings are outlined and drawn on in Chapters 3–6.

Meetings with all consenting Australian interviewees were recorded and transcribed to facilitate analysis. A series of thematic tables (Chapter 4) and diagrams were assembled to illustrate the different perspectives of stakeholders to primary research issues concerning:

1. Opinions on the need for a guarantee to attract investment.

2. General issues to be considered in the design of an appropriate instrument.
3. Specific design requirements.
4. Opposing arguments against use of a guarantee.
5. Support arguments in favour of the use of a guarantee.

A Think Tank meeting was held in Melbourne in October 2013, hosted by AustralianSuper, involving 24 Australian and international experts and all members of the Research Team. Key participants, Dr Peter Gurtner, and Piers Williamson, shared their experience of operating intermediary financing agencies within the context of social housing guarantee frameworks in the UK and Switzerland.

Industry and public discussion was also fostered through a repeat of their presentations and involvement in numerous sessions at the National Housing Conference in Adelaide as well as through outreach by the research team via numerous professional and public media outlets (Lawson 2014; Berry & Williamson, ABC Radio October-November 2013; various online publications—see project website for updates). A submission to the Commonwealth's Senate Inquiry into Affordable Housing (Lawson and Berry, 2014) was also made drawing on this and earlier research findings.

## **1.9 Towards an Australian investment mechanism for affordable rental housing**

The research approach and methods employed above provide for an internationally informed and well-grounded proposal for an Australian mechanism to channel investment towards affordable rental housing via well regulated not-for-profit housing associations.

The report puts forward two options for boosting investment and reducing financing costs. It also identifies the skills and resources required to put a preferred option into practice, thereby providing practical input towards policy implementation.

While this report aims to inform policy development, on its own it cannot bring about the process of actual reform. Bi-partisan and inter-governmental commitment is required to progress Australia's housing aspirations, implemented via well-crafted public policy and informed by industry expertise.



## **2 FINANCING AFFORDABLE HOUSING INVESTMENT IN AUSTRALIA: THE LENDING ENVIRONMENT IN 2013**

Australia's commercial banking sector is dominated by four large banks, some of which have developed an interest in lending to the Community Housing Organisation (CHO) sector. Extending credit to CHOs allows those non-profits to draw down loan funds to build or purchase new dwellings, to be repaid over time from net rent revenue. These private commercial finance relationships have become the norm for larger CHOs and have pioneered cross-sector understanding between the banks and the non-profit housing sector.

However, Australian fieldwork for this project has revealed that this lending has not become standardised and remains sub-optimal for supporting sustained growth of community housing in Australia. Unworkably short loan terms hamper long-term sustainability and risk management, and changeable levels of interest among the 'Big Four' banks have created an inefficient on-going educational process about the investment fundamentals of community housing. Over the past five years, perhaps two or three of the large banks have developed CHO lending policies and staffing expertise at any given time, but delayed government implementation of stock transfer or credit committee misunderstanding of reputation risk has frustrated consistent lending practice. The deals that have been achieved can be described as 'one-off' and subsequent CHO debt raisings have needed to reinvent the wheel. To an extent, the smaller banks such as Bendigo Adelaide Bank's Community Sector Banking (CSB), MECU and ME Bank have stepped in to offer some competition and variety in credit offerings, though they are unable to be consistently price competitive with the national banks. Until recently, state-owned lender Homestart has provided competitive finance for CHOs operating in South Australia.

### **2.1 The integral role of private debt finance in supply outcomes**

Private finance is often one element in a package of financing affordable rental housing that may include government grants, public loans, guarantees and tax exemptions. In recent decades, private debt finance has become an increasingly important partner as public funds decline. This has brought risks and thus costs affecting the nature of 'social' housing provided. Today, supply is increasingly reliant on investor appetite rather than public policy, amidst risk adverse markets and much tighter public finances and considerable policy risk. Nevertheless, keeping the cost of private finance to a minimum makes public subsidies go further and may improve supply and affordability outcomes. Drawing on interviews with CEOs and/or CFOs of nine larger community housing organisations based in New South Wales, South Australia and Victoria, this section provides a contextual setting for our SHG proposals by outlining recent CHO experience on the conventional lending environment.

### **2.2 Evolving financial context for Australian affordable rental housing**

The vast bulk of Australia's social housing is public housing which was developed during the period 1945–80. Provided by state and territory governments, this housing 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—for example, private finance secured by a community housing organisation to match public funding in underwriting a particular scheme, or
- indirectly—for example, the community housing organisation raises finance to underwrite wholly privately funded affordable housing as a complement to, and condition of, receiving title to wholly publicly funded housing.

The first of the above approaches is exemplified by the Victorian Government's program committed in the 2007–08 State Budget, whereby \$300 million was earmarked for not-for-profit organisations to build 1550 new dwellings predicated on the CHO raising 25 per cent of capital costs via commercial debt, and the state contributing 75 per cent (Victoria Auditor General 2010).

The second of the above models is demonstrated by the 2008 Social Housing Initiative (SHI) of the Nation Building Economic Stimulus Program as implemented in New South Wales. Here, the state government directly constructed 6000 dwellings under the stimulus program, with these wholly publicly funded dwellings being subsequently transferred into not-for-profit CHO ownership by competitive tender 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 per cent 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 (NRAS) 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 up-front 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 this process banks need to be reassured of the quality of decision-making and management within CHOs. The need for private finance has driven major transformations in CHO governance and capacities. According to in-depth AHURI research on their organisational development and decision-making, Australian CHOs have:

... enhanced organisational governance and executive capacity—especially by bringing skills related to financing, property development, asset management and business development functions to Boards and senior management—and transformed organisational culture (Milligan et al. 2013, p.4).

CHOs aim to minimise costs through achieving the lowest possible interest rate—usually calibrated in terms of the margin above the contemporary standard inter-bank bid rate or ‘BBSY’.

Potentially of equal or even greater importance than interest rate margin are the terms attached by the lender. First, in order to secure the loan the borrower will be required to commit assets. The nature and scale of the security demanded will impact on the attractiveness (or otherwise) of the terms. Second, the loan will be for a fixed duration. Given that housing is an operating, long-lived asset, there is logic and international precedent in seeking debt terms measured in decades rather than years. The shorter the term the greater the re-financing risk because the sooner the borrower will need to face the possibility that the debt may not be renewable, forcing the sale of assets, or higher costs of finance will need to be accommodated within the organisation's budget. Because of the need to hedge against such risks, the length of the loan is in practice a material contributor to overall cost of funds.

## **2.3 The experience of raising commercial bank debt in Australia**

CHO private finance requirements have expanded in recent years due to growing development activity, as well as a trend toward stock transfer from government to the sector that can involve a commitment to leverage to provide additional dwellings (see above). In fulfilling such requirements, CHOs have as yet remained wholly reliant on commercial bank debt. Given the sector's relatively immature status, there has yet to be any scope for the kind of trend seen in, for example, the UK where the private underwriting of affordable housing has largely switched from bank debt to bond finance in recent years (Pawson & Wilcox 2013).

Of the nine CHOs included in the study:

- Three had recently settled large re-financings (\$20–\$50 million) to fund new development and/or refinance earlier small loans.
- Three were in the process of raising large debt facilities for the same purposes.
- One had secured \$10 million in loan facilities, of which a proportion had been recently refinanced.
- One had recently negotiated its first moderate-size (<\$20 million) loan but had not yet settled the facility.

One CHO had no debt in place but had recently engaged with lenders to an advanced stage of term sheet negotiation, but did not proceed after being unsuccessful in a government land tender.

A further CHO approached reported that they had no debt, and therefore were not pursued further.

## **2.4 Purpose of debt**

CHOs raised commercial debt for three reasons: to finance construction, to fund turnkey acquisition, or to refinance existing loans.

Construction finance is much higher in risk for the lender due to non-completion hazard: the risk of being unable to recoup value from a security asset if a halt in construction delays the generation of rent revenue. Some CHOs' debt facilities covered a construction period for two years, converting to an operating loan upon project completion. However, construction finance is in general difficult to secure in Australia as reported by participants in the 2012 AHURI Investigative Panel (Milligan et al. 2013), and this has driven many CHOs toward purchasing turnkey developments from the open market rather than constructing their own purpose-built housing.

A number of CHOs who had raised construction-period finance noted that significant government funding of development costs had unlocked banks' willingness to lend. (This acts as 'first-loss' equity.) Moreover, as noted by one interviewee, the active involvement of government as a party to a tri-partite lending structure was viewed by the lender as critically important. Banks derive comfort from the understanding that the government will intervene to stave off or respond to a borrower default, though this pledge is explicitly limited to nominating another CHO to step in. (Australian states do *not* offer vacant possession or any other assistance that would lead toward banks foreclosing on the security property.)

#### *2.4.1 Type of debt: project-specific line of credit*

CHOs within our sample sought bank finance to increase their housing stock, most often in response to a grant of a portfolio of housing (or housing investment finance) from the state government in New South Wales or Victoria (see Section 2.2).

In practice, however, not all the bank loans that have been settled have been tied to a specific development or acquisition project at hand, as is typical for property finance. Rather, some non-profits had instead secured broad lines of credit, often initiated with a CHO's branch banker—the local manager of the institution providing operational (revenue) banking services to the organisation. Project-specific debt, in contrast, was usually negotiated by a bank's head office in Sydney or Melbourne, where the major banks have attempted to set up a single point of contact with a sector-wide knowledge of community housing within either the government or infrastructure division. Branch-initiated lending to CHOs has not always been communicated up the line to this intended single point of contact further hampering sector lending practice maturity.

Lines of credit are more conventional small business-banking responses to CHO growth, and lack the sophistication of insulated, project-specific financings where a development or acquisition project is funded in isolation on its own feasibility merit. Broader lines of credit tend to muddy the delineation between CHO operations and growth initiatives, and therefore risk cross-subsidising. (While using the cash flow from one set of dwellings to fund the expansion of another is certainly an accepted practice, a line of credit is even broader than this.)

The Board of one CHO was, at the time of the fieldwork, choosing between individual lenders, one offering project-based debt, and another a loan structured as a line of credit facility with security over the company's entire assets. The CHO was seeking to refinance two project-specific loans and triple the original debt limits to fund significant new expansion.

The most important consideration for the relevant Board in making this decision is risk minimisation (in this case, around interest rate risk). Building capacity for the CHO by raising additional funds with which to grow was an ancillary by-product, not the main motivation of the venture.

## **2.5 Debt raising process**

In seeking to raise debt, most of the CHOs had conducted a competitive process among a range of potential lenders. Others had restricted their attention to institutions with whom they already had a relationship (e.g. in the case of a regional CHO, a regional branch lender who was considered familiar with the drivers of the region.) As previously noted, the Australian debt market is already quite concentrated, with only four large commercial banks, some smaller banks such as BankWest and St. George who are owned by the four majors, smaller institutions such as CSB, MECU, ME Bank, and one state-owned lender (South Australia's HomeStart, see Box 2) which enables some competition for community housing sector finance. From the CHO

perspective, competition is further limited given the non-participation of two major banks (ANZ and for a time CBA) in new originations. Some CHOs elected a strategy of splitting debt between two lenders to avoid 'all eggs in one basket' and, as one interviewee argued 'to increase competition [in re-financing]', but this diversification strategy is challenged by the lack of players.

Most CHOs had raised or were raising debt in-house, using financial skills already present in the CFO or other staff. One had used an external consultant. One rejected a consultant's proposed fee and instead managed their own debt raising through a Board member who later joined the executive staff. One hired a debt expert on a short-term contract to work in-house.

## **2.6 Transactional time burden**

In recent instances debt facility negotiations had taken approximately five to six months. However, some earlier loans had taken up to two years to negotiate due to the need to involve both government (to release their existing mortgages) as well as the banks.

Conditions Precedent (CP) stipulated by banks are not reported as excessively onerous, except in cases of re-financing other banks' loans. CPs are usually property-related; for example, a condition precedent to drawing down acquisition finance is often reportedly a satisfactory independent valuation of the property being purchased.

Loans are set-and-forget. While negotiations may be demanding, banks were reportedly hands-off once agreements had been signed. CHOs do not report burdensome reporting. Banks focus on management rather than project performance and require compliance with a 'notifiable events' framework.

CHOs found that they had initially needed to invest time in bringing lenders up the learning curve on the nature of the community housing business and the remoteness of reputational risk, but this has moderated over time with greater familiarity gradually developing.

## **2.7 Debt terms**

### *2.7.1 Term of loan*

CHOs are most commonly offered three-year terms, even for projects in stable rental operation. Five years may be negotiable, but typically only at a higher interest rate. Sometimes the headline duration for an agreed facility might be longer—for example, 10 years—but only on the proviso that the terms would require to be re-negotiated every three or, in one case, five years. Thus, the '3x3' facility secured by one CHO meant that the bank had a right to re-negotiate terms at each three-year point—effectively a re-financing (interest cost) risk for the borrower. While CHOs were united in a view that terms exceeding five years would be desirable, it was generally recognised that this was currently an unrealistic ambition given the lack of maturity of the community housing finance market. Unable to get its bank to provide a five-year term on an entire facility, one CHO had needed to split a \$40 million facility between separate three-year and five-year tranches.

Exceptionally, one CHO had been negotiating on a 15-year debt facility with Bendigo Adelaide Bank's Community Sector Bank, but this transaction had yet to be settled at the time of the fieldwork in 2013. Another CHO noted that they had an agreement in place with a bank to re-negotiate terms one year before the loan term expiry to provide some breathing room should an issue arise in refinancing. However, they added that there are serious transactional costs in this renegotiation every two-to-

three years, and also made it risky for them to enter into interest rate hedges where the length of the hedge is longer than the term of the loan.

Two CHOs noted that longer-term finance might also be available via offshore financing—for example, private placements with foreign financial institutions. One had investigated this option, but expert advice concluded that the cost to hedge the currency fluctuation risk cancelled out the advantages.

Clearly the short loan terms experienced by CHOs in the current market do not match the asset life of the rental dwellings, and add significant refinancing risk as well as recurring time burden of negotiating new loans time after time. It is the single most untenable borrowing condition facing CHOs in Australia today, underscoring the relevance of this project's exhaustive search for more workable financial mechanisms. Given the long-term operating profile of a rental property, living under refinancing risk is akin to being hostage to the need to sell the dwellings at short notice should acceptable (financially viable) terms not be agreed at the pre-determined review or debt expiry points. For an organisation whose mission is long-term stability of tenure for tenants, this is anathema.

### *2.7.2 Interest rate*

Interest rate margins are a crucial indicator of the extent to which finance can be secured on favourable or competitive terms. These are usually expressed as a spread on standard indices such as the London Interbank Offer Rate (LIBOR) or BBSY (Bank Bill swap bid rate, a benchmark interest rate quoted and distributed by Reuters Information Service). The BBSY is typically used by financial institutions or corporations engaging in interest rate swaps and related transactions and is therefore variable. Interest rate margins over BBSY quoted by interviewees ranged from an extremely competitive 0.93 to 2.5 per cent (yielding interest rates, at the current time of historically low global interest rate indices, in the range of 5–7%).

Some bank loan facilities also include a line fee over the entire loan amount. One CHO explained that their lender had waived the line fee in exchange for a shorter term; in several other cases the inverse relationship between length of loan and interest rate was confirmed.

One smaller bank reportedly has at times offered loans where its margin is quoted on a base rate nominated by its Board, not a standard rate, which therefore cannot be hedged. Thus, the only hedge a CHO may employ in these circumstances is to fix the rate on a percentage of the loan. However, going forward, the CHO is motivated to re-finance with a bank that can enable more standard, robust interest rate hedging.

Indeed hedging of interest rate risk is a large issue for CHO boards and financial officers. CHOs report that all the commercial bank lenders are eager to market hedging products, which add cost to the borrowing. One CHO had reportedly 'saved nearly \$1 million' in not pursuing a hedging product over the past three years. However, far from cavalier, the same CHO confirmed that their CFO actively monitored rate movements, and reported monthly if not weekly to the CEO on rate movements and risk to the organisation's financial position. In this case, perhaps the financing cost burden was partially exchanged for the staff time burden.

Many affordable housing loans are interest-only, with principal due upon completion of the loan term (this would typically be payable by re-financing). One interviewee stated that its policies were more conservative than the bank's—while the loan agreement was interest-only, the organisation's practice was loan amortisation over 24 years—in effect pre-paying part of the principal from excess cash flow, and therefore having less

to refinance at the end of the short term of the debt. Interest-only lending is another hallmark of the undeveloped nature of CHO borrowing.

### 2.7.3 DCR and LVR

The metrics of Debt Cover Ratio (DCR, also called Interest Cover Ratio (ICR)) and Loan to Value ratio (LVR) are traditional bank lending measures used to calculate the size of a supportable loan.

Fundamentals of real estate development finance hold that a project is feasible when its cash flow, upon completing construction and commencing operations, is adequate to fund repayment of the amortised debt over a specified term. Indeed commercial banks 'size' the amount of a loan by the fundamentals of what cash flow, including a margin for fluctuations (DCR), is available for debt repayment, and what value (the V in LVR) the new property will have upon completion, again with a margin, so that it is adequate to extinguish the outstanding debt (the L in LVR), if the borrower fails to make repayments and the bank must therefore foreclose on the security.

In Australia, banks have come a long way in their understanding of the community housing sector, and no longer apply LVR as the primary determinant of loan size, as with other property lending. This is for two reasons: first, because LVR relates to the use of the underlying property as security for the loan. Hence, in a default scenario, the lender will foreclose on the asset and sell it to repay the loan, and therefore requires a risk buffer (an LVR of less than 100%) in case market values fall over time and sales proceeds are inadequate to repay the loan. In lending to CHOs, banks also fear the reputational risk if they foreclose on a dwelling housing low-income tenants, so they do not regard the security value of the property as paramount as they would rather constrain the loan amount than risk potential media criticism. One CHO reported that LVR was 'irrelevant' in its negotiation with its lender. In general, LVR ratios are reported at around 40 per cent of security value. (For reference, pre-GFC, conventional property lending LVR ratios ranged between 75 and 90%)

Another reason for LVRs increasing irrelevance is that banks' property valuations have been very conservative—unrealistically low values applied to assets because the rental cash flow is constrained by affordable housing restrictions. For example, even with newly constructed Nation Building properties, CHOs report that one bank had valued the security properties at perhaps half of actual market or replacement value. Interestingly, international research partners The Housing Finance Corporation in the UK reported that they had developed a customised valuation methodology for rent-restricted dwellings, compensating for the rent restriction in the traditional discounted cash flow calculation method.

For these two reasons, DCR rather than LVR has become the dominant measure in 'sizing' or calculating the size of a loan supportable by a new development or a combination of new and existing portfolio properties. Commercial banks describe this as a 'cash flow lend, not a security-based lend'.

Punitive DCRs of 2x (meaning CHOs would have to demonstrate free cash flow twice that required by debt repayments) were quoted in the early days of community housing lending, but ratios quoted by current borrowers are between 1.3x and 2x, most commonly at the mid-point. One CHO reported a graduated DCR, saying that this was the key metric in the bank negotiation. Lender agreement to an increased term length (to only five years) was dependent on increasing DCR from 1.55x for the first year, 1.65x the second year, and 1.75x thereafter. This increasing compliance hurdle is unproblematic because inflation in rental income as well as in costs usually results in increasing interest rate servicing buffer over time. It is the key metric of the very first year's DCR that calculates the all-important loan principal amount, therefore

achieving 1.55x for the first year of a five-year debt facility represented success in the context of this \$40m loan.

## **2.8 Security**

The security, or collateral, taken by banks to underpin a loan is often the most contentious part of negotiation. The scale of security agreed is extremely important in terms of the extent to which a CHO's future endeavours are accordingly constrained. Security is in part a subjective exercise based on negotiation, and largely upon the lending community's perception of the community housing sector's professionalism and growth prospects. There is little direct evidence on the extent to which state-level and, from 2014, national regulation systems have provided comfort to CHO's lenders. One CHO noted that in these early days of community housing lending, any default by a single organisation would have damaging ripple effects on the entire industry.

Therefore, despite their loans being sized on the cash flow fundamentals of CHO development projects, commercial banks have often required security beyond the subject property.

Typically, project-specific loans are secured by specified assets, and broader lines of credit are secured by broad charges over a company's entire assets (Fixed and Floating Charges—FFCs). However, in the case of community housing lending, all banks have endeavoured to impose FFCs irrespective of the specific nature of some loans. CHO's efforts to resist such terms have met with mixed success. From the borrower viewpoint, FFCs are undesirable because of the constraints placed on future activities: a CHO would have to obtain bank consent before encumbering any assets in financing subsequent development projects.

Several CHO's reported modest success in negotiating down banks' security demands by playing lenders off against one another. Most had, nevertheless, had to pledge assets in addition to those being financed, thus sterilising this part of the balance sheet from underpinning later growth activities. In practice, many borrowers found that the smaller banks have been the most inflexible on insisting on FFCs.

## **2.9 Security Trusts**

While time-consuming to establish, Security Trusts are considered flexible alternatives to FFCs. A Security Trust is the alternative to a bank putting a mortgage over every single property owned by a CHO—for example, in the case where one interviewee reported a settlement having included 600 documents due to this requirement. Instead, security is reduced to an instrument that involves specific—but not all—company assets. Having set up a Security Trust, a CHO can move assets in and out of the structure in line with the outstanding borrowing/risk that must be secured.

However, as acknowledged by one interviewee, the decision to establish a security trust was in part a symbolic act to demonstrate financial sophistication to lenders rather than a particular efficiency.

In obviating the need for property-specific mortgages, a security trust structure reduces document volume. However, much as the mortgage of a formerly government-owned property requires a subordination deed, the Security Trust requires a Tripartite Deed with the government that still retains an interest. It was also reported that establishment of the Security Trust required Housing Registrar permission.



## Box 2: Homestart a state owned financial intermediary

Homestart is a compelling instance of a state-owned lending corporation providing finance to community housing development. Until recently, it has offered an extended loan term unavailable from commercial banks.

Homestart was founded in 1989 during the high interest-rate environment at that time to provide lower-cost mortgages to home purchasers. In 2009 it started lending to the CHO sector, alongside its mortgage business. Its CHO loans are like a large home loan: they are amortising and are lent for longer terms than the three-to-five years offered by commercial banks. Homestart has funded ten providers including Unity, Junction Housing and Community Housing Limited. No defaults have occurred. Loans are sometimes structured with a 10-year bullet repayment requirement more akin to the bond financing of UK affordable housing providers (Pawson & Wilcox 2013), and a line fee is charged. Homestart has seen itself as the backstop CHO lender. Supplementing a standard package offered to CHOs, Homestart's alternative Advantage Flexi product offered an interest free term of five years, enabling the borrower to replay the principal early. The incentive to pay down is that the interest cover ratio requirement otherwise increases.

Homestart has also served to keep commercial bank lenders in check. When one of the major bank lenders initially quoted a 3x interest cover ratio to a CHO, Homestart countered at 1.5x to bring the other lender into commercial line. Discussing its activities in early 2013, Homestart expected that it would be needed all the more in light of Basel III higher risk ratings applied to property lending and residential assets in particular (Bank of International Settlements (BIS) 2013).

Homestart itself is run with keen probity oversight and its own cash reserves, and reports ultimately to the South Australian Minister of Planning. In its first 16 years, it endured 19 Treasury reviews by state Treasury, but returned a profit every year, so slowly earned stakeholder confidence. It provides a model for government participation in a financial intermediary.

Homestart also builds capacity of CHO borrowers, instructing them 'don't confuse regulation with governance'. Providers are urged to train boards to take responsibility for the management of the loan.

## 2.10 Section conclusions

Our review has found that the commercial borrowing terms currently experienced by community housing providers have been poorly matched to the housing assets being funded which has hampered CHOs' potential to address affordable supply shortfalls. Moreover, with loans typically limited to three-year terms, and usually involving relatively large margins over standard interest rates for anything longer, the effective cost of finance remains high, even at a time of unusually low background bank rates. Our research has found that securing commercial bank debt tends to be resource-intensive, often requiring four-to-six months of debt raising and negotiation time for these one-off transactions, which then must be constantly monitored and repeated in advance of the loan's expiry. The evidence continues to support development of a more efficient housing bond model.

Otherwise, how long might it take for loan terms to stabilise and become more competitive once bank understanding and 'normalisation' of the lending to the sector is achieved?

Such normalisation is slowly occurring, as providers report having successfully played off banks against one another to achieve better terms in a competitive debt-raising

process. However, there is still not yet enough volume of lending in this sector for sustainable best practice to emerge with loan terms that better reflect the assets being financed (meaning, crucially, longer duration loans). There is still great variability as regards interest-only vs amortising, project-specific loan vs line of credit, etc. which also speaks to the relative immaturity of practice. Further, different states provide widely varying Tri-partite Agreements, which frustrates the standardisation that debt financing could achieve under a Commonwealth-supported model (even with the leap forward of the National Regulation System for CHOs).

The structural problem of Australia having relatively few commercial lenders would still exist, even with more maturity and standardised terms. Further, banks often assign a limit to the amount of exposure they will take toward a particular sector based on overall assessment of risk fundamentals, and a surge in CHO debt demand could exhaust these limits across the few suppliers, even for low-risk projects.

Commercial bank lending is unsustainable as the only source of funds for community housing. Australian experience has shown that attention to the sector has been dependent on having a champion within the bank concerned. This can place the sector in a vulnerable position. For example, in the case of one major bank, the departure of its former CEO (who had championed a credit committee-adopted policy toward the community housing sector) resulted, it is believed, in that institution becoming much less active in the space.

Also, difficulty in raising construction-phase debt has influenced some providers to purchase new dwellings off the open market rather than to develop their own custom-designed housing. This may well be sub-optimal. Such purchased dwellings, built by conventional developers, may well be of lower-quality construction than what the CHO would otherwise build itself with long-term operation in mind. Where dwellings are built to sell quickly into the investment market for maximum profit rather than for long-term ownership, this would be expected to result in less robust and sustainable finishes and systems. Purpose-built construction can incorporate efficient, life-cycle costed mechanical systems for greater sustainability and future-proofing as well as lowering costs for tenants over time.

These knock-on effects together with the cost and inefficiency of negotiating one-off debt facilities and the unfavourable terms experienced in the sector, underscores the importance of securing a new, more stable, and large-scale source of debt finance for Australia's growing community housing sector to realise its potential to meaningfully supplement the country's inadequate affordable housing supply.

### **3 THE GROWTH OF SUPER FUNDS AND THEIR POTENTIAL ROLE IN AFFORDABLE RENTAL HOUSING**

#### **3.1 The growing significance of superannuation funds**

Twenty years ago the Commonwealth Government created a new circuit of savings and investment known as superannuation.<sup>5</sup> In just two decades, broad based compulsory contributions by employees and employers have generated one of the fastest growing pension schemes among advanced economies (Towers Watson 2013).<sup>6</sup> Today, several Australian funds: Australian Super, QSuper and First Super are among the largest 100 pension funds in the world.<sup>7</sup> 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.

Super funds aim to generate sufficient incomes on 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 2013).

Today, fast growing 'super' funds play an important role in Australian's welfare on retirement and simultaneously in the nation's infrastructure development. In this space, affordable housing can be considered alongside infrastructure investment, in generating returns not only for members, but also for the wider Australian community. This section focuses on the potential of superannuation funds' role in providing institutional investment in affordable rental housing.

#### **3.2 The super cycle of savings and investment**

The 'super' system has greatly influenced the flow of domestic savings in the Australian financial system and changed the pathway through which investment is provided in terms of credit for business, property, infrastructure etc. Understanding the nature of this circuit helps to appreciate what role it could play in affordable rental investment.

Household savings, via their superannuation accounts, have provided super funds with the purchasing power to provide banks with the funds to underwrite a range of activities. Super funds purchase wholesale paper from banks that, in turn, provide a source of credit for business, property and home finance.

There has been an important change since the GFC in corporate lending, as referred Reserve Bank of Australia (RBA), with super funds purchasing corporate bonds more directly:

... a shift is taking place in the way businesses are funding themselves.  
Helped by the pool of funds that has been built up through the superannuation

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<sup>5</sup> A circuit of compulsory savings underpinning Australia's pension system was legally established in 1992 by the *Superannuation Guarantee (Administration) Act 1992*. Funds that 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*.

<sup>6</sup> Australian funds grew by 11.2 per cent in 2002–2012, compared with 8.9 per cent during the same period for the 13 largest funds worldwide (Towers Watson 2013, p.15).

<sup>7</sup> Followed closely by Start Super, Uni Super and Commonwealth Superannuation Corporation, Retail Employees Superannuation Trust, Hesta and Sun Super (OECD 2013, p.13) <http://www.oecd.org/pensions/PensionFundInfrastructureAustraliaCanada2013.pdf>.

system, businesses were able to raise substantial amounts of equity when debt markets dried up during the financial crisis (Batellino/RBA 2010).

In this way Australia's compulsory superannuation system plays a key role investing in Australian corporations.

However, it has also been claimed that household savings diverted to super funds, have eroded the deposit base of retail banks, making them increasingly reliant on international wholesale capital markets to fund their credit demands. Referring to this trend, senior financial analysts including Dr Ken Henry, argue that:

Australia's short-term, offshore debt financing is not sustainable and exposes the Australian economy to long-term structural risks (Henry 2012, p.10).

As demonstrated with the active role of the AOFM in the RMBS market during the GFS and subsequent guarantee on savings deposits, government intervention was and (potentially) continues to be crucial to maintain the stability of the Australian financial system.

### **3.3 The investments super funds make**

Appreciating the potential for super funds and other large players (e.g. insurance and sovereign wealth funds) to invest in bonds backed by rent revenues, requires an understanding of the factors which influence the investment choices of such financial institutions.

We know that Australian superannuation funds are invested in a wide range of assets. Fund managers are free from any prescribed requirements steering their asset strategies or any regulations governing asset ratios, rates of return, exposure limits or guarantee of benefits.

Unlike similar entities in many other 'advanced' economies (OECD 2011), Australian super funds, rely on the guidance and approval of their Trustees, often with the external advice of asset consultants, to determine their own specific investment strategies. Each fund is quite unique in this regard, having their own policies for various assets and different norms for each portfolio specifying risk, return and liquidity that provide guidance to fund managers in their day to day and longer term investment decisions.

Super funds are statutorily bound to maintain a level of liquidity sufficient to match expected outflows of retiring members and transferring members.

Since mid-2013, the default MySuper scheme has come into effect and its impact on pension asset allocation strategies is still uncertain. This scheme aims to give much greater control to individual account holders and promote more transparency in fund investment decisions. It is also aims to mitigate excessive fees and commissions charged by equity brokers.

#### *3.3.1 Bias towards equities over fixed-income (bonds)*

At an aggregated level, among many other assets such as equities and property, super funds invest in fixed income securities such as government and corporate bonds.

According to a recent global study (Towers Watson 2013), Australian pension funds have a considerably lower fixed income asset weighting than 13 other established pension systems in the OECD. Correspondingly, Australia also has the highest proportion of pension fund assets invested in equities among these countries.

The debate regarding Australian funds' equity bias is of great relevance to this study and provides insights into the design of any new bond instrument to promote investment in affordable rental housing.

It has been argued that Australian super funds are relatively young and consequently, many superannuants are still in the accumulation rather than payout phase of their policies. The strong performance of Australian equities in the past, existence of franking credits on local equities, combined with the limited supply of government and corporate bonds has certainly fuelled investment priorities. There has also been a strong shift from defined benefit (DB, 19% and declining) to defined contribution (DC, 81%) schemes relieving pressure for more conservative payout led strategies (Towers Watson, 2013:5).

Senior financial experts have argued that reliance equity returns, while rational in the short term, may present an excessive risk to policy holders in the long run (Henry 2012). More broadly, the bias towards equities may undermine the development of a corporate bond market, which is currently pushing banks to rely on international capital markets to meet their credit demands (Davis 2012) with all the currency risk that this entails.

According to Davis (2012a) the political feasibility and financial market climate for reform to expand the bond market is ripe:

... almost everyone seems to support initiatives to develop a local corporate bond market to broaden corporate funding sources. On the other [hand], almost everyone believes that super funds have an excessive equity bias and need more fixed interest (bond) investments.

This view has crystallised amidst financial circumstances and policy efforts that favour the development of a much deeper Australian bond market:

A recovery of securitisation, covered bond issuance, resurgence in the Kangaroo bond market, and government initiatives to develop the corporate bond market might change that situation.

### **3.4 The Australian bond market and superannuation funds**

As defined in our Positioning Paper (Lawson 2013), bonds are a debt instrument of the issuer to the bond holder, where the issuer owes the holders a debt and, typically interest in the form a coupon. The standard bond has a defined term or maturity upon which the issuer must pay the principal to the bond holder.

As a percentage, the Australian bond market is considered small to average in size, but is dominated by corporate debt as public debt has been constrained for a number of decades (Debelle/RBA 2011). The Australian corporate bond, while relatively small and diverse in quality, is growing. However, demand for well rated bonds will outstrip supply as pressure increases on AFIs to hold quality assets and meet their Basel III prudential requirements. The need to grow this market has been recognised by Australian governments, authorised deposit taking institutions (ADIs) and fund managers across the financial system. Despite a longstanding bias against fixed-income securities such as bonds (Deloitte Access Economics 2011), the necessity for growth provides a significant opportunity for policy-makers to support stable highly rated rental housing-backed securities.

The Australian market comprises a limited number and range of government bonds (Commonwealth and State Government) and a growing market for non-government bonds; the latter is dominated by Australian Financial Institutions, Australian Corporate Bonds, Long Dated asset based securities (backed by pools of home

mortgages) and Australian dollar 'Kangaroo bonds'. Most bonds are rated by well-known credit rating agencies and have been stable since the GFC.

Purchasers in the bond market are primarily wholesale investors, with the exception of government bonds, and the typical size of corporate tranches is \$500 000 (Debelle 2011). Investors purchase bonds as a hedge against inflation, to hold value and diversify their portfolios, balance risks posed by more volatile equity investments and provide for a more stable and predictable income source (Debelle 2011; Henry 2012).

Pension funds acquire fixed income assets, such as bonds, which meet specific risk/return and liquidity criteria for specific asset portfolios and that also meet the strategic objectives across all portfolios for diversity, longevity and hedging.

Assessments of risk and return offered by different fixed income securities are undertaken by (in house or external) asset consultants and also by external credit rating agencies. Such appraisals factor in risk/return ratios, the financial health of the issuer, the bond's ranking in the issuer's capital structure (from senior secured debt to subordinated debt etc. affecting repayment of interest and principle on the borrower's default) and the length of the bond. Typically, longer dated bonds tend to present a higher risk than shorter term bonds, since these allow increased opportunity for default.

When making decisions concerning asset allocation, trustees examine the composition of the funds they manage and examine the life cycle demands of their policy holders. For example, an ageing and retiring group requires stable returns to meet payout requirements. Fund managers of Australia's remaining defined benefit schemes rely more heavily on:

... fixed income securities to match the duration or cash flows, of their accrued liabilities; and if they use highly-rated fixed income securities they can also limit credit risk. (Broadbent Palumbo and Woodman 2006, p.5)

Fixed income assets are also perceived as more transparent and cost efficient investments than equities, with much lower management fees, than high fee/commission equities. Such holdings also tend to be considered as complementary to overall investment strategies—an insurance policy amidst volatile markets and part of a package of assets that can anchor value and portfolio returns in uncertain times (Taylor 2012).

The Australian Securitisation Forum promotes an increasing role for fixed income assets in portfolios in order to reduce Australia's reliance on offshore markets and equities, and because:

[T]he capital stability and income predictability of fixed income securities make them an important cornerstone of any investor's portfolio and they play an increasingly important role in underpinning retirement income products for Australia's ageing population. (Dalton, CEO, ASF 2012)

One reason for the modest role of fixed income assets in Australian pension funds is the widely held assumption that bond markets are fairly homogenous and generally low yield. However, there is a growing market of corporate bonds offering a range of risk ratings and returns. The Australian Government aims to increase the debt and breadth of this market, in order to grow an alternative pathway for raising investment in Australian companies, than via the credit constrained commercial banks.

For super funds, fixed income investments play a well-established albeit modest role, becoming more highly weighted later in superannuant life cycles. Over time with demographic ageing this proportion is likely to amplify. With the shift to My Super, one

theory is that fixed income may be too illiquid for moveable accounts, while others argue that value for money (low fees and commissions) will make bond holdings more attractive.

So far we contend that bonds are the most suitable instruments for channelling investment towards the affordable rental housing sector (Lawson et al. 2012; Milligan et al. 2013). We now need to know how these could fit within the fixed income portfolios of super funds, alongside government, corporate, mortgage revenue and covered bonds.

### **3.5 Key features of Australian bonds**

Australian bonds vary in their key design features, these include the type of (fixed/floating/linked to a benchmark and spread) coupon payment over the bond's term and whether they are callable and able to be cashed in prior to maturity (NAB n.d).

Table 7 below provides a description of bonds available on the fixed income market, as presented by the largest pension fund Australian Super for the benefit of their fund members and individual investors.

**Table 7: Fixed income investments and their characteristics (AustralianSuper 2013)**

<b>FI investments</b>	<b>Description</b>	<b>Access</b>	<b>Advantages</b>	<b>Disadvantages</b>
Debt securities issued by governments in Australia and overseas.	Debt securities issued by governments in Australia and overseas	Australian Government bonds can be bought directly through the Reserve Bank of Australia Wholesale investors also buy and sell on secondary market Individuals can access via managed or super funds	Australian Government bonds have an AAA credit rating. They're referred to as 'risk free', meaning they are free of credit risk Regular fixed interest payments usually offer higher interest rates than short-term securities like bank bills Bond prices can rise on secondary market	Credit risk varies for international bonds Inflation and interest rate risks Bond prices can fall on the secondary market
Debt securities issued by state governments.	Debt securities issued by state governments	Wholesale investors purchase directly through issuer or on secondary market Individuals can access through managed or super funds. NSW government bonds are available directly to retail investors	Regular fixed interest payments Usually offer higher interest rates than short-term securities like bank bills Bond prices can rise on secondary market Higher coupon rate than government bonds	Credit, political, inflation and interest rate risks Bond prices can fall on the secondary market
Corporate bonds	Debt securities issued by companies to raise funds	Wholesale investors purchase directly through issuer or on secondary market Individuals can access through managed or super funds. Some corporate bonds are listed on the ASX	Regular fixed or floating interest payments Usually offer higher interest rates than government bonds Bond prices can rise on secondary market	Credit, inflation and interest rate risks Bond prices can fall on secondary market
Debentures	Debt securities which use the property of the issuer as security	Direct from the issuer They are usually offered by financial institutions or companies investing in properties or other business activities	Regular fixed interest payments usually offer higher interest rates than cash accounts and term deposits	Credit and interest rate risks Can be difficult to sell as there is no secondary market unless the security is publicly listed



<b>FI investments</b>	<b>Description</b>	<b>Access</b>	<b>Advantages</b>	<b>Disadvantages</b>
Mortgage backed securities	Securities backed by mortgages that have been pooled together	Direct from the issuer or through the secondary market	Regular floating interest payments usually offer higher interest rates than cash accounts and term deposits	Credit and interest rate risks Security prices can fall on secondary market
Hybrid securities and notes	A cross between a corporate bond and a share—they are issued as debt securities and can be converted into shares at a later date	Through stockbrokers	Regular fixed interest payments or dividends usually offer higher interest rates than other bonds	Credit and interest rate risks Security prices can fall on secondary market More volatile than other bonds Interest payments can be deferred in some circumstances Can be difficult to sell as there is limited trading
Covered Bonds	Bonds issued by ADIs (usually banks) that are backed by a specific pool of assets such as mortgages. They are usually AAA rated.	Direct from issuer or through secondary markets	If the issuer defaults the investor can access a pool of assets (residential mortgages) to cover their principal Can have a higher rating than the issuing institution Potential for higher returns than other AAA rated securities	Credit, inflation and interest rate risks There are restrictions on the amount of covered bonds ADIs can issue, with a maximum of 8 per cent of a bank's assets

Source: Australian Super 2013

Bond investors are also interested in the tradability of their investments; in other words their liquidity risk. Liquidity is reduced and an investment less attractive when bonds are traded by few investors or they are part of a small (less than \$500 000 parcels) or infrequent issue and have a declining credit rating (NAB n.d). Investors are also wary of 'orphaned assets,' meaning securities that are one-off rather than recurrent, requiring extensive research and underwriting prior to investment and therefore limiting resale liquidity (contribution of super fund manager to the IP 2013). To date, Super funds have expressed concern that investments relating to affordable housing government initiatives will become orphaned if the policy proves short-lived.

### **3.6 Role of super funds in developing Australia's infrastructure**

For large advanced economies such as Australia, long term investment in infrastructure and the role of pension funds, insurers and sovereign wealth funds, is a concern featuring prominently on the agenda of the forthcoming G20 meeting (Brisbane, 2014). National leaders will discuss high level principles developed by the OECD (2013a) that assume their governments play a key role facilitating long-term investment by creating appropriate and consistent policies and framework conditions and also co-financing infrastructure assets. With regards to financing vehicles and support for long-term investment, these principles urge governments to:

consider providing risk mitigation to long-term investments projects where it would result in more appropriate allocation of risks and their associated returns. Such risk mitigation mechanisms may include credit and revenue guarantees, first-loss provisions, public subsidies, and the provision of bridge financing via direct loans (OECD, 2013, p.9).

Increasingly, Australian super funds are pressed to become more active investors in goods and services of national economic significance (IPA 2010; RAI/EY 2012; SMART 2014); including infrastructure such as airports, harbours and railways.

Funds already make infrastructure investments when the risk and return conditions align with their investment strategies both within and across asset portfolios, when specialist expertise is available and when government commitment ensures suitable rates of return and an ongoing pipeline of suitable investments (Ernst and Young/FSC 2011). Currently, these conditions are not pervasive in Australia. However, suitable infrastructure investment opportunities continue to be found by Australian super funds in countries as diverse as China and Poland.<sup>8</sup>

In recent years, government aspirations for infrastructure development to increase national productivity and competitiveness and the dearth of Australian investors to fund it, have elevated the role of super funds to the top of the political agenda (Abbott 2013, Coalition Policy on Infrastructure 2013, IPA 2010). In a message to G20 nations at the World Economic Forum, the Australian Prime Minister highlighted the need for improved mechanisms to channel investment towards more productive markets, arguing that:

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<sup>8</sup> "The returns from many pieces, from brownfield Australian infrastructure, are poor and they are lumpy," Association of Superannuation Funds of Australia Chief Executive Pauline Vamos said in an interview in Sydney on April 15, referring to infrastructure already in operation. The funds are instead looking at assets with steady returns and will continue to invest in "China, Poland, Europe, the UK, everywhere" in I McDonald and N Somasundaram, 2013, 'Australian Pensions to Invest in Foreign Infrastructure Assets', in *Bloomberg News* 17 April <http://www.bloomberg.com/news/2013-04-17/australian-pensions-to-invest-in-foreign-infrastructure-assets.html>

Building infrastructure drives growth in the short term through investment and employment, and makes economies more productive in the long term. .... Finding ways to help capital markets to better channel global savings to productive investments ... will also be a priority for 2014. (Abbott 2013)

The Coalition Government's policy on Infrastructure (2013) is more specific regarding the need for a pipeline of infrastructure projects for investors:

There are substantial benefits to delivering a clearly articulated, national pipeline of infrastructure projects. A pipeline that provides a much higher degree of transparency about what, where and when infrastructure projects will come to market will create a natural incentive for a deeper engagement by investors (e.g. superannuation funds) and the infrastructure sector (e.g. construction, finance and advisory companies). (Coalition 2013, p.9)

Pension funds have argued that they do and are indeed increasingly willing to invest in infrastructure but cite a number of barriers that need to be addressed in order to expand their role.

First and foremost the financial returns must meet policy holder requirements; funds must have adequate management expertise to assess the risks and returns; and the tax settings need to be made more attractive.

A report for the Financial Services Council (Ernst and Young/FSC 2011) cites the following barriers to infrastructure investment faced by Australian pension funds:

- Problems with liquidity.
- Poor alignment with investment strategies.
- Greenfield projects being less attractive.
- Complex, expensive bidding processes.
- A lack of a clear project pipeline.
- A lack of specialist expertise.

There have been numerous and important proposals in this realm to which pension funds have tried to respond including tailoring investments to suit pre-retirement, retirement and post-retirement phases of policy holder needs, the greater role of annuities to support and stabilise investments, the merging of funds to build expertise and reduce fees, and the development of skills in more complex infrastructure investments (Broadbent Palumbo & Woodman 2006; Henry 2012; Ernst & Young/EY 2011). These demands and changes cumulatively influence the capacity of super funds to play a more integral role in Australian infrastructure investment.

In parallel, there have been a number of industry based proposals by Infrastructure Partnerships Australia, *'The role of superannuation in building Australia's future'*, including the provision of tax incentives to nationally and regionally significant infrastructure investments (IPA 2010).

This report provides a straightforward view of the risk and return profiles of different types of infrastructure investments:

Risk and return profiles of infrastructure assets can vary substantially depending on the sector where the asset is located. Highly regulated sectors and those with established revenue profiles, such as an operating toll road, social infrastructure assets, or assets featuring long-term government or fixed contracts (e.g. Power Purchase Agreements), each offer relatively low returns because they have little associated risk. By contrast, assets which contain a

degree of risk or full market risk such as rail, airports and seaports offer higher rates of return. (IPA 2010, p.28)

Expected rates of return for greenfield, existing brownfield and new brownfield are summarised below in Table 8.

**Table 8: Infrastructure risk return profile (IPA 2010)**

<b>Infrastructure</b>	<b>Asset characteristics</b>	<b>Investment duration</b>	<b>Expected internal rate of return (IRR)</b>
<b>Primary (Greenfield)</b>	<ul style="list-style-type: none"> <li>→ Design, build and operating risk</li> <li>→ Similar to traditional private equity</li> <li>→ High debt levels</li> <li>→ Significant risks</li> </ul>	→ 3 to 5 years, then sold	→ >15%
<b>Secondary (Brownfield)</b>	<ul style="list-style-type: none"> <li>→ Well established assets with known cash flow, similar to A-1 commercial real estate</li> <li>→ Common monopolistic characteristics</li> <li>→ Debt levels reduced</li> <li>→ Risk minimal</li> </ul>	→ 15 to 30 years	→ 10–12%
<b>Brownfield plus capital</b>	→ Existing assets that require new investment	→ varies	→ 12–15%

Source: IPA 2010, p.27, drawing on Probitas Partners 2007.<sup>9</sup>

Specific illustrations of infrastructure investment returns are also provided in the IPA report, such as Toll Roads during the operational phase offering a low risk investment, with a cash yield of 4–8 per cent and airports a medium risk with 8–12 per cent cash yield (IPA 2010, p.28).

To date brownfield development of airports, hospitals, roads and rail have been primary targets for infrastructure investment by superannuation funds. Obviously, the high yields on these investments reflect their higher risk.

The most recent contribution to the infrastructure investment debate comes from the University of Wollongong's Green Paper, *Infrastructure imperatives for Australia* (SMART 2014). This argues for greater alignment between Australia's infrastructure funding needs and government efforts to develop Australia's long-term capital markets. Specifically the paper recommends the development of an Australian Infrastructure Market (AIM) and strategic use of funding support and guarantees to justify long-term private investment in certain infrastructure projects (IPA 2010, p.15), with greater investment certainty provided via the government's commitment to a 10-year rolling pipeline of projects.

Policy reform in this area has been rapid with discussions continuing at the Brisbane G20 and is expected to be ongoing. Alongside Treasury and ASIC efforts to facilitate the expansion of corporate debt and retail bond markets in recent years, the Australian Government has enacted a number of measures to reduce the disincentives for private expenditure on nationally significant infrastructure that result

<sup>9</sup> Probitas Partners, 'Investing in infrastructure funds', Probitas Partners, September 2007.

from the long lead times between incurring deductions for, and earning assessable income from, such expenditure. From July 2013, the Income Tax Assessment (Infrastructure Project Designation) Rule 2013 provides a tax incentive to infrastructure projects of more than \$100 million and encourages applications for a tax loss incentive in order to attract private investment in nationally significant infrastructure projects (Australian Government 2013).

### **3.7 Role of managed funds and affordable rental housing**

Many aspects of discussions concerning infrastructure have also been raised in the field of affordable rental housing. Issues of secure and adequate revenue, longevity of assets, scale of funding needs and a commitment to a pipeline of developments are important to these closely related fields. The need for co-financing and guarantees has also been raised in recommended reforms (Milligan et al, 2013, Lawson et al. 2012, Berry and Williams, 2011).

Given the declining propensity of governments to invest in social and economic infrastructure directly, new sources of finance for social and affordable housing must be attracted from the private sector to ensure community needs and expectations are met. In order to attract such funds, housing providers need to convince appropriate types of investors, interested in long-term rental income, that future revenue flows to social/affordable housing providers are adequate. Suitable revenue settings and conditions need to ensure investors of a viable return. Given the low income tenants providers must house, policy settings need to ensure not only adequate but also ongoing rent assistance (Berry & Williams 2011, p.2).

Given the scale of housing needs, and the inability of governments to provide for them directly, harnessing superannuation and insurance funds is an obvious route to take, especially given their long-term investment horizons and the limitations and risks offered by short term commercial finance (as outlined in Chapter 2). However, as emphasised by Milligan et al. (2013) and unlike many European countries, there is little Australian experience of institutional investment in rental housing. Lack of information, or information asymmetry, has undermined the formation of an investor market for affordable rental housing. Further, the market has been too small and fragmented for investors to warrant developing their expertise further in this area. Perceived complexity and lack of government commitment also erodes interest.

An earlier AHURI Investigative Panel recognised that institutional investment might need a degree of revenue subsidy to ensure adequate returns to investors (Berry & Williams 2011, p.20). A second Panel (Milligan et al. 2013) confirmed the desirability of debt instruments or bonds for which there was a long-term demand and which could be created in pools of sufficient size to attract investors. Further, it was recommended that only entities both regulated and underwritten by government in a variety of ways, including capital grants and revenue subsidy, should be targeted for investment.

The 2011 IP suggested inflation-proofed payment streams based on rents plus any government rental assistance as well as an implicit and explicit government guarantee on parts of the financing package. This, it was believed, would allow the bonds to be priced above government debt yet well below commercial bond rates. That in turn would allow lower (than current market) rents to be charged. It would also create a new pool of assets to underpin stable long-term returns to institutional investors and their clients and give further momentum to the creation of large national highly professionalised social housing organisations who could secure efficiencies in both development and management (Berry & Williams 2011, pp.20–21). As envisaged by

Lawson et al. (2012) a suite of various bond tranches would be an essential component of this framework.

The 2013 IP proposed specific policy measures such as equity investment of land and/or capital by the government; a revolving loan fund to finance the construction phase prior to institutional take-out, some form of credit enhancement, as well as enhanced income support for lower income tenants to improve their access and ongoing affordability (Milligan et al. 2013, p.4).

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 the productivity, liveability and environmental sustainability of Australian cities and remote regions, such as mining areas. 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),<sup>10</sup> which in turn support stable revenue flows to support moderate returns from low risk mortgage revenue bonds.

Pension and insurance funds clearly have the potential to invest in this long-term 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 policy holder requirements. New international banking regulations also require funds to hold higher quality assets, such as AAA rated bonds.

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

Once a sound business case has been provided and in order to help establish a market for investment, governments need to guarantee private investments in publicly co-financed, appropriately regulated CHO rental developments. This enables sound long-term rental housing providers to attract lower cost, longer term private funds.

As in Switzerland and the UK, together 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 regard to the establishment of a financial intermediary to facilitate infrastructure investment (Crowe 2013; Coalition 2013; SMART 2014; RAI/EY 2012).

A number of pension systems, such as the Norwegian Public Service Pension Fund and some Australian super funds, play a niche role in financing mortgages for their own members via banks they also own, such as Members Equity Bank and MECU. During the course of this study, ME Bank expressed an interest in expanding this role

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<sup>10</sup> See NSW waiting times for different regions and unit sizes <http://www.housingpathways.nsw.gov.au/How+to+Apply/Expected+Waiting+Times/Sydney+South+Eastern+Sydney+and+Northern+Sydney.htm>

to support the development of a bond and financial intermediary to facilitate investment in affordable rental housing:

... if there's a bank that should play a role in this, it should be ME Bank, the whole genesis of ME Bank was to provide affordable mortgages to working Australians, so it should be a space that we commit to. (Senior bank executive)

Chapter 6 develops this potential further, by proposing to providers, governments and investors a suitable mechanism for sourcing funds under attractive risk/return conditions. 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.

### *3.7.1 Self-managed super funds and housing and negative gearing*

So far, the above discussion has focused on large scale managed funds. Mention should also be made of self-managed superannuation funds (SMSF), being the fastest growing segment of the superannuation industry (RBA, 2013).

SMSFs are increasingly interested in property investment and are active in the residential market. The RBA's Financial Stability report (2013) outlines how changes in tax provisions have significantly influenced the growth of highly-g geared property investment by SMSFs, which now constitute 30 per cent of their super assets and about 23 per cent of this investment is in housing.

Residential investment by SMSFs is encouraged via a cumulative range of tax provisions: negative gearing, capital gains exemptions and limited recourse provisions. Combined, these entice SMSF investors to become both landlords and speculators in *existing* housing. This heady cocktail of incentives is not available to home owners or indeed large scale institutional investors with the intention to provide long-term rental housing.

Since 1993, property investors have steadily increased their use and reliance on negative gearing provisions, as indicated by ATO statistics. Researchers have found that negative gearing strongly promotes short term investment strategies which prioritize capital gains over and above long-term rental income. This motivation promotes more frequent churning of properties, which in turn greatly eroding the security of the tenants housed, with vacant possession often demanded at sale (Commonwealth of Australia 2010; Wood & Ong 2010).

According to the ATO in 2009, 67 per cent of investors in rental property make use of negative gearing provisions. Detailed research has found that one in four investors sell their rental property within 12 months of purchase (Wood & Ong 2010, p.24).

Recent analysis of the role of various government policies and related taxation provisions has found that negative gearing costs Australian tax payers at least \$5 billion per year (based on calculations drawing on ATO Taxation Statistics 2010–11 by Eslake (2013)). This is currently more than all Commonwealth housing assistance programs combined. This large subsidy for investors persists in the absence of government evaluation and reform to ensure taxation provisions for investors align with Australian housing policy aspirations. Unlike its more targeted tax credit 'cousin' NRAS, currently under review, negative gearing need not address housing supply, public housing waiting lists or provide secure tenancies for those unable to access home ownership.

It has been argued that if directed to new supply SMSF residential property investment could be part of a solution to help solve existing and projected housing supply needs.<sup>11,12</sup>

It is clear that much more efficient and effective investment pathways are required to boost housing supply and improve affordability and access by low to moderate income tenants (Lawson 2013). The remainder of this report is dedicated to this goal.

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<sup>11</sup> C. Joye 'SMSF effect on property is \$450bn elephant in the room', *AFR*, 29 September, 2013, [http://www.afr.com/p/markets/market\\_wrap/smsfs\\_effect\\_on\\_property\\_is\\_bn\\_elephant\\_wr7Sym5hYU6bAQSCdNHODN](http://www.afr.com/p/markets/market_wrap/smsfs_effect_on_property_is_bn_elephant_wr7Sym5hYU6bAQSCdNHODN)

<sup>12</sup> A Kohler, , 'The trouble with SMSF property', *Business Spectator*, 30 September, 2012, <http://www.businessspectator.com.au/article/2013/9/30/financial-services/trouble-smsf-property>



## **4 A NEW PATHWAY? STAKEHOLDER VIEWS**

This chapter draws on extensive stakeholder interviews and additional input from the industry Think Tank examining options for a Social Housing Guarantee in Australia. It builds on the findings of an international and national review of literature concerning the use of intermediaries and guarantees to improve long-term financing for affordable rental housing outlined in the Positioning Paper (Lawson 2013).

As demonstrated by Chapter 2, the short terms of commercial finance as well as limited and uncertain government support, have been major constraints on the growth of the non-profit housing sector in Australia (Deloitte Access Economics 2011; Berry & Williams 2011; Milligan et al. 2013; interviews with CFOs of leading CHOs, 2013–14). Reliance on the commercial banking sector for private mortgage finance, amidst tight credit conditions and limited retail competition, has stunted the development of a mature private financing market for affordable rental housing. Current incentives such as negative gearing are poorly targeted and even counter-productive.

### **4.1 A new pathway?**

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, summarised in this section).

However, larger institutional investors, such as superannuation funds and insurance companies, have little experience of investing in affordable rental housing directly (Lawson et al. 2012; Milligan et al. 2013, interviews conducted with fund managers, 2013).

Indeed, for Australian social and affordable rental housing to become a new ‘asset class’, standardised investment policies guiding investment still have to be formulated (Milligan et al. 2013). Tentative and path breaking steps towards a pooling mechanism by the managed funds sector (CSB and Grace Mutual around NRAS) indicate the most likely way forward. However, fund managers are wary of the high cost of financial intermediaries that can erode their potential yields. Fees and commissions charged by for-profit financial intermediaries also negatively impact on the borrowing costs of housing associations.

Building on this evolving experience, facilitation by a not-for-profit intermediary under government stewardship (as outlined in the Positioning Paper) can effectively address the inefficiencies and high costs of small fragmented borrowing demands and for-profit financial intermediation.

Not-for-profit specialist financial intermediation has been the tried and proven direction of the European models reviewed for the past two decades (Lawson 2013), channelling billions of funds towards social and affordable rental housing, which have enjoyed growing government and financial sector acceptance, especially since the GFC. Financial intermediaries such as the Swiss Bond Issuing Cooperative and the UK’s Housing Finance Corporation have substantially reduced the cost of financial intermediation, delivering lower borrowing costs to housing providers. Intermediaries such as these have played a market-forming role and ensured a stable flow of lower cost longer term investment towards the affordable rental housing market.

### **4.2 Financial intermediation—a recap**

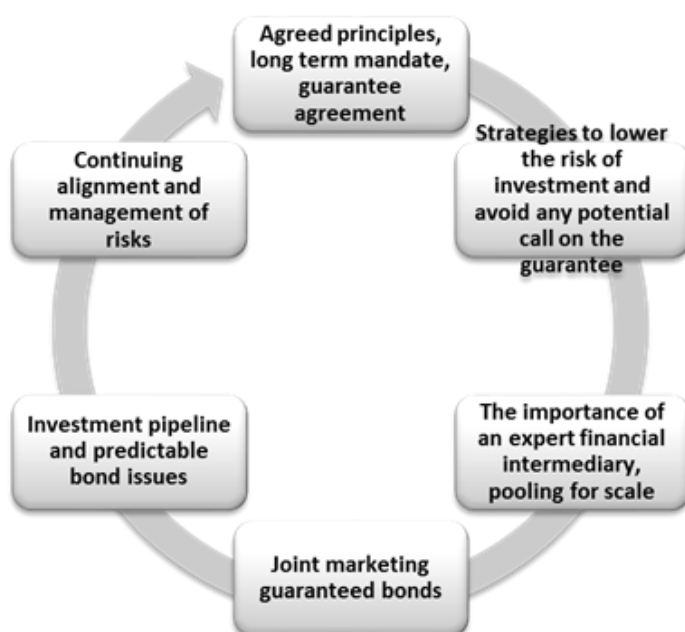
Financial intermediation is not a familiar term for many Australian housing policy-makers, although it is standard practice in the finance sector. It is a process by which

investors and borrowers are brought together efficiently in pools or standardised instruments rather than in expensive one-off transactions, as outlined in Figure 6 below. Ideally this occurs with maximum transparency and expertise to reduce market failure, improve risk/yield/ratios, and reduce financing costs.

The following points outline the basic steps that would be involved in such a process, when applied to Australia's CHO sector:

1. Borrowing demands of registered CHO providers are assessed and approved by a specialist financial intermediary (SFI), for credit worthiness and policy compliance.
2. To achieve economies of scale, loan demands are pooled and parcelled for securitisation and bonds issued by an SFI (with a lead bank or via private placement).
3. The SFI may be private, non-profit or publicly owned: regardless, it must be cost efficient, skilled and accountable. In this report, we recommend two different options for an SFI. Such an intermediary could be hosted by a not-for-profit debt market specialist, embedded within the financial services sector with close ties to the managed funds sector.
4. Securities need to have sufficient risk/yield profile to attract potential investors.
5. Lower risk translates to lower yield, which should be passed on as lower interest loans to borrowers by an efficient, expert and accountable SFI.
6. Risks are reduced by a well-regulated, financially sound housing sector.
7. Co-financing arrangements also play a role: perhaps subordinated public loans setting conditions but also providing equity/collateral and/or yields enhanced by tax incentives.
8. Repayment of lower cost loans is underpinned by rent revenue, supported by direct payment of rent assistance to providers.
9. With all these risk reducing features in place, governments provide a conditional guarantee governed by an agreement (volume cap).

**Figure 6: The process of financial intermediation as applied to housing investment with a guarantee**



Expert financial intermediation is unlikely to emerge in Australia from the managed funds sector, without clear government commitment to its establishment and to a pipeline of co-financed housing investments.

In a closely related initiative, a report by Ernst and Young for the Regional Australia Institute (RAI/EY 2012) has recommended the pooling of local government borrowing demands and issuance of bonds by a financing authority, with the backing of a government guarantee.

Their report also recommended that the Australian Government investigate the establishment of a 'national financing authority for local government' which 'would have a mandate to invest directly in local government programs by providing competitive and low-risk finance, and to facilitate inward investment' The RAI/EY report emphasises:

... the need to ensure that large institutional investors, like the Australian superannuation industry, are offered attractive debt instruments by the local government sector. This is best achieved by bonds issued by a national organisation which are underwritten by the Commonwealth. (p.4)

### **4.3 Potential application to affordable rental housing**

Well regulated, professionally audited and transparently managed not-for-profit housing associations, are the Australian Government's preferred delivery mechanism for affordable rental and social housing. This is evidenced by their central role in the SHI, NRAS 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 demonstrated by Chapter 2.

Increasingly constrained public budgets necessitate reliance on private investment. For this investment to flow, the government needs to work much more actively and positively to increase investor confidence and familiarity in order to ensure that this new pathway is actually forged and maintained.

In order to reduce the cost, increase leverage and broaden access to finance, governments need to do two things: first, establish a program of long-term co-financing affordable rental projects to provide starting equity and second, provide a structured guarantee to attract long-term private investment in them.

Such an approach would build on the experience of the successful LGCHP and the more recent SHI stimulus (KMPG 2012). Unlike the SHI, it requires a much lower rate of government equity when coupled with an expert financial intermediary and investment guarantee that unlocks private funds rather than funding construction outright. Of course, planning reforms facilitating access to sites via residential codes, inclusionary zoning and contributions from the redevelopment of brownfield sites would also ensure housing associations have access to well-located sites.

In an era where governments in many advanced countries are unwilling or unable to provide considerable direct funds for social housing programs (Gibb et al. 2013), planning measures, intermediaries and guarantees are now the essential tools of a modern affordable rental housing policy.

Combined, such a strategy would considerably speed up the provision of necessary affordable housing at minimal government cost and use the capacity of emerging housing associations and state planning systems much more effectively.

Further, such a strategy would maximise the benefit of any related government subsidies, such as rent assistance and tax exemptions, and greatly enhance supply

outcomes (Lawson et al. 2012) with demonstrated economic benefits in terms of job creation, productivity and sustainable growth (KPMG 2012).

#### **4.4 Stakeholder views on the design of an Australian mechanism**

Towards the development of an appropriate mechanism, 21 key stakeholders were interviewed during 2013 and 2014 concerning the design of a financial intermediary and related enhancements to increase the volume of long-term, lower cost investment flowing towards the affordable rental housing sector. These interviews were in addition to the nine telephone interviews conducted with CHOs.

The interviewed stakeholders, listed in Appendix 1 included:

- Experienced Commonwealth Government executives, in current and previous housing policy management roles.
- Senior housing policy officials at the state level in three state jurisdictions.
- Senior housing market experts, reporting to government (National Housing Supply Council).
- Leading economic commentators (Chief Economist, major investment bank).
- Federal Treasury officials responsible for infrastructure and housing supply.
- Industry funds (peak bodies, large superannuation fund managers, fixed income portfolios).
- Superannuation trustees (Australian Institute of Superannuation Trustees).
- Superannuation asset consultants (Frontier).
- Rating agencies (Standard and Poor's).
- Banks owned by industry superannuation funds with CHO loan portfolios.
- State Treasury (NSW).
- Fixed income investors (FIIG).
- Debt market specialists serving the industry funds sector (IFM Investors).
- Investment firms with pooled rental real estate experience (defence/student accommodation).

Transcripts, email correspondence and meeting notes enabled interviewee responses to be categorised concerning:

- The perceived need for a financing mechanism with some form of guarantee.
- Arguments for and against the development of such a mechanism.
- Important issues to be considered in the design process.
- Key design features and implementation requirements to reflect the Australian economic context.

##### *4.4.1 Views on the need for an enhanced financing mechanism*

All stakeholders were asked their views on the need for a guarantee to enhance the terms and conditions of private investment in affordable rental housing.

A range of views were sought across government departments including the Department of Social Services and Treasury as well as relevant (former) policy advisory bodies being the Advisory Committee for the Reform of the Australian

Government's Housing Assistance Programs and the National Housing Supply Council. Leaders of other successful policy initiatives, such as the NDIS, were also interviewed for their insights concerning the policy-making process.

During the course of the research project, there was a change of national government, with the election of the Abbott Liberal-National Party Coalition in September 2013. This change and the new government's housing policy agenda have not altered the aim of relevant policy to increase institutional investment in affordable housing. Both the Abbott and Gillard/Rudd governments, articulated by the previous Minister for Infrastructure and Transport and current Treasurer, have expressed an interest in the use of bond instruments and guarantees, with the Coalition proposing a more 'independent' financial intermediary (free from direct Ministerial control) and wider use of guarantees to increase investment in infrastructure more generally, which has been widely reported in the media.<sup>13</sup>

Housing policy officers at state and federal levels emphasised the need to reform current financing arrangements for public housing and new social housing. A more flexible approach to delivery, offering greater locational advantages for tenants and enhancing their opportunities for participation in paid work was considered paramount. At the state level, managers of housing policy in Victoria were very supportive of initiatives that would address the current problems facing the funding of social housing and improve conditions in order to increase the level of social and affordable housing supply. It was broadly accepted that the current model of under investment and low levels of supply were not sustainable, failing community needs and undermining acceptable standards for decent housing. It was considered that institutional investors, while having funds to invest, faced barriers that could be substantially reduced by government. It was stressed by one senior state official that government has a role in facilitating investment to achieve policy outcomes it can no longer support directly, particularly in today's worsening market outlook for low and moderate income households.

The need for a new circuit of investment linking the pension funds to investment in housing was raised. Furthermore, in the context of constrained government investment, poor commercial lending conditions and very limited institutional interest, guarantees were cited as the only cost effective option remaining available to government.

Senior housing market experts providing advice to the government also noted the Coalition Government's expressed interest in the use of guarantees and tax incentives to substantially increase investment in road and rail infrastructure. They considered that such mechanisms were also relevant to increase investment in affordable rental housing (see note above).

A key objective of the government's NRAS scheme is to attract large scale institutional investment in affordable rental housing. According to officials from the Department of Social Services (DSS), NRAS has been increasingly over-subscribed in each of the funding rounds and especially the most recent round in 2013, with 75 000 applications for 10 000 incentives.

Recent statements on housing policy by the responsible Minister, Kevin Andrews, indicate the government's continuing support for NRAS, albeit with revisions, and stated support for increasing private investment in the housing association sector. The Minister has also expressed an interest in allowing small investors to become more

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<sup>13</sup> See reports by Crowe 2013, 2013b (both in *The Australian*, with Warren Truss quoted on PPP projects), Coalition Policy 2013.

directly involved in building houses for low-income renters, rather than the current system of only allocating bulk incentives to larger scale developers.

However, in matters relating to guarantees and the possibilities of credit enhancements for affordable housing supply, senior policy advisors from the Department of Social Service deferred responsibility to the Commonwealth Treasury.

Interviews with the relevant Treasury official (since moved from this position) indicated that consideration of a guarantee could be made by Treasury at the request of DSS. A cautious and conditional view on the use of guarantees was expressed, as well as a preference for direct investment by government. This view was based on the potential moral hazard and horizontal equity implications when considering the beneficiaries of any guarantee.

While Treasury holds a general view that government should raise the finance itself, rather than indirectly provide cash flow support via a guarantee, it was pointed out that this has not been the chosen course to date. Ongoing budget policy has been to reduce the level of government debt. This of course, necessitates reliance on private (typically foreign) investment to achieve necessary levels of affordable housing supply and infrastructure provision [in the absence of a climate and regime encouraging Australian pension funds to do so in Australia]. It was pointed out by interviewers that current commercial borrowing conditions do not permit an expansion of supply, given the burdensome conditions and risk posed by short loan terms.

Federal Treasury wanted to be kept informed of the progress of the research and information was duly provided by the research team on the technical issues and requirements of guarantee schemes established in a range of countries, which established a housing supply bond market, reduced borrowing costs, boosted housing supply demonstrating close to zero default rates with little or no impact on government accounts. This Treasury official attended the industry Think Tank, but has since taken another position in the public service.

While strong opinions were expressed by both state and Commonwealth Treasuries concerning targeting and moral hazard concerns, few practical suggestions were made regarding the technical requirements of guarantee design to address these issues.

Turning now to these private financing stakeholders, interviews were undertaken with several superannuation funds, their asset consultants, Trustees and ratings agencies. These included Australia's largest superannuation funds with substantial fixed income portfolios and industry funds providing pensions for construction and building workers. They expressed a keen interest in being involved in design of an appropriate financial instrument, while support for a government guarantee varied. One fund manager argued it was essential, while opinions varied over the level of risk necessary to deliver higher yields and attract investors. It was pointed out by the interviewers that higher yields would increase the financing costs for housing providers, curtailing public policy outcomes.

One large Fund Manager was keen to play a leading role in the design of an appropriate instrument. However, in contributing the considerable time and investment expertise to take this lead would require compensation—most likely in terms of bond pricing. If possible, the Fund Manager would also issue bonds without a government wrap, if the housing association could afford increased interest costs as a result. A lead development role would have to be costed as a premium on the price of the bonds. It was also contended that total government backing, by reducing risk, also potentially undermines yields and may make the bonds less attractive to some investors.

The need for the establishment of a specialist financial intermediary (SFI) or ‘collective vehicle’ was recognised by industry fund managers in order to achieve scale and ensure expert assessment of risk. Such an SFI could be embedded in the super funds’ own bank, such as Members Equity Bank and its fund manager IFM Investors. Both have a respected reputation and are vehicles that pension funds are accustomed to working with. IFM Investors, a debt specialist, provides super funds with professional market structuring and risk allocation strategy which offers clear efficiency gains for borrowers. It was argued that ME Bank already has a lending function and their experience can provide sound commercial oversight of housing providers. In addition to participation in the Think Tank, follow up interviews with both IFM Investors and ME Bank were undertaken by the research team, informing the two options outlined in Chapter 6.

Asset consultants also demonstrated a strong will to investigate the new asset class in pooled rental housing and were aware of the interest by pension funds in this space. Some consultants had already invested considerable time analysing a proposed NRAS fund model, which reportedly foundered over high fee structure and government uncertainty. Asset consultants were keen to find a solution for all parties and considered that fund managers within the super sector were becoming more informed and comfortable with the CHO sector in recent years. They anticipate that funds would be willing to provide considerably longer term debt than the commercial banks (currently two to three years). However, it was also stressed that it would be cheapest for government to do it itself, for example, by using an NBN structure which involves the public raising of funds for a specific purpose, which could be backed by an implicit government guarantee (see Chapter 5).

Rating agency Standard and Poor’s plays various influential roles which are informative for consideration of a guarantee on housing investment. First, they rate the ability of governments to cover their debt obligations, including any debts guaranteed depending on the structure and nature of the guarantee provided. Second, they assess the credit worthiness of bond issuers to investors, ranking debt instruments, potentially such as bonds backed by loans to housing providers.

Standard and Poor’s considered that a government guarantee could be politically difficult in the current context and would have to face concern regarding moral hazard. Any guarantee would have to be assessed alongside alternative forms of state action to provide comfort. However, Standard and Poor’s noted that the magnitude of exposure potentially to be guaranteed in the housing proposal was minute compared to government balance sheets and therefore was unlikely to impact ratings.

It was recommended that in the first instance, housing departments investigate borrowing directly through central authorities in order to take advantage of the strong credit rating status of Australian governments. However, it was also recognised that this will add to government debt and therefore not likely to be supported by central agencies. Importantly, it was stressed that the ongoing ability to service debt, rather than the level of debt itself, was the main factor influencing the rating of any government.

One bank currently providing loans to CHOs has approval from its Trustees to play a more active role in developing a suitable mechanism for affordable rental housing, which they saw as being firmly within their goals for Corporate Social Responsibility:

... if there’s a bank that should play a role in this, it should be ME Bank, the whole genesis of ME Bank was to provide affordable mortgages to working Australians, so it should be a space that we commit to. (Senior bank executive)

This bank considered that such a role would be transformed by the existence of a specialist intermediary to aggregate loans demands and a carefully structured government guarantee, which combined would reduce the cost of funding significantly. According to IFM Investors, the financial intermediary role must be cost effective and fees kept sufficiently low to remain attractive to both investors and borrowers.

According to fixed income investment analysts specialising in Australian securities, the spread of any bond above BBSY was critical. Several specialists in this area recommended that pricing of long dated AAA bonds would (initially) be around 150 basis points above BBSY.

Refinancing issues were also considered critical for some investors, which depended on the existence of a secondary market. Views on this differ, with some specialists suggesting that two banks acting in line as lead would be sufficient to enable trading.

Specialists in debt markets had a strong preference for targeting fixed income markets via well executed securitisation tranches of loans rated from AAA to BBB, in order to raise funds. This implied the alignment of risks right through the securitisation vehicle from origination, to generation and management, with the credit worthiness of the CHO borrowers in the loan pool matched to the rating of different bonds. Different risks would appeal to different types of investors and across their portfolios and would need to be strategically marketed.

According to several specialists, any government guarantee could be temporary and burn off over time.<sup>14</sup> Debt market specialists argued that a guarantee need only apply to a small proportion of loans in a securitisation structure. Further, while the government guarantee offered to support the RMBS market during the GFC provides a precedent, a new rental housing equity investment by government could be much more efficient.

Overall the views expressed by financial stakeholders on the feasibility and attractiveness of an enhanced investment instrument for affordable rental housing were positive:

... anything that gives investors a decent spread, I think at the moment, they'll look at it very closely ... (Senior fixed income investment analyst)

Debt market specialists considered that the low rental yields and lack of capital gains offered by CHOs necessarily required tapping into fixed income investment markets, with income streams linked to rental income over a period of 20 years.

#### *4.4.2 Views on facilitating and mitigating factors*

Government officials offered various factors that would facilitate or mitigate reforms to improve private investment conditions in affordable rental housing. There was recognition that existing funding models have failed:

There is a view that has been espoused by both Parliamentary Committees, our Treasury colleagues and the Productivity Commission that that model is unsustainable and the question then is 'what else is there out there?' and there

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<sup>14</sup> 'As people get more comfortable with the product, and the pricing of it in particular, then they... you could gradually burn it [the guarantee] off and reduce the coverage for the gap. So it might be 100 per cent for the first five years and then you take it down to 80 per cent, then you take it down to 50 and the really long ones, you might have 30, 40 per cent coverage. So that reduces the contingent liability on the Commonwealth. And rating agencies will take that into account as well of course. So you've got people looking at it from all sides here. It's whatever the best, whatever gets it across the line.' (Senior fixed income investment analyst)



are a range of choices. One of them being: How can we build a different funding model for social and affordable housing? We do know in Australia there's a lot of institutional investment around. The super funds have a lot of money and also some of the banks are interested in this space, but the barriers that they want to overcome have to be addressed in part by government (State Manager of Housing Policy).

COAG aims to ensure that all Australians have access to affordable, safe and sustainable housing which can, in turn, contribute to their improved social and economic participation. According to senior policy advisors, targeting private investment to new affordable rental supply can be aligned with several government agendas, such as social inclusion, liveable cities, productivity and employment. Some officials strongly considered that a guarantee would support market based efforts to access private, rather than rely exclusively on public, investment and has the potential to accelerate growth in its preferred provider of social housing. While the use of bond instruments with a government guarantee could support the government's aim to increase private investment and correlates with emerging policy directions in infrastructure financing, it was pointed out by one senior policy manager that no explicit statements have yet been made by the Minister concerning housing supply bonds or measures to enhance investment other than NRAS. Nevertheless, officials were interested in 'hard evidence' on what models could work in the Australian context, drawing on international best practice while being adapted to Australian needs and market conditions.

According to the government officials interviewed, factors hindering reforms to improve the investment climate for affordable and social rental housing primarily stem from government's assessment of its own capacity. Housing policy officials lamented the low priority of housing alongside very strong competition from other major policy agendas. The failure of past schemes had had a corrosive impact on housing finance initiatives in some states, but certainly not all, with the ACT, WA and SA taking the lead. A lack of financial expertise among housing policy officials, the difficulty of quantifying benefits to satisfy Treasury and apprehension about their ability to target guarantee beneficiaries undermined their confidence in designing appropriate policy instruments.

Treasury officials considered rising house prices and improving general market conditions as the best way to improve housing wealth and welfare, but gave little emphasis on the distribution of such benefits. One senior Treasury official was loath to accept that housing markets failed at the bottom end. Negative gearing was consistently cited as a 'no-go' policy area. Treasury officials expressed a preference for direct expenditure to address housing stress, such as Rent Assistance, despite the trend in declining expenditure and constrained growth in social assistance. The Treasury officials in both the state and federal jurisdictions had little or no experience in using guarantee instruments in the field of affordable housing investment. General antipathy towards guarantees was rationalised in terms of reliance on market processes, impact on horizontal equity, difficulty in targeting beneficiaries and assessing the risks of the guarantee being called.

Turning to investors, fund managers emphasised the large and growing appetite for longer term quality paper, citing a strong overseas market for Australian RMBS. A bond instrument of suitable scale would be worthy of interest from Australian pension funds and, while lower yield, would meet their need for diversification. All investors recognised the demographic and market necessity for increasing investment in affordable rental housing, but overriding this, their concern was primarily about rates of risk and return and strategic portfolio requirements.

Investors considered that clear targets for guaranteed investments could be easily established and would enable transparent accountability to government. The stable cash flow offered by NRAS was quite attractive to certain types of retail investors, but was an unsuitable instrument for superannuation funds given their very different tax regime. A bond was, however, an appropriate vehicle for investment, and investors' comfort would likely grow over time with good performance. Housing provider regulation was considered important, but a matter between the specialist intermediary and regulator and not for the detailed focus of investing funds.

Investors cited a number of factors currently hindering their participation in the affordable housing market. First, the over-arching investment climate in Australia favours investment in equities. There is a bias against fixed income investments, such as bonds, due to the portability of super savings, a history of strong returns on equities, the existence of franking on equities not bonds, and competition from small investors. Small investors in one or two properties are able to negatively gear investment in rental properties and hence accept a lower rate of rental return.

Second, affordable housing faces competition from other infrastructure investment priorities for funding. Affordable housing is still a relatively new concept, which takes considerable effort to understand and assess in order to develop a viable scheme and attract sufficient investor interest. Numerous small CHO borrowers represent unattractive inefficiencies to investors. Recent attempts to pool demands by for-profit intermediaries have merely absorbed the benefits in high fees and commissions. Rates of return are just too low to compete with alternative investments. There is a fear among fund managers of the partial draw down of loans backing the bonds and one off 'orphaned' assets.

Third, the bond has to be suitably priced in relation to the level of risk. While risks are difficult to estimate for a new product in the early phases, no risk is also unattractive for investors. There are various types of risks that may hinder market development such as the risk of refinancing expired bonds, the liquidity risk posed by a small market with few buyers and sellers, and risks presented by CHOs growing too fast with inadequate financial management capacity. Investors were also concerned about any reputational risks associated with defaulting CHOs and their tenants.

Investors also directed their critical comments to government, suggesting (as noted above) that direct public investment would be cheaper. They were also concerned that government's commitment in this area was fickle and lacked necessary technical financial skills.

A number of expert commentators, including financial economists, public policy and housing market specialists were also interviewed for their views on the factors enabling or hindering suitable investment mechanisms. In general, experts considered that housing affordability was an issue of growing and broadening national significance, increasingly recognised as not only a social welfare concern but also a key factor in economic productivity.

Reduced government funds necessitated greater reliance on private investment. Experts suggested that bonds would be the most appropriate instrument to attract investors and that guarantees would drive tax payer's dollars further to achieve clear policy outcomes. It was argued that given governments were largely creating the risk, through their preferred funding and assistance models, they therefore needed to re-assure investors by covering this risk. The potential for governments to borrow for capital works, as with states, was also cited as a cost effective and reasonable route to raise investment, capitalising on their strong credit rating.

Experts cited a number of factors hindering the development and implementation of policy in this area. First, there is a lack of political will and commitment to reform policy, despite clear inequities and market failures in this segment of the housing market. This partly relates to the muted political power of households who continue to absorb high costs and the vocal lobbying of property investors (contrasted with the silence of powerless, insecure tenants). Further, the antipathy and lack of experience of the Australian public service was also mentioned as a factor impeding policy development, echoing other stakeholder views.

The differential taxation settings influencing types of investors were also mentioned, such as negative gearing enabling low rental yields; land taxation mitigating against larger scale institutional landlords, and the management problems and reputational risks perceived by investors.

#### *4.4.3 Views on issues to be considered for an appropriate mechanism*

Stakeholders identified a wide range of issues important to the design of a mechanism to facilitate investment in affordable rental housing, which are summarised from their interviews below:

##### *Government:*

- Needs to align with current government policy and mode of intervention.
- Needs to have a positive and appropriate impact on housing supply.
- Informed by an understanding of current CHO funding conditions,
- Supports a more predictable revenue stream underpinning not-for-profit providers and strengthens their capacity to grow supply.
- Based on an awareness of different institutional investor's needs, settings and expectations for rates of return must be positive relative to other forms of investment.
- Aware of the impact of other housing measures (e.g. negative gearing, depreciation and variable tax rates, capital gains exemptions) on relative attractiveness of rental investment to different investors.
- Promotes a suitable scale and cost of investment to contribute in a meaningful way towards affordable housing supply.
- Establishes a mechanism, such as a specialist financial intermediary which distances large investors from day-to-day management concerns of small borrowers but protects their investment.
- Enhancement to private investment is cost effective compared with alternative strategies, such as direct capital funding.
- Enhancement has clear limitations, conditions and boundaries that can be applied and refined over time.
- Has positive indirect consequences for other segments of the housing market, community and broader economy.
- Promotion of housing delivery models that provide opportunities for and participation in paid work, rather than poverty traps.
- Enhancement must improve horizontal equity between households, investors and landlords.

##### *Expert commentators:*

- Growing political support for mechanisms to support infrastructure investment, which can readily relate to affordable rental housing.
- Address inadequate and uncertain equity position of CHOs with equity injection program (grants, loans, transfers, land).
- Ensure a predictable revenue stream, review eligibility, rent policy, rent assistance, keep NRAS.
- Remove management complications, must be as straight forward and compatible with alternative investments.
- Pooling demands to ensure sufficient scale \$50–100 million bond issues.
- Structure, financial strength and operating credentials of guarantee.

*Investors:*

- Interested in completed, tenanted projects, with no development risks.
- Low rental yield and no capital growth implies fixed income investors rather than high return equity finance.
- Securitisation of a pool of loans possible, rated from AAA to BBB, with alignment to creditworthiness of borrowers in pool.
- Cash flow coverage important, housing stock must offer a reliable revenue stream and be favourably distributed across the housing markets of urban and regional areas.
- Need an incentive for first investors to step in.
- Bonds must offer an acceptable spread above BBSW and meet portfolio criteria for asset allocation, return and liquidity targets (or be compensated in risk/return) of investing funds.
- At least two banks required to lead issue and offer online market for tradability.
- Debt markets are unlikely to trade bonds with greater than 10-year term; beyond that not currently attractive.
- Returns influenced by demographics, pressure to diversify assets, relative performance.
- Low yield fixed income products not sufficient for Defined Benefit schemes.
- Ideally must be as tradeable as state government bonds are.
- Fees and commissions need to be lower than previous attempts to create an affordable rental housing product.
- Given the small market, investors require a predictable pipeline of issues and more certain liquidity.
- Bond yields must have growth potential, they can potentially be indexed to CPI, at least +3–4 per cent.
- Issues need be of a suitable scale, backed by mortgages with acceptable standards of due diligence.
- Bond prices must meet the defined risk/return and liquidity portfolio targets and have reasonable potential for secondary sales.
- Sufficient risk to be attractive, but de-risking critical dimensions—rent revenue, management, policy risk.
- Guarantee can be temporary, and burn off over time.

*Rating/Asset Consultants:*

- Capacity to cover interest on debt, main focus in rating government's contingent liability, not how much debt.
- Structure of guarantee and recourse to government is important, as well as its existing contingent liabilities.
- Rating agencies are increasingly aware that the high cost of housing and lack of affordable rental housing undermines the competitiveness and productivity of Australian cities, just as inadequate transport infrastructure does.
- Important to reduce the cost of fees and commissions charged by any financial intermediary in order to reap the benefits.

*4.4.4 Views on necessary design features*

Stakeholders provided specific insights concerning the desired financing instrument, specialist intermediary and forms of enhancement, as summarised in Table 9 below:

**Table 9: Key design elements—stakeholder views**

Key design elements	Australian stakeholders' recommendations
Instrument	<p>Tradeable security based on streams of rental income, with required credit enhancement to establish asset class and grow market quickly.</p> <p>Simple and straight forward mechanism, with no excessive bureaucracy or 'moving parts'.</p> <p>Developed with close and meaningful interaction between the pension funds and government, facilitated by a 'deal maker'.</p> <p>No expectations of same returns as infrastructure equities, entirely different asset class.</p> <p>Bond 5–9 years, current market unlikely to accept longer terms.</p> <p>Attractive if priced at 150 BP+ above BBSW with potential for 3–4+ growth above CPI, but could come down over time.</p> <p>Could offer a range of risks, not all have to be AAA 150–200 BP+ BBSW.</p> <p>Issues must be of sufficient scale—50–100 million, with regular pipeline of issues accumulating to become a tradeable bond market.</p> <p>Issuance could be possible without guarantee, but would require sufficient returns, guarantee reduces required yields to approximately 150BP above government bonds.</p> <p>Securitisation of rental revenue in the form of mortgage backed securities.</p> <p>Create a quickly crowded market and a secondary reselling mechanism.</p> <p>Must be repeatable, no orphaned assets.</p> <p>Market needs to reach above 1 billion within several years.</p> <p>Rating desirable but not necessary; needs to be cost effective, independent and expert.</p>
Intermediary	<p>Expert not-for-profit, potentially embedded in existing not-for-profit industry fund manager or credit cooperative.</p> <p>Low fees and commissions, to maintain pass on benefit to investors and borrowers.</p> <p>Specialist technical expertise (find, import, develop).</p> <p>Able to target and aggregate potential borrowers.</p> <p>Power to enforce CHO management compliance.</p> <p>Use investment specialists to facilitate securitisation process.</p> <p>Pools assets, tranche and get rating for different slices (up to 20 levels).</p> <p>Formation of Special Purpose Vehicle with Trustee.</p>

<b>Key design elements</b>	<b>Australian stakeholders' recommendations</b>
Regulation	NRS 'hand in glove' with financial intermediary to reduce financial risks and ensure compliance with guarantee eligibility targets. Authority able to identify vulnerable CHOs and prevent problems; must have 'teeth'. CHOs must have proven capacity to manage.
Revenue	De-risk rent revenue. RA must be adequate, indexed, regionally differentiated, promote economic participation.
Role of government	Policy stability, clear and supportive. Transparent certification process for issuing guarantees. Define feasible social policy and supply targets, matched with tax incentives. Agreement on lending volume and guarantee obligations.
Features of the guarantee	Clear eligibility and supply targets. Governed by a capped lending volume, enforceable limit. NRS and guarantee agency work together to ensure ongoing compliance. Government defines overall volume of obligations, defines target and eligibility and receives reports on potential contingent liability. Borrowers can contribute to contingency fund, collected by intermediary as a fee on top of loan interest. Borrowing remains off government budget, only contingent liability need be noted on public accounts. Financial intermediary accumulates separate fund, partial guarantee reserve. Backed by unencumbered assets of the borrower. Potential to sell dwellings if required for return, before recourse to government guarantee.

## **5 BUILDING ON AUSTRALIAN POLICY AND PRACTICE IN THE USE OF GUARANTEES**

### **5.1 Aim and context**

The goal of this section is to provide specific insight towards developing a model structure that will work in the current Australian conditions, drawing on Australian experience in the use of guarantees. Specifically, this section aims to:

1. Outline and discuss the implications of current Australian public finance guidelines and regulations concerning the use of guarantees to support private investment in particular policy fields.
2. Identify and analyse the actual or potential role of guarantees provided in specific cases.

The more detailed and complicated the credit enhancement structures are, the greater the transaction costs and the greater the prospect of asymmetric information and moral hazard. Differences in 'risk perception' are also likely to widen. That is, borrowers and lenders of different types will tend to see the world differently. Some investors may become overly optimistic that governments will step in regardless of any constraints or limitations placed on its support, while others may have little confidence in on-going government support of housing provision. Not only do these varying perceptions have wide implications for pricing, they make or break whether an emerging structure or asset class of housing provision may be established at all.

As always, financial markets work most efficiently when simplicity, transparency and the free flow of information prevail. Rental providers, especially non-profits delivering affordable outcomes, must transparently demonstrate their financial, operational and governance strengths within a robust national regulatory system, in order to build the level of confidence in the financial sector necessary to attract their interest. Appropriate government guarantees have a complementary role to play in achieving this outcome. Moreover, when robust complementary policies and regulations are in place, the impact of guarantee structures will be greater and the cost to government, lower. This suggests that guarantees should form part of an overall structure of government support aimed at expanding the supply of (affordable) rental housing.

### **5.2 The public finance accounting treatment of government guarantees**

The issue of government guarantees is a thorny one, especially for the central agencies of government. The governing rule in countries committed to a broad neoliberal approach to economic policy is that governments should only intervene where markets demonstrably fail and then only in ways that enhance economic efficiency. In this view, guarantees are allowable only where the benefits outweigh the costs. This, inevitably, relies on judgments made by key officials on the basis of incomplete information. Standing behind these judgments are the assessments by the major ratings agencies on which the evaluations of investors rely when pricing the risk of the various instruments available to them. In spite of the poor performance of the agencies in the lead-up to the GFC, investors have little else to turn to. Since, much of what purports to be 'risk' turns out to be, in fact, rank uncertainty, there is a tendency for all agents, government Treasuries included, to be conservative in their approach to guarantees; the IP report notes the panel participants' view that the treatment of guarantees, etc. is 'a matter of informed but subjective interpretation'. Thus, the onus is on proponents of the use of guarantees to build a very strong case for their use in a



particular policy field. This is the aim of this AHURI project, namely, to critically appraise different approaches to guaranteeing investment in social housing and inform the development of a model appropriate to Australian conditions.

The basic guide to Australian public officials is provided in the Australian Government Department of Finance (2003) *Guidelines for issuing and managing indemnities, guarantees, warranties and letters of comfort*.

These guidelines are designed to advise officials of their responsibilities when considering entering into arrangements involving issuing indemnities, guarantees, warranties, or letters of comfort on behalf of the Commonwealth. These guidelines also reinforce the importance of sound risk management strategies and awareness regarding the use of such instruments (p.3).

The forms of support are as follows:

- An *indemnity* is a legally binding promise by the government to take on the loss or damage suffered by another party.
- A *guarantee* requires the government to assume payment of a debt or other obligation of another party if the latter defaults. As noted above, the IP report notes that guarantees can be structured in a number of ways to be fit-for-purpose; there is no 'one size fits all' option.
- A *warranty* entails government assuring another party that an asset the latter purchases, is fit for purpose.
- A *letter of comfort* is a device used to facilitate a transaction or arrangement without the *intention* of creating a legally binding obligation on government. As such, it carries less weight with the recipient and may lead to different expectations as to its import if called upon.

Any or all these instruments could be used in facilitating private investment in rental housing. Letters of comfort, in particular, are not favoured precisely because they may be later deemed to create a legal liability for the government. All four forms of support create contingent liabilities of various levels of intensity. The potential exposure of government does not, in general, create on-budget impacts until and unless the risk is crystallised. (However, as a working rule-of-thumb, the Commonwealth Treasury will include the estimated cost to itself on budget if it judges the probability of crystallisation at greater than 0.5 or 50 per cent.; if below 50 per cent, the contingent liability is noted on the Statement of Risks (Milligan et al. 2013, p.48)) Nevertheless, accepted accounting and audit practices require close monitoring of the potential cost impact on government budgets of these contingent liabilities and the risk management practices in place to minimise those possible impacts. Past reports of the Australian National Audit Office (ANAO) have suggested improvements in the practices of issuing and managing guarantees and other assurances (hereafter termed 'guarantees'); (See ANAO 2003 and Australian Government Department of Finance 2003, pp.5–6).

The recent report of the Infrastructure Finance Working Group (2012) notes the uncertainty in accounting for infrastructure investments on government budget statements, in spite of the guidance provided by the Australian Accounting Standards Board and the International Public Sector Accounting Standards, concluding:

... despite the existence of these standards there is currently no definitive method used to account for infrastructure investments. Moreover, determining the actual impact of an infrastructure project on a government budget can be extremely complicated and will depend on the individual nature of each proposal assessed on a case-by-case basis. (p.38)

As noted above, the starting point for the use of guarantees is clear. The Australian Government's policy on issuing indemnities, guarantees, warranties and letters of comfort is to accept such risks only when the expected benefits, financial or otherwise, are sufficient to outweigh the level and cost of the risk which the Commonwealth would be assuming. As a matter of principle, risks should be borne by those best placed to manage them—that is, the Australian Government should generally not accept risks that another party is better placed to manage (DF 2003, p.7).

Although the primary emphasis is on ensuring that the financial position of the Commonwealth is not impaired, a close reading shows that the expected benefits can be 'financial or otherwise'. Little written guidance is given on what the 'other' benefits could be or how they are to be valued. Likewise, the measurement of the cost of risk assumed by government is left open and implicitly devolved to judgment on a case-by-case basis. This project will need to tease out the *specific factors* that would need to be addressed in order for government to be comfortable that the actual guarantee(s) given to boost the supply of affordable housing meet the qualitative criteria listed below.

The guidelines further direct officials to (among other requirements):

- Explore all other avenues to achieve the desired outcome—that is, guarantees are to be the last resort; the continuing housing affordability crisis in Australia, documented by successive reports of the National Housing Supply Council and the persistence of significant homelessness, suggest that we may, indeed, be approaching the situation of last resort. It is highly unlikely that the provision of an SHG would 'crowd out' private investment in affordable rental housing, since existing patterns of investment are characterised by the dominance of unsophisticated investors committed to rental investment for a range of financial and non-economic reasons (Wood & Ong 2009).
- Establish the risk to be assumed and a case for government to assume the risk; this project attempts to do this in cooperation with key stakeholders in the public, not-for-profit and private sectors.
- Impose timeline termination of the liability given the duration of the guarantee and associated obligations.
- Calculate the possible maximum loss to government and value-for-money in the event of loss.
- Ensure relevant legislative requirements are met.
- Ensure appropriate risk management procedures are in place; in the case of a suitable social housing guarantee, it may be necessary to propose further reforms to the evolving national regulatory system for social housing providers in Australia.

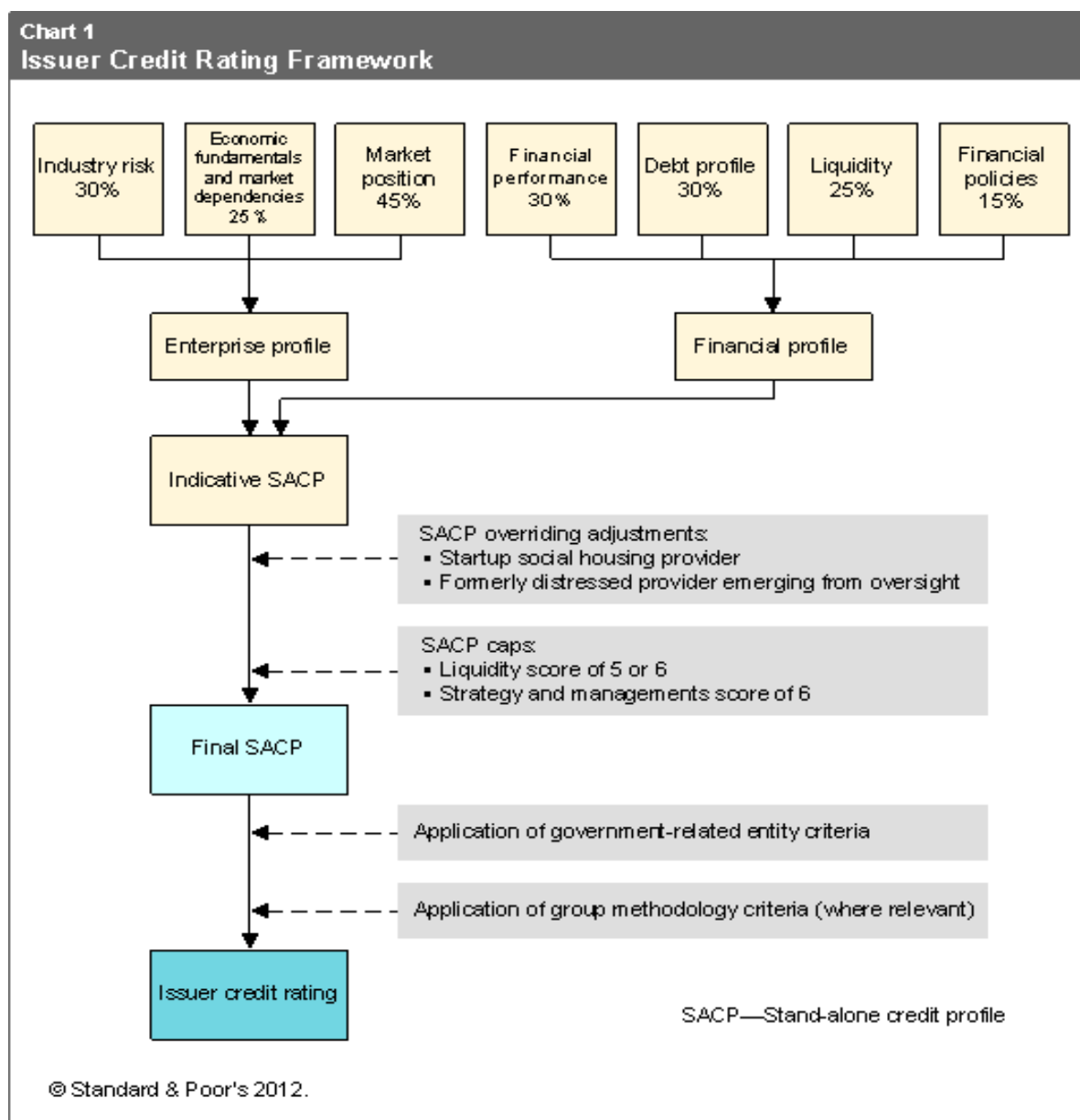
The constraints on issuing guarantees have progressively tightened over the past two decades, in line with closer audit practices and demands for greater efficiency and transparency in government. *The clear implication—to repeat—is that proponents of government guarantees for particular economic and social outcomes must establish a very strong case in support, not least to overcome the bureaucratic reluctance to move along this complicated path; it is far easier and safer for officials to say 'no'.* This project aims to assist policy-makers and financial sector agents to develop the awareness of the successful models operating internationally and local requirements for moving forward on this task.

An important pressure for government when considering 'off-budget' mechanisms like guarantees is to protect their overall credit rating with the major agencies. A

downgrade of sovereign debt carries significant adverse budget implications, especially in the light of current European experiences. The Infrastructure Finance Working Group (2012, p.19) noted that the past downgrading of state government credit ratings from AAA to AA+ has increased state public borrowing costs by around 50 basis points. The robustness of the administrative and monitoring systems in place to track and manage government exposure and to handle risks peculiar to the policy field involved will influence how ratings agencies make their decisions.

In the case of guarantees that support the provision of affordable rental housing by non-profit providers, the credit standing of the latter become relevant to the structuring of the guarantee and the rating of its guarantor. The ratings agency Standard and Poor's (2012) has a well-developed methodology for rating non-profit social housing bond issuers and has applied it in a number of countries (see Figure 7 below). Ideally for a government providing a guarantee in this field, the providers (whose performance will largely determine the probability of the government's risk crystallising) will score a 'stand alone credit profile' (SCAP) of at least 2, the second strongest score, based on a rating of single a/a- (adequate) to aa/aa+ (very strong) on the two key factors, financial profile and enterprise profile. Each sector receives an 'enterprise profile' assessing the background strength/risk/growth potential of its core enterprise and this risk weighting modifies each issuer rating. The IP report (Milligan et al. 2013, p.48) notes that Standard and Poor's have, in fact, assigned the social and affordable housing sector's enterprise profile a '2' (on a scale of 1 [lowest risk] to 6 [highest risk]) in countries like Australia. This should give governments a level of comfort in providing guarantees on, for example, debt raised by 'tier 1' Australian CHOs.

Figure 7: Standard and Poor's Issuer Credit Rating Framework (2012)



### 5.3 Use of guarantees: select cases

Government guarantees have been used sparingly to date in Australia. There appears to be little systematic consideration of when and where they should be used, or how they are to be structured, implemented and monitored. Their use has tended to be issue specific and reflect the particular priorities and pressures facing governments in the immediate term. Three recent cases are described below. Cases 1 and 3 are instructive because they *do not entail any guarantee* but the general approach could be supplemented by an appropriate guarantee structure when applied to the creation of a credit-enhanced housing bond-type instrument targeted at institutional investors. Case 2 describes a policy innovation in the transport infrastructure sector, in which a (state) government guarantee figures prominently.

#### 5.3.1 Case 1: the National Broadband Network

The NBN is Australia's largest infrastructure project to date. To be rolled out over the 2012–21 period, the network, as originally envisaged, is intended to provide super-fast

broadband coverage to 13 million Australian premises, business, government and residential. It is to be fully funded by government equity contributions of \$30 billion and the sale of \$13 billion in infrastructure bonds to private investors by the Australian Office of Financial Management. In line with guidelines established by Infrastructure Australia (2011), the infrastructure bonds would satisfy the following conditions:

- Independent governance.
- No implicit government guarantee<sup>15</sup>.
- Should not 'crowd out' private providers.
- Not to be used for grants.

The benchmark for these tradable bonds, facilitating their pricing, would be tradable long-term Commonwealth bonds and covered corporate bonds introduced by legislation in 2011.

The advantage to government is, supposedly, that the impact on government operating and balance sheet statements would be minimal (Dalzell 2012). In fact, as argued above, 'perceptual' risk—the underlying belief of investors that the Commonwealth would always be there to prevent NBN Co. failing—means that government can never transfer 'catastrophic risk', especially during the construction and early operational periods when operating losses are accruing. (The recent discovery of asbestos in a number of Telstra pits is an example of unforeseen costs and operational contingencies that will affect the crystallisation of risks as the roll-out progresses.)

The Coalition Federal Government, elected in September 2013, is currently reviewing the NBN project with a view to shifting from fibre to the home to fibre to the node. It is not clear what the implications are for future financing options.

However, it is quite clear that, as currently envisaged in the original NBN plan, infrastructure bonds would not be suitable for the provision of affordable rental housing, because:

- Government has not yet widened the scope to include residential buildings (i.e. a telling case for inclusion has not been made and accepted).
- The guidelines rule out 'implicit' (and by implication, explicit) guarantees, though, as noted above, implicit guarantees are likely to be in the eye of the beholder, the would-be investor.
- The pricing of infrastructure bonds is likely to be too high, based on reviews of past practice (Ernst and Young/FSC 2011; IPA 2010).

The first two barriers can be addressed by documenting the growing evidence of market failure with respect to the mismatch between the effective demand for and supply of rental housing and establishing the indirect benefits of closing that gap in terms of enhanced labour productivity. For example, the bonds are intended to encourage earlier provision of road and port infrastructure vital to major mining projects. However, another supply-side constraint on optimal operation of those projects hinges on the immobility of labour and the high costs of a fly-in-fly-out workforce. Constraints on labour productivity also apply in large urban regions. An

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<sup>15</sup> An implicit guarantee exists when a significant number of potential investors believe that the government will, in the final instance, step in to prevent default. A prime example occurred in 2008 when governments and central banks around the world moved to prevent chain insolvencies in the banking and shadow banking systems. This was widely expected. Resulting actions included government guarantees of bank deposits and wholesale borrowings.

adequate supply of rental housing at appropriate locations and price points reinforces the overall productivity and agglomeration economies of cities and surrounding regions. Thus a case can be made for guarantees attached to infrastructure type bonds targeted at housing supply (see Lawson et al. 2012)—and have been used in this way overseas (see Lawson 2013). It should be noted that the Infrastructure Finance Working Group report (2012) ruled out guarantees as inefficient by definition, without providing argument or evidence. In view of changing views and evidence internationally on the inefficiencies of purely market-driven approaches, central agencies in Australia should, following the lead of the IMF, reconsider its hesitancy in considering well-constructed guarantee schemes (see Lawson 2013).

The third barrier has been addressed by Alan Kohler who argues that (1) about 70 per cent of bonds are held by overseas investors desperate to move their wealth into hard currency, highly-rated sovereign debt without chasing yield; (2) Australia fits the bill nicely; (3) hence, the appropriate benchmark is not Australian bonds plus a risk margin, but US government bonds plus risk margin. Kohler (2012) concludes:

Rather than wringing our hands about the capital inflow [pushing up the value of the Australian dollar] why not give global investors something to invest in other than Aussie government bonds and export liquefied national gas projects? Specifically, infrastructure bonds to finance a huge national building program of roads, ports, bridges, airports using money borrowed at super low rates to take advantage of this once-in-a-lifetime opportunity. It would assist the non-mining economy of the eastern states; cushion the transition from the peaking of the mining investment boom and set Australia up for the future.<sup>16</sup>

The recent decline of the Australian dollar below parity with the American dollar somewhat reduces the force of this argument. However, as long as the former stays high by historic standards, and the Australian economy continues to grow faster than other G20 nations, overseas investors are likely to maintain their appetite for domestic financial instruments.

By extension, a properly structured bond enhanced by appropriate guarantee(s) could attract a share of the flow of defensive inward foreign investment seeking low-return-low risk assets. The key challenge would be to design and manage a guarantee scheme that the probability of the risk crystallising is vanishingly small and thus does not adversely impact the government's budget and balance sheet position. In other words, if the risk is judged small enough, only part of the nominal value of the guarantee sum would appear 'on-budget' or, alternatively, be noted as a contingent liability in government financial statements. This would minimise any adverse impact on the overall credit rating of the government providing the guarantee. The UK government is currently demonstrating through rigorous analysis the excellent prospects for such a bond product in Britain (see the detailed review of the new UK scheme in Lawson 2013). We adapt a version of this model integrating relevant aspects of the Swiss approach in Chapter 6.

### 5.3.2 Case 2: NSW Government Waratah Bonds

This case describes a relatively standard approach to government guarantees tied to specific policy fields, in this case large transport infrastructure projects. It also illustrates the importance of getting the structure and targeting right. It is an approach that could be tailored to support a housing bond product.

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<sup>16</sup> Ex Reserve Bank board member, Warrick McKibbin, has made a similar point (quoted in Milligan et al. 2013, p.4, fn.6).

In 2011, the new NSW Liberal Government introduced Waratah bonds (WB) intended to fund major public infrastructure projects. This was deemed necessary in the light of loss of investor confidence in the wake of well-publicised problems with PPP projects like the Cross-City and Lane Cove tunnels. The bonds were aimed at retail investors, including those operating self-managed superannuation funds and were initially offered as standard fixed rate instruments with three- and 10-year terms. Interest was paid half-yearly and the principal repaid at maturity. The bonds were sold by the NSW Treasury Corporation (TCorp) whose debt is guaranteed by the NSW Government. The coupon rate was set just above normal state debt rates to reflect the security offered by the government guarantee. The bond proceeds were to be held in a 'Restart NSW' fund and an initial target to raise \$300 million was proclaimed.

The investor response was underwhelming. This is not surprising, since the coupon rate offered was one to two full percentage points below interest rates on bank term deposits that, up to \$250 000, are fully guaranteed by the Commonwealth Government. Moreover the term deposits paid out quarterly rather than half-yearly, further widening the effective return gap. By 2012, barely \$20 million of bonds had been sold and the target was reduced to a still optimistic \$200 million.

Subsequently, a new annuity-type version of the bond was put to the market alongside the fixed rate bullet product. Waratah Annuity bonds (WAB) return a combination of interest and principal throughout the nine-year term, with nil residual return at maturity. WAB are also inflation-indexed to CPI on the upside. The latest Series eight issue was launched in January 2014.

WB and WAB, like standard state government bonds, depend for their pricing on the (changeable) credit rating of the NSW Government, currently AAA. The guarantee involved is, therefore, implicit. The bonds are not asset-backed securities but unsecured debt obligations of TCorp. They are aimed at investors seeking low-risk, low-return assets with a reliable income flow and—in the case of WAB—inflation protection.<sup>17</sup> Waratah bonds are intended to be held to maturity. There is no formal secondary market but TCorp may, at its discretion, repurchase at a price determined by a standing formula, especially if the investor can demonstrate financial stress. Zenith Investment partners (2013) have judged the risk of non-repayment of WAB (current Series 5) as 'very low' and suitable for long-term investors who do not require ready access to their investment. Zenith find that WAB compare favourably to indexed-linked bonds currently in the market and note that such assets show low correlation with other asset classes, including traditional fixed interest products. This suggests that WAB, in particular, may appeal to institutional investors with long-dated liability obligations seeking to rebalance their portfolios in order to gain greater diversification benefits. However, Zenith also makes the point that the credit worthiness of governments and their financing agencies is liable to sudden changes, sometimes for the worse. As the recent and continuing turmoil in global bond markets, and the sovereign debt crisis in many European countries attest, there is no such thing as a risk-free investment; the idea that government bonds provide such a benchmark is a fiction required by modern finance theory and not supported by 'eight centuries of financial folly' (Reinhart & Rogoff 2009).

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<sup>17</sup> See WAB marketing article targeting retirees seeking low risk guaranteed fixed income investments, <https://www.waratahbonds.com.au/resource/Article%20in%20The%20Switzer%20Super%20Report-%2028%20Oct%2013.pdf>

### 5.3.3 Case 3: Social Benefit Bonds

Like Case 1, this approach rules out guarantees but could be refined to integrate partial guarantees that reduce some investor risk and required yield, without threatening the main incentive structures put in place.

In 2011–12, the NSW Government trialled a new debt instrument—social benefit bonds (SBB). This move reflects a government strategy of shifting provision of key basic services like mental health and children in care to large well-established non-government providers. The rationale is that the latter are likely to be able to deliver these services more effectively and for lower cost than traditional government provision. SBB are targeted at investors seeking appropriate risk-adjusted returns while also achieving valuable social outcomes; in other words, the bonds are ‘economically targeted investments’, not ‘ethical investments’.

The actual return to investors will depend on the extent of the expenditure savings the state government reaps. If the savings are large enough, investors will be repaid their principal and a positive (interest) return in addition. If government savings are inadequate, investors may lose not only their interest but also part or their entire principal. This suggests that these bonds are likely, initially, to be perceived in financial markets as high risk, in part because of their novelty and the lack of market data to allow investors to price the risk. It also means that the credit and performance rating of the non-government providers will be critical to that calculation, since the government provides no guarantee or other support. Beyond that, investors will need to be comfortable with the method of calculating the savings to government and any rules for dividing the savings between government and investors.

During 2012, preferred providers were selected to work with NSW Treasury to develop SBB for projects in reducing recidivism in the state justice system (with Mission Australia) and out of home care pilot projects for children at risk (with Uniting Care Burnside). A number of large financial institutions are assisting both trials. Social Ventures Australia is working with Uniting Care Burnside to develop SBB to fund its children at risk program; Social Ventures Australia (SVA) is a non-profit organisation run by financial sector professionals, similar to other social entrepreneurship organisations emerging in other countries. SVA accomplished a modest close of its Newpin SBB in 2013 (\$7 million; stakeholder interview notes), but it is unclear if any greater uptake is forthcoming from the investment sector. The structure is very sensitive to the actual monetary ‘bed night’ calculation that the NSW Treasury assigned to the foregone expense of each defined unit of foster assistance. A similar monetary value and mechanism would need to be developed around foregone expense for social housing.

A similar approach to social provision is apparent in a number of other countries, including the United States and United Kingdom. In the case of the UK, the national government is encouraging the development of ‘social impact bonds (SIB), very similar to the NSW initiative. (This policy approach is discussed in the earlier Housing Supply Bonds Study (Lawson et al. 2012, p.17)). An organisation called Social Finance run by directors and staff drawn from the financial services sector is active in this embryonic market. Social Finance was recently contracted by Essex County Council to market an SIB aimed at keeping at-risk adolescents out of government care. Successful outcomes are to be measured by the reduction in number of days spent in care, increased school attendance, wellbeing and reduced offending. The funds raised will pay for family services delivered by a large established care organisation. Successful outcomes are ‘expected’ to deliver investors an 8–12 per cent return. The key question is: Will potential investors have the same expectations and will even this very high possible return attract their interest? High required returns



are a function of high risk, the fact that government provides no support or comfort to potential investors.

If early sales of SIB fail to meet required returns, the market for them will quickly die. Government has a strong long-term incentive in encouraging such a fledgling market to consolidate and grow. There is an efficiency (infant industry) case for some form of credit enhancement in the early stages. Perhaps government could provide a guarantee on repayment of principal in return for a share of any upside return; in effect a 'collar' reducing the downside risk to investors. Outcome-related payments to the non-government service provider could also be carefully tailored to encourage successful outcomes.

The main point to make here is that, as currently configured, SBB/SIB type products are only likely to attract professional, mainly retail investors and/or those with a strong social mission. The former investors would demand high returns for achieving performance outcomes, while the latter are scarce in number and size. However, if such products could be developed, and their market deepened through the use of targeted guarantees, the policy field of—for example—(reducing) homelessness is an obvious target for their deployment. For example, SBB managed by an intermediary could funnel finance raised to Tier 1 housing associations committed to housing homeless persons. To do so would create an instrument that departs from the strict architecture of the SBB/SIB approach currently adopted, resulting in a hybrid product.

Any guarantee granted by the NSW government must satisfy a 'public interest test', as stated in Treasury Circular 10/14 (November 2013). Most guarantees that have been granted to date have applied to non-profit bodies, though not exclusively; some commercial entities operating in industries like tourism have sought and received a guarantee. Where commercial public agencies benefit from a guarantee, a fee is charged in order to maintain competitive neutrality with the private sector. Guarantees in NSW are authorised under the Government Guarantee Act.

In the case of a guarantee-modified SBB product, the fee payable to government could—for example—be generated through an aggregating intermediary for Tier 1 housing providers.

Nevertheless, reliance on an SBB/SIB approach is, in our view, risky, depending as it is on 'the Big Society' concept.<sup>18</sup> Based on the interviews with financial sector actors carried out for this project, the proposed product is unlikely to attract significant interest from institutional investors. Lack of transparency, complexity, suspicion of the capability of unregulated non-government providers, and the lack of market relevant information would bar most institutions from engagement, short of extremely high expected returns payable by governments. In short, if successful, such products would cost government dearly; if they fail to attract investor interest important community services would remain unfunded.

#### *5.3.4 Case 4: Export Finance and Insurance Corporation*

For over 50 years, the Export Finance and Insurance Corporation (EFIC) has supported the growth of Australian companies in their international activities by providing loans, guarantees, bonds and insurance products. This it achieves through a number of programs, including those that provide guarantees of one kind or another.

Examples include the following:

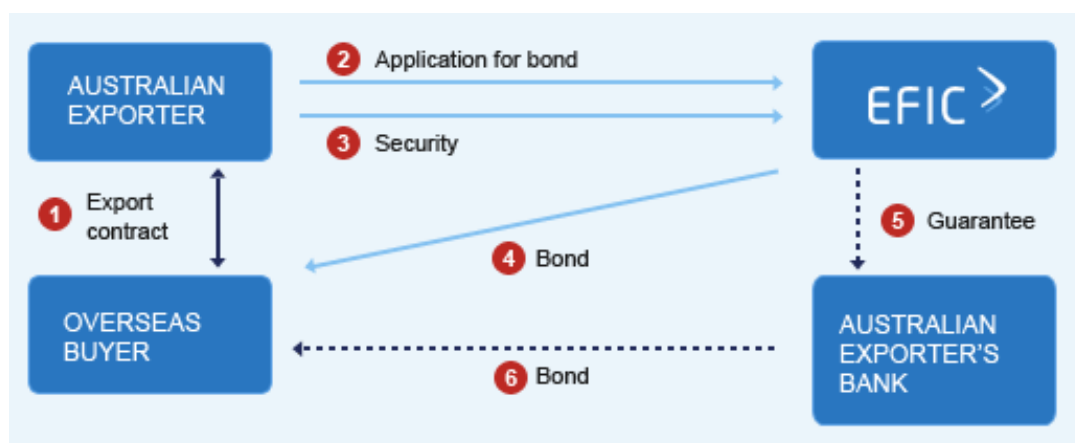
1. Advance Payment Bond

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<sup>18</sup> In a recent critique of The Big Society policy approach, in general, and the SBB policy, in particular, written as a Background Paper for the ACTU, see MacDonald (n.d.).

An overseas buyer will often be required to pay an upfront amount to the exporter. The buyer, in return, will require an assurance or guarantee that, in the event that the goods or services are not supplied as per the contract, the advance payment will be returned. A bond for this purpose may be provided by the exporter's bank. However, for those exporters who are unable to secure a commercial bond in this way, due to inadequate collateral required by the bank, EFIC may provide the bond, either directly to the buyer or indirectly via the bank at a lower cost to the exporter than normal commercial options. This assists Australian exporters build their overseas markets without over-committing working capital. In effect, it enables smaller, newer firms to enter and compete more effectively in global markets. The key elements of this approach are noted in Figure 8 below.

**Figure 8: Export Finance Insurance Corporation Advance Payment Bonds with EFIC guarantee (EFIC, n.d. a)**



## 2. Performance Bond

An overseas buyer may also require assurance that, in the event that the exporter fails to deliver as noted in the contract, it will be able to call on the bond to cover or minimise its losses as a result of non-compliance. The structure of this arrangement is essentially the same as that illustrated in the diagram above (Figure 8).

## 3. Warranty Bond

A buyer may require the exporter to provide a bond covering any losses incurred after delivery to cover losses as a result of the latter failing to meet the warranty conditions in the contract. The arrangement follows that illustrated above in Figure 8.

EFIC also works with US financial institutions to help Australian exporters meet the much higher guarantee requirements for firms selling into the American market. Typically, US buyers require a guarantee covering 100 per cent of the contract value as opposed to the 20 per cent level in other international markets. Such an impost effectively prices many potential exporters out of the lucrative US market, especially those without a strong track record there. In addition, EFIC offers guarantees to banks enabling exporters to directly access working capital in excess of levels otherwise attainable.

EFIC is part of the Foreign Affairs and Trade portfolio, reports to the Minister for Trade and provides finance, guarantees, insurance and bonding facilities to support Australian companies exporting or investing overseas. Eligibility involves 'criteria [that] are product specific, and include EFIC being satisfied that all parties in a transaction are acceptable and capable of fulfilling their respective obligations'. Evaluation assessment involves economic and financial viability, home country impact,

environmental impact, social impact, and labour rights. EFIC provides an annual report to Parliament, disclosing information on the type of projects supported. In addition to default or non-performance risks noted above, EFIC guarantees cover the specific risks of currency inconvertibility/Transfer restrictions, confiscation, expropriation, nationalisation and violence/war.

The overall aim of EFIC, then, is to reduce the financial barriers facing Australian firms seeking to grow their businesses internationally and to do this by the effective use of guarantees enshrined in particular bond arrangements. The key to the success of this approach is that EFIC will usually accept lower collateral backing for the bonds provided than normal commercial benchmarks require, reducing the call on exporters' working capital and fixed asset base, allowing them to compete more aggressively in international markets. This assistance is particularly useful to SMEs and established firms moving overseas for the first time. In efficiency terms, there is an 'infant industry' rationale for EFIC's approach.

## **5.4 Implications**

Governments in Australia display extreme reluctance in using guarantees as a form of credit enhancement, except where they can be tied to specific, well-established economic or, more rarely, social policy commitments. There are well established examples in Australia, such as export credit guarantees and the support of home ownership provided by the 1960s creation of the Home Loans Insurance Corporation (subsequently privatised). Most importantly, the Australian Government routinely guarantees the solvency of the banking system, as interventions during the early stages of the GFC demonstrated. Not only were all deposits up to one million dollars (subsequently reduced to \$250 000) lodged in approved deposit-taking institutions guaranteed, but the government moved swiftly in 2008 to guarantee the wholesale borrowings of the banks when international credit markets froze in the aftermath of the Lehman Brothers collapse in the United States. The authorities in other advanced economies likewise acted to shore up their banking systems in order to prevent an escalating credit crunch causing major depressions around the world. A 2009 estimate by the Bank of England of the value of the total annual guarantee provided to banks by the UK taxpayer amounted to £107 billion, higher than the annual expenditure on social security or education. This estimate was based on the difference in the value to the banks of the two ratings the banks would attract from the ratings agencies, the first with the government guarantee, the second without (quoted in MacKenzie 2013, p.16). It's not clear what the value to the Australian banks of the Australian taxpayers' guarantees is but it most certainly would far exceed the fees paid by the banks to the government in the immediate aftermath of the 2008 crisis. There is obviously a strong public good argument in favour of government ensuring the stability of the nation's banking system. Equally, it is clear that the guarantee represents a massive, continuing subsidy to bank shareholders and senior managers, to the extent that the latter's remuneration depends in part on bank profits. In theory, a persuasive public good argument, based on enhanced productivity and economic stability, can also be made to legitimate the considered use of guarantees in other fields, notably affordable housing (e.g. see Berry 2006).

In summary, there are some cases that governments deem important enough to step in and provide a degree of support; put another way, there is recognition that incomplete and imperfect markets can lead to inefficient or sub-optimal outcomes without appropriate government action. The stance of the Productivity Commission, noted above, that guarantees are inefficient by definition, is clearly not supportable, either in theory or policy practice. We need to find out why governments seem to be reluctant to consider the appropriateness of guarantees on a case-by-case basis. Is it

because no one really knows how to price guarantees? Is it because of central agency suspicion that guarantees, however circumscribed, will impose open-ended costs on future government operating statements? Is it because Australian officials are unaware of best practice elsewhere? The key policy challenge is attacking these and similar barriers and demonstrating how properly structured and managed guarantees can be used to cost-effectively expand the supply of affordable housing for those in greatest need. It is likely that targeting homelessness (in light of the recent Census finding that more than 120 000 'households' were homeless on Census night 2012) is a good strategy, using an infrastructure-type bond with a guarantee rolled in (as Treasurer Joe Hockey suggested when in Opposition (Crowe 2013)). It will be a challenge to get governments to extend their view from economic infrastructure to housing. The argument could be two-fold: (1) cost savings to government in dealing with homelessness and its follow-on costs for government and (2) the labour productivity gains created by better quality and located housing for workers, including those currently effectively excluded from workforce participation, in the context of an increasing dependency ratio as Australia's population ages. Similar arguments can be advanced for creating a funding flow into the non-profit sector to expand the supply of housing suitable for people with a range of disabilities who will progressively be able to draw on the new opportunities provided by NDIS.

## **5.5 Key issues in developing a Social Housing Guarantee (SHG) for Australia**

Assuming that affordable housing can be developed as a viable field for institutional investors, through the provision of suitable guarantees and the development of infrastructure-type financial instruments, a clear framework for proceeding will need to be implemented.

In an important book published by The World Bank, Irwin (2007) argues that governments shy away from offering guarantees because of:

1. The difficulty in identifying and valuing the myriad risks involved in large infrastructure projects.
2. The political tendency for powerful vested interests to seek to transfer risk to government.
3. Biases built into judgments about difficult to value risks and a tendency to over-confidence in making those judgments.

Recent experience, he notes, has thrown up examples of costly mistakes concerning government guarantees; he refers here to the Sydney cross-town tunnel.

Nevertheless, he also argues that, properly managed, government guarantees can speed up the provision of necessary infrastructure, at minimum actual public cost, without over-burdening or distorting current government budgets and service provision, while also benefiting from the expertise and experience of private investors and service providers.

This is most likely to be achieved when three conditions are met:

1. The government's advisers and decision-makers have a framework for judging when a guarantee is likely to be justified.
2. The government's advisers know how to value the cost of a guarantee.
3. The government decision-makers follow rules that encourage a careful consideration of a guarantee's costs and benefits.

Irwin's book sets out to help governments meet these three conditions.

*Project risk* refers to the unexpected variation in the total value of the project. *Stakeholder risk* refers to the unexpected variation in the value of a project to a stakeholder—for example, the government. *Particular risks* relate to unexpected variations in specific factors that impact on project and stakeholder value.

Conventional wisdom has it that a risk should be allocated to the party best able to manage or mitigate it. This is too vague. Irwin proposes that each particular risk should be allocated to the party that can most effectively:

1. Influence that risk.
2. Influence the sensitivity of project value to that risk—for example, by being able to anticipate or rectify a downside movement.
3. Absorb that risk.

Having identified the key risks that it could bear, governments can supplement the qualitative assessment of the potential costs by estimating the quantitative impacts. Irwin's book provides details of techniques to quantify the costs of particular risks, like insolvency of the private investor. In sum, they attempt to:

1. Identify the risks the government is considering bearing—for example, a specific guarantee to housing bond holders.
2. Determine government's financial rights and obligations to the project.
3. Identify the risk factors that will determine the cost to government if crystallized—for example, loan default by bond seller.

Then measure the government's possible exposure:

1. What is the most the government can lose?
2. What is the probability of loss?
3. Consequently, what is the likely loss?

The UK housing bond guarantee scheme, discussed in detail in Lawson (2013) offers a model for how this approach can be adopted in this policy field.

The basic rules that governments should follow include:

1. Each guarantee opportunity should be evaluated on a case-by-case basis. There are no general rules of thumb to fall back on. By implication (as noted above), the blanket dismissal of guarantees by government is invalid, since it is likely to prevent efficient projects from proceeding.
2. Modern accrual accounting, rather than cash accounting, methods are vital to ensuring that the long-term costs and benefits of guarantees are considered and properly included in the public accounts. Even the best practice public accounting systems may inadequately value these impacts and require appropriate notes to the accounts and measures like the following.
3. Government departments providing guarantees may be required to pay the estimated cost of the guarantee into a special fund to help manage the future cash flow risks of the guarantee. The private investor and/or borrower may also be required to contribute to this fund which is first drawn upon if the guarantee is called upon.

In determining the expected cost to government, a Bayesian approach to probability judgments is most likely to capture the difficulties inherent in predicting uncertain future outcomes. That is, 'prior probabilities' of default can be regularly updated using the most recent data to calculate the 'posterior probability' of defaults on outstanding

guarantees. This has the benefit of requiring governments, on behalf of taxpayers, being aware of the changing environment in which risks are crystallising (or not) and re-setting their guarantee fees and accounting for their real liabilities accordingly.

Finally, it is worth stressing that the Positioning Paper for this project (Lawson 2013) distilled the following key principles/lessons from the international cases reviewed in detail:

The program of selectively providing government guarantees should:

- Be based on agreed principles, long-term mandate and a defined facility agreement.
- Lower the borrowers' risk of investment while minimising any potential call on the guarantee.
- Inform investors and market the bonds, including the guarantee.
- Create an expert financial intermediary to aggregate and assess borrower demands.
- Pool demands and ensure regularity of bond issues.
- Carefully structure the guarantee in terms of risk allocation and reporting.

The end result of encouraging private finance must demonstrably create a growing stock of housing rented to lower income and otherwise disadvantaged households at affordable—that is, sub-market—rents. Government policy (perhaps in a revised National Affordable Housing Agreement) needs to state clear supply targets to be met, the criteria of eligibility of tenants, with due consideration to issues of horizontal and vertical equity, the impact on private landlords in the commercial sector and the requirements imposed on non-profits by the Australian Charities and Not-for-Profits Commission (or its successor).

## **6 A MECHANISM TO GROW LONGER TERM LOWER COST INSTITUTIONAL INVESTMENT**

### **6.1 Policy rationale**

Why should governments in Australia provide guarantees and/or other forms of credit enhancement to the affordable rental housing sector? Clear justification by proponents of this form of public enhancement for institutional investment is an important requirement of the Australian Government's guidelines on the use of guarantees.

The first-line answer is that current mechanisms of provision have broken down resulting in a growing structural shortage of suitable housing for people of limited means or with special needs. Public housing is in crisis with state governments unable to adequately maintain, still less expand its ageing and obsolescing stock and the Commonwealth unwilling to continue funding the states to rectify accumulated problems. The private rental stock is skewed towards middle-to-higher income and otherwise favoured tenants as small investors seek to protect the value of their investment, resulting in the effective exclusion of lower-income households. Increasing income inequality and insecurity has effectively removed the prospect of home ownership from a growing proportion of households, especially young Australians. The ratio of average housing prices to average household incomes in Australia's major cities remain among the highest in the advanced nations.

However, the current situation reflects more than a housing shortage crisis. Much of the available rental stock is ageing, of poor quality and in the wrong locations to support a productive economy undergoing major structural readjustments (Berry 2006; Wulff et al. 2011; Lawson et al. 2012; Kelly 2013). Governments face a double challenge: how to establish policy settings that address the emerging housing crisis while also bringing their budgets back from structural deficit. Following Irwin's comments noted above and the detailed international review of Lawson (2013) in the Positioning Paper for this project, strategically provided and carefully managed government guarantees could bring forward an expanded supply of affordable rental housing at manageable cost to government in terms of the scale of output achieved.

While government savings are increasingly being directed to balancing the budget, private household savings are increasingly being concentrated in the superannuation sector, now accounting for more than \$1.62 trillion (APRA 2014). Indeed, for the first time, superannuation savings now exceed total savings in the commercial banking system (interviewee: financial sector). This fact has broad implications for Australia. First, it means that the banks are increasingly reliant on international wholesale credit markets; recent history has shown how volatile these markets are and how the Australian Government may need to step in and support the banks when that volatility threatens bank solvency. Second, the superannuation funds are investing a high proportion of Australian savings overseas, funding infrastructure and commercial activities in China and other growing economies, rather than financing the growth of a transitioning Australian economy; moreover, the Australian taxpayer is subsidising this capital outflow in the implicit hope that they will reap more in fund returns than it costs in foregone income tax revenues.

The superannuation funds also face a challenging environment. At some stage (estimates vary from five to 20 years hence—2018 to 2033) they will predominantly shift from an accumulation to a pension phase. As the baby boomers retire and face a lengthening average period of retirement, their funds will need to match their investment returns to the steady outflow of pensions to retirees. This is likely to

happen as governments in Australia move their budgets back into surplus, creating a shortage of low risk-low return securities that the funds will need to rebalance their portfolios. A steady supply of highly rated affordable housing bonds could help meet the projected demand for this class of asset. The funds also face a political risk that future Australian governments and regulators will look less favourably on the continuation of tax-favoured, mandatory superannuation contributions and savings, if those savings continue to flow overseas and fail to meet the investment needs of the nation. The OECD (2011) has pointed out that Australia's retirement pension system is the least prescriptive of all the advanced economies.

At the 2012 National Housing Conference, Jennifer Westacott, CEO of the Business Council of Australia, argued that (adequate) housing should be integrated with broader economic policy concerns, rather than treated as a social policy matter entirely. 'So my main message today is that housing matters for the economy, productivity and people's lives. Its impacts are far reaching' (Westacott 2012, p.1). She particularly focused on housing as a tool for enhancing productivity in the Australian economy, arguing that future living standards depended on lifting lagging productivity growth:

... appropriately located housing supply and a diversity of housing types is important for lifting economy-wide productivity by better matching people's skills with job opportunities where and when they arise. The Business Council of Australia recently looked at the barriers to delivering Australia's unprecedented pipeline of major investment opportunities. The availability, affordability and quality of housing was one of the top challenges raised for attracting talent (p.2).

Westacott offered 'four pillars' for improving the operation of housing markets in order to enhance Australian productivity and growth. The third pillar focuses on expanding the supply of affordable housing, supported by the attraction of large scale private investment. Her personal proposals in this context were:

- A common housing subsidy—matched by continuous capital investment.
- The supply and provider system shifting over time to one based around the community housing sector.
- Diversity of rent arrangements with a focus on cost recovery rather than income-based rents.
- A capacity to increase private sector borrowings and redevelop and renew housing estates. The UK experience was that 60–65 billion pounds of private sector capital went into social housing.
- More flexible and common-sense allocation policies which cater for a wider group of people and tackle the concentration of very disadvantaged people in some locations.

## **6.2 Strategic objectives**

The overall aim of this section is to propose steps towards expanding the supply of affordable rental housing financed by housing bonds attractive to institutional investors. Specifically, this aim requires the creation of a new asset class with low volatility characteristics in order to match the increasing appetite of superannuation funds and other institutional investors for debt securities of this type with the need of non-profit housing providers for low cost finance to meet the excess demand for affordable rental housing.



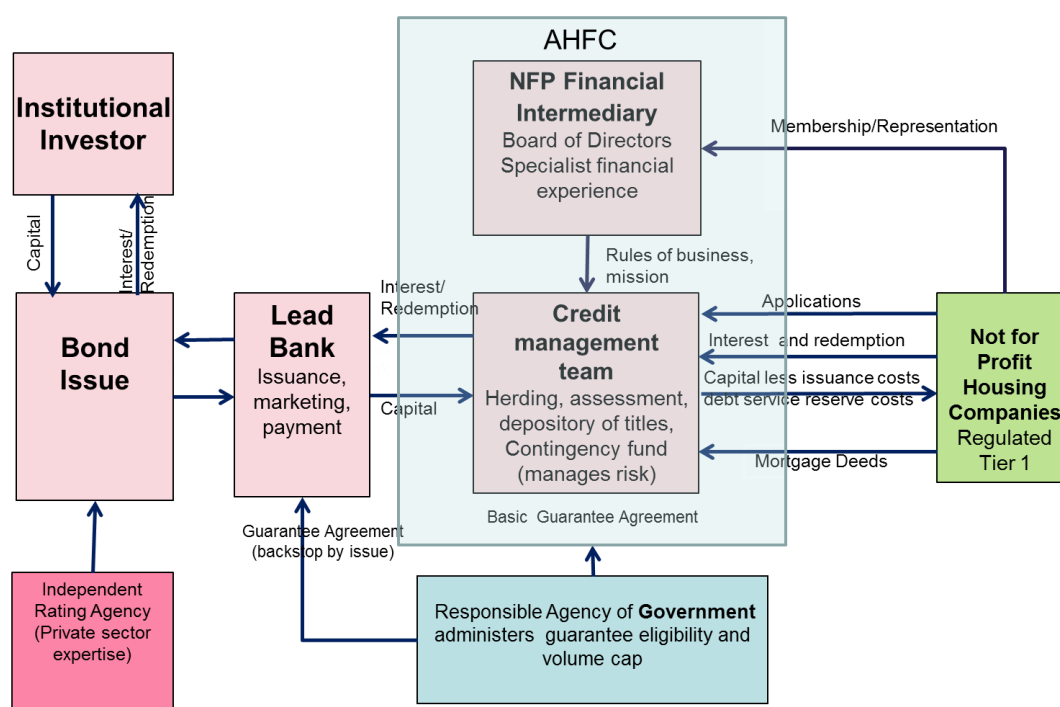
## 6.3 Options

Following the interviews and think Tank outlined in earlier sections of this report, and subsequent discussions with participants, the research team has developed two options for more detailed consideration. Each is discussed below.

### 6.3.1 Model A—Affordable Housing Finance Corporation

This model is based on the established Swiss approach outlined in the accompanying Positioning Paper (Lawson 2013). It became clear during the project Think Tank that the Swiss and new UK models were essentially the same. Figure 9 below provides a schematic representation of the key elements and linkages; note that the names of the boxes are indicative, the important points relate to the proposed functions and linkages, which are outlined in more detail below.

**Figure 9: Model A—Affordable Housing Finance Corporation (AHFC)**



The first step is the creation of an independent non-for-profit entity ('NFP Financial Intermediary' box) comprising an expert Board of Directors the majority of which are to be drawn from the financial sector. The 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 organisation 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 (see e.g. Chapter 1, Box 1 on the Swiss agreement). 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 maximises 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 (tier 1 and tier 2) of the non-profit housing sector in Australia;<sup>19</sup> the quality of the Financial Intermediary (The Board); the value of the individual properties backing the bonds. 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.

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:

1. a borrower defaults after other procedures and processes fail, and
2. the reserves held by 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.<sup>20</sup> 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

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<sup>19</sup> Tier 1 and tier 2 housing provider meet a range of criteria enshrined in the National Regulatory System. Both these classes of organisation 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.

<sup>20</sup> Such a reserve was used by the UK's THFC to convince HM Treasury of the very low risk of the guarantee to government.

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 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.<sup>21</sup>

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 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 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 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 10 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, 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 Australian Tax Office (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).

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<sup>21</sup> 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 Cooperative and negated any need to rely on government support.

Lawson et al. (2012) 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 3 presents an example using both capital grants, no-interest loan leveraged by high grade bond finance.

**Box 3: 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 = \$2400 p.a. for 10 years
+ \$1050 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 \$553 000 000 over 10 years (\$55 350 000 average per year) or \$508 160 000 PV. The grant component could be provided as a cash outlay or through stock transfer.

However, as the analysis in Chapter 2 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 per cent coupon rate plus amortised repayment of the no-interest loan by government over the 10-year period. 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.

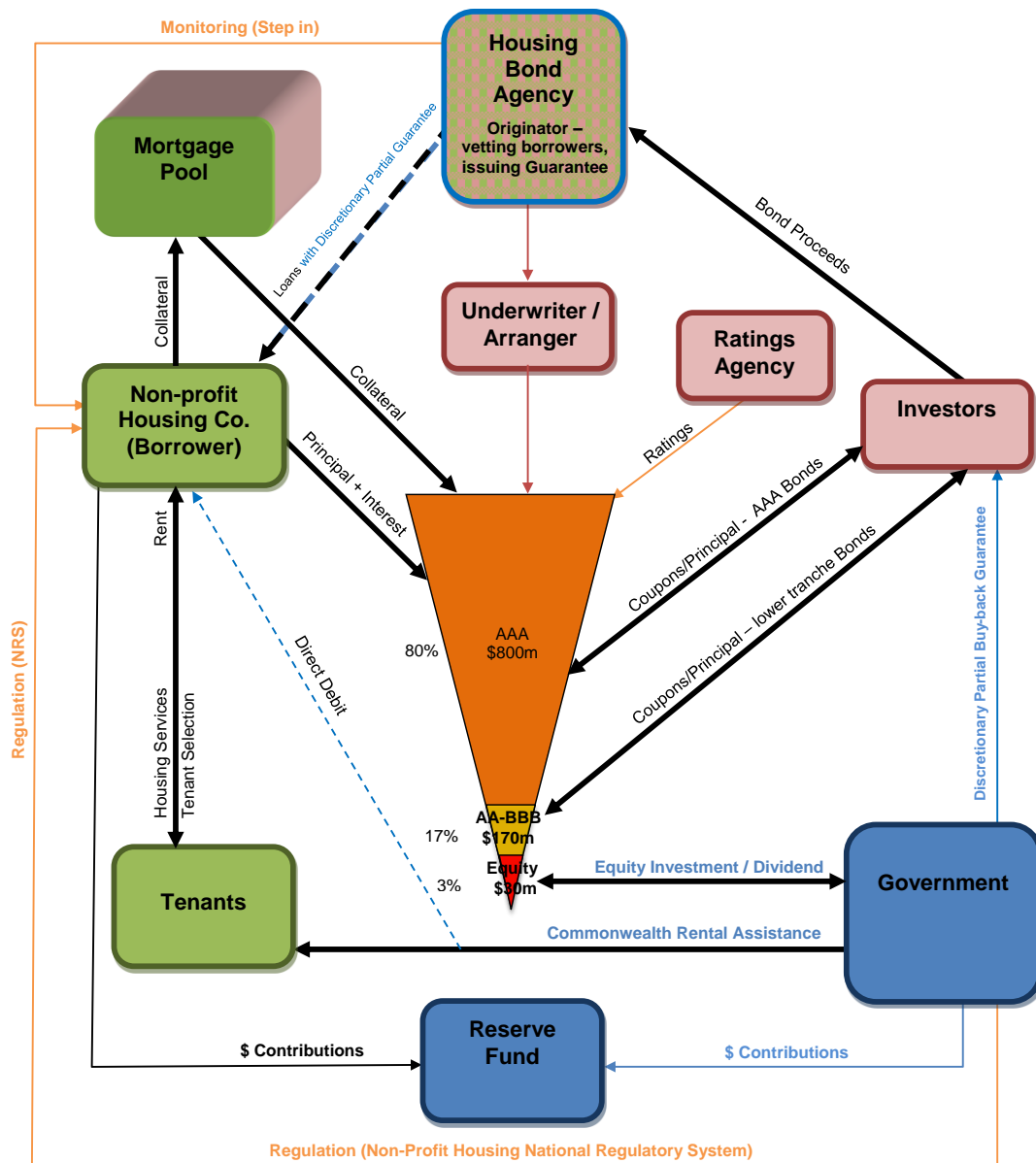
The period following the GFC illustrates how a combination of Nation Building funding, NRAS and selective stock transfer by state housing authorities can substantially boost private investment in affordable housing. Hopefully, Australia will not face a similar crisis soon but we can learn from that experience and engineer more benign ways of leveraging private investment into this sector.

### 6.3.2 Model B—Securitisation

This approach draws more centrally on the leadership of the financial sector in securing a large flow of private investment into highly rated housing bonds, using the established tool of securitisation. It responds to the finance industry’s tendency to ‘go with what they know’ and try to blend a new concept into an existing familiar construct. This model is a way to bridge the unknown when introducing a new asset class.

This structure is most commonly associated with combined pools of residential mortgages (RMBS) but here is pooling the debt of several affordable housing CHOs. A guarantee by government is not *required* in this instance but is replaced by direct equity and cash contributions to the scheme. However, partial guarantees could be factored in in order to reduce investor risk and required return; thereby reducing the coupon rate payable by borrowers and increasing further dwelling output. Figure 10 below outlines this approach; the proportions have been discussed with financial sector experts in the field but should be seen as indicative.

**Figure 10: Model B—Securitisation**



The inverted triangle represents a conventional securitised bond issue; the example assumes an overall investment of \$1 billion. Based on an equity tranche of \$30 million, bonds of two classes are issued, rated by an independent agency. Lower rated bonds form around 17 per cent of the structure with the highest rates AAA bonds (80%) supported by the equity and low rated bond tranches. This structure depends on the priority of returns to investors, with *all* holders of AAA bonds receiving their coupon payments *before any* payment is received by low rated (mezzanine) bond holders. Only when *all* bond holders have been paid are returns made to equity investors. In this way the relatively tiny proportion of high-risk equity is ‘magnified’ manyfold to underpin significant AAA loans to CHOs.

The bonds are backed by the housing assets secured by individual project loans. The rating of the bonds will depend on the agency’s assessment of the value of the dwellings securing the structure, the capacity of the borrowers (CHOs) to meet repayments and any credit enhancement provided by government. In the latter context, the model suggests that, following European examples (see Lawson 2013), government co-contributes, along with providers, to a reserve fund held in trust to cover possible default. This reserve fund can be drawn upon by the Housing Bond Agency to meet payments due while it steps-in and resolves problems with individual providers. In the event that this mechanism fails to ensure payments due to lenders, the structure empowers the repossession and sale of the mortgaged dwellings of the defaulting provider, with principle paid in the same strict order, all AAA holders first and so on down the line. Holders of top-rated bonds only suffer losses if and when the 3 per cent equity buffer is exhausted, followed by lower rated bonds and the realisation of the dwellings fails to fully repay their outstanding claims. Conversely, equity investors (government) only receive their full entitlement if no defaults occur.

Markets will price the relative risks assessed for each security class. Initial discussions with financial experts suggest that the required return to AAA bondholders would likely range in the 100–200 basis points above Commonwealth long-term bond rates and the equity tranche if held by private investors would require a return around 20 per cent. The mezzanine bonds would be priced in between these ranges. However, actual pricing would depend on the detailed structure developed and marketed. Early issues would inevitably entail a ‘novelty’ or new product premium on required returns, until competed away as markets became more comfortable with the product and its performance.

As the diagram demonstrates, this approach generates a very significant magnification effect. In the example, a government equity input of \$30 million generates private investment of \$800 million targeted at affordable housing provided by tier 1 housing associations. (The lower rated higher coupon bonds are taken up by private investors, including superannuation funds). However, government, under this approach, must also contribute to the reserve fund some agreed amount. Given the monitoring role of the National Regulatory System and the step-in powers of the Housing Bond Agency, this contribution is likely to be relatively small; international experience suggests an average corporate bond default rate by housing associations of less than 1 per cent, zero in countries like the UK. The 3 per cent equity stake of government may eventually be able to be sold to private investors once markets are able to assess the actual default rate of borrowers. Initially government may have to accept a significant discount rate on selling its equity stake. The more effective the protection provided by the national regulatory system and the larger the quarantined reserve fund covering potential default, the lower the expected default rate and the smaller the discount rate on equity realisation; if actual default rates track the Swiss and UK examples—that is, they are zero—government will realise a handsome profit on its investment, as indeed, the AOFM did in the wake of investing in maintaining the

residential mortgage backed securities market in the wake of the GFC. Alternatively, if actual developments instance ineffective regulation and/or an inadequate reserve fund so that defaults arise, the value of the equity tranche will evaporate and the cost of bond finance rise.

More importantly, government will still be required to contribute equity to providers, as in Model A. Indeed, because of the complex arrangements and fees structures of securitisation, Model B is likely to result in a higher cost of bond finance to providers, reducing their capacity to leverage. In other words, unless substantial efficiencies can be generated through structured finance, the loan-to-value ratio supportable by providers will fall, reducing somewhat the scale or magnification effect of this approach. In the UK case, prior to the introduction of the new guaranteed bonds, government was required to contribute around 40 per cent equity to housing associations borrowing the remaining 60 per cent from corporate bonds issued by the Housing Finance Corporation. Moreover, because of the magnification effect, substantially more dwellings can be financed under Model A, requiring a greater direct equity contribution, even at 20 per cent.

#### **6.4 Selected model**

Either of the approaches outlined in Models A, the Affordable Housing Finance Corporation, and B, Securitisation, could be developed and implemented in order to establish a housing bond regime in Australia targeted at expanding the supply of affordable housing through the non-profit housing sector. Each approach has advantages and disadvantages from the point of view of the key stakeholders—borrowers, lenders, and government. Most importantly, from the viewpoint of government, properly structured, both models have only limited impact on government financial statements. Table 10 summarises the remaining advantages and disadvantages.

**Table 10: Comparison of two options: Affordable Housing Finance Corporation and Securitisation**

	<b>Model A AHFC</b>	<b>Model B Securitisation</b>
<b>Borrower-CHO</b>		
Advantages	Lower interest cost Transparent Specialist expert intermediation Reinforces regulatory system Cost efficient fund raising	Magnification generates more debt funds therefore more housing built Financial sector accustomed to structure (via RMBS)
Disadvantages	Requires new agency Delay as financial sector becomes aware of structure Reluctance of government to supply guarantee	Necessity of structuring leads to higher transaction cost Higher borrower cost
<b>Lender/investor</b>		
Advantages	Comfort with government guarantee to address perception of risk Uncomplicated, as assessment performed by specialist and rated independently	Familiarity with product
Disadvantages	Sovereign risk	Unfamiliarity with rental sector High transaction costs
<b>Government</b>		
Advantages	Minimal impact on Budget with careful guarantee structure Expanded supply of affordable housing	Capital market discipline on providers Expanded supply of affordable housing
Disadvantages	Risk of call on guarantee	Greater requirement for government investment

On the basis of the advantages and disadvantages noted in Table 10 above and the input of interviewees and participants at the Think Tank, *the research team is of the view that Model A—the Housing Finance Corp—provides the best way forward in current Australian circumstances for the following reasons:*

1. It is relatively simple and transparent and can be harmonised with the new National Regulatory System for non-profit housing providers.
2. 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.
3. It minimises the impact on government budgets.
4. It provides lower cost of finance to providers, compared to the likely pricing of Model B and current bank finance and, hence over the medium to long run, is likely to maximise the expansion in the stock of affordable rental housing.
5. Following the preceding point, Model B requires a higher equity contribution by project sponsors, increasing the demand for government capital subsidies to non-



profit CHOs; the government equity grant to UK providers in the case of conventional bond finance averaged 40 to 50 per cent, falling to 20 per cent on the new guaranteed bond product (CEO, Housing Finance Corporation).

6. Properly structured and managed, Model A reduces to negligible levels the probability of the government guarantee being called.
7. Australia can draw on the successful experience and expertise of other countries.

## 7 IMPLEMENTATION AND CONCLUSIONS

The proposal for an Affordable Housing Finance Corporation (AHFC) comes at an ideal time as governments across Australia aim to increase institutional investment in productive and life enhancing infrastructure investments, such as affordable rental housing. It is clear that existing credit pathways are failing these ambitions. Australia's rapidly growing super funds are now coming forward with practical proposals to fill the gap.

The proposed AHFC model provides an industry informed approach which learns from international best practice. In some senses the proposal is not 'new' or novel. It is based on a simple and established model, which has been successful in a number of countries.

The AHFC model responds to current market conditions and identified barriers facing Australian providers of affordable rental housing and institutional investors and responds to their concerns with an appropriate way forward. The following section provides a road map for implementing the preferred mechanism or 'bridge' to substantially increase longer term, lower cost institutional investment in affordable rental housing in Australia.

### 7.1 Building on research evidence

Building on the relevant research findings outlined in this report, guarantees and intermediaries are considered to hold the key to steering large volumes of investment towards social and economic infrastructure, such as affordable rental housing, especially during a time of long-term credit scarcity and constrained public expenditure.

We know from earlier research that there is potential for improved conditions via the managed funds sector, yet there are barriers to be overcome. Institutional investment requires large scale investment opportunities (\$50–200 million upwards, accumulating to over \$1 billion), with an adequate risk-return profile and well established yields. Given the emerging status of affordable rental housing as an asset class, such investment would require more certain and long-term government support (Milligan et al. 2013).

This research re-confirms that heavy reliance on debt and commercial lending conditions are impeding the growth of the affordable rental sector. High cost, short term and extensive covenants, pose substantial refinancing risks to providers and undermine their capacity to build up equity (Tier 1 interviews, June 2013–January 2013, for this project).

The proposal for a suite of Housing Supply Bonds in 2012, which included AAA Housing Supply Bonds backed by government guarantee (Lawson et al. 2012) attracted positive interest from superannuation funds, as reported in the *Australian Financial Review* on 31 May 2012 (Hurley & Wilmot 2012).

This report has identified specific enhancements to attract institutional investment. It demonstrates that Australia has an established Commonwealth policy on the use of guarantees, but to date has limited the scope of its implementation. This policy and its guidelines, aim to facilitate investment to meet economic and or social policy commitments. However, to date, the policy has not been used to support investment in affordable rental housing. There are also Commonwealth policies to expand Australia corporate bond markets and longer term debt, to align with infrastructure investment needs and investor demands. Most recently, the Coalition Government has expressed interest in publicly supported private finance mechanisms to boost

investment in infrastructure, involving guarantees. Such policy initiatives and proposals strongly align with proposals for affordable housing investment outlined in this report.

Interviews conducted for this study reveal administrative reluctance to use government guarantees and very limited professional experience in their design and use. Discussions with key stakeholders throughout the second half of 2013 developed an awareness of the growing use of guarantees in other countries and of their relative efficiency when compared with the cost of direct expenditure or reliance on purely market models. Research findings confirm that guarantees and financial intermediaries can play a very positive role establishing a much more robust investor market for affordable rental housing, improving financing terms and conditions and ensuring funds are well targeted to expand new supply of housing for eligible households. Guarantees not only make existing public funds go further by reducing financing costs, their expert assessment and the reserve funds they accumulate ensure the likelihood that any call is minimised. As shown in the Swiss and UK examples, the likelihood of default has been close to zero.

Bi-partisan interest in channeling investment, and funds managed by the superannuation sector in particular, towards Australia's infrastructure needs has enhanced the political feasibility of well-targeted guarantees for investment in affordable rental housing.

## **7.2 Applying key principles**

This report has drawn on a wealth of international best practice and local industry advice regarding how such a mechanism could work in the Australian housing and investment context.

The guiding principles distilled from international experience in the use of guarantees for affordable housing (Lawson 2013), directly inform the design of the proposed Affordable Housing Finance Corporation (AHFC model). These principles concern the establishment of clear boundaries for applying the guarantee and stakeholder commitment to a sustainable business model via professionally managed CHOs. Further specialist expertise in financial intermediation is necessary to assess and vet applications for guaranteed funds. Pooling will also be required to reach a sufficient scale of bond issues, alongside government commitment to a pipeline of investments, which together promote the establishment of a robust investor market. Most importantly for government, the guarantee needs to be structured in a way that has several lines of defence against default, using expert resources to assess risk and build up sufficient reserves to cover agreed loss sharing arrangements.

The following Table 11 outlines how the Affordable Housing Finance Corporation will put these principles into practice.

**Table 11: Putting principles into practice with the AHFC**

Principles	Affordable Housing Finance Corporation Practice
Boundaries	<ul style="list-style-type: none"> <li>→ Targeted to investments in affordable rental housing for low and moderate income households.</li> <li>→ Allows for differentiation of targets to meet regional needs and policy goals (e.g. sustainability, inclusion, renewal, key worker)</li> <li>→ Contestable, competitive allocation of guarantee certificates to promote transparency, innovation and efficiencies, between Tier 1 CHOs and strong Tier 2 CHOs with consolidating development expertise.</li> <li>→ Defined and regular process for competitive allocation of guaranteed bonds, underpinning a pipeline of investment opportunities and justifying long-term investor interest.</li> <li>→ Clear debt coverage ratios for project-related borrowing to protect investors and borrowers, informed by specialist understanding of CHO business models.</li> <li>→ Guarantee agreement defining overall volume cap (and hence contingent liability) for government, providing a pipeline and giving certainty to investors.</li> <li>→ Guarantee only provided separately on each issue up to an agreed cap for an agreed period, maximising incentives for individual borrowers to meet their commitments.</li> <li>→ Long term policy commitment to co-financing and revenue arrangements to provide equity and secure revenue.</li> </ul>
Lowering risk	<ul style="list-style-type: none"> <li>→ Addresses investor information asymmetry by the AHFC providing specialist credit assessment expertise to ensure CHOs have sufficient equity and revenue base to service debt, before any investment is made.</li> <li>→ Investors' commitments are protected by government guarantee, which in turn is backed by credit assessment expertise of financial intermediary, credit assessment of rating agency, maturity of successful CHOs, monitoring and step-in powers of regulatory systems and the reserve funds accumulated by the intermediary (see below).</li> <li>→ Ensures that the likelihood of default is minimised, preventing any call on the back stop role provided by government.</li> <li>→ Promotes excellence and efficiency in regulation.</li> <li>→ Draws on but does not duplicate regular professional reports to National Regulatory System and state-based regulatory systems.</li> <li>→ Builds effective links with RSs to provide early warning systems to AHFC and makes use of their provisions to enforce compliance.</li> </ul>

<b>Principles</b>	<b>Affordable Housing Finance Corporation Practice</b>
Transparency and commitment	<ul style="list-style-type: none"> <li>→ Commitment by government to provide adequate equity and revenue support to not-for-profit, below market rent providers of rental housing, including the establishment of equity support (grant, public loan, planning contribution) and refinements to improve adequacy of CRA and NRAS.</li> <li>→ Strongly promotes government commitment to an enforceable and appropriate regulatory system, appropriate NRAS and ATO rules.</li> <li>→ Clearly defined guarantee, offering investors the full faith and credit of the government.</li> <li>→ Appropriate joint marketing strategy by all stakeholders involved.</li> </ul>
Expert intermediary	<ul style="list-style-type: none"> <li>→ Establishment of an independent AHFC, governed by an expert Board of Directors, served by a professional credit management team.</li> <li>→ Not-for-profit intermediary efficiently managed to reduce fees and commissions charged to both investors and borrowers.</li> <li>→ Vets and herds CHO investment needs, assesses proposals and their risks.</li> <li>→ Has financial expertise to manage the assessment, pooling, rating and issuance process.</li> <li>→ Builds up sufficient reserves to cover potential and unexpected contingencies, while maximising cost efficiencies for investors and borrowers.</li> <li>→ Works closely with RSs to enforce compliance among borrowers, and provide early warning to AHFC.</li> </ul>
Scale and frequency	<ul style="list-style-type: none"> <li>→ Pooling converts multiple smaller borrowing demands to achieve efficient scale for investors.</li> <li>→ Regular bond issues to sustain market interest.</li> <li>→ Bond issues are individually rated.</li> <li>→ Lead banks, with expertise in bond issues, bring issues to market and facilitate liquidity of bonds.</li> </ul>
Adequate structure	<ul style="list-style-type: none"> <li>→ Last resort government guarantee reduces investment costs and offers investors full guarantee of principle and coupon in the event of default.</li> <li>→ Guarantee agreement identifies trigger points for an early warning system to prevent defaults, harmonised with RSs.</li> <li>→ AHFC builds up two reserve funds via pass through of the capital loan to CHOs and a premium on the interest paid.</li> <li>→ Guarantee is only drawn on following the exhaustion of AHFC funds and CHO debt recovery process.</li> </ul>

### **7.3 Commitment and leadership**

Government leadership is critical in generating momentum in this field; this is, perhaps, the major finding from our international review of best practice. Current policy settings and financial market conditions have prevented to date any real progress on the attraction of large scale, low cost private finance to boosting the supply of affordable housing in Australia. Debate and rhetoric have replaced action in this space since Judith Yates first raised the idea of equity bonds as part of the Housing Policy Review by the Commonwealth in the late 1980s. Australian governments and housing agencies have committed to leveraging private finance to this policy purpose since the mid-1990s; almost 20 years later the housing policy community is still debating how to do it. International evidence clearly shows that significant volumes of private investment can be drawn on to expand housing but only if and when appropriate government policies provide the right incentives and information to investors and the latter trust that government commitments will be honoured over the long term. (Lawson (2013) provides the latest in a long line of AHURI and other studies establishing this incontrovertible fact; Westacott (2012) notes that around £65 billion of private investment has financed the substantial growth of the non-profit housing association sector in the UK since the mid-1980s.)

An Affordable Housing Finance Corporation (AHFC) depicted in Model A, as argued in Chapter 5, depends on the continued flow of recurrent Commonwealth subsidies and also the provision of a growth fund to support the housing providers' equity base, a precondition for leveraging bond finance to acquire and manage new dwellings let at sub-market rents to eligible tenants currently struggling to access adequate housing in the private market. The growth fund could comprise cash commitments by the Commonwealth and the transfer by states and territories of appropriate land or public housing with capacity for redevelopment. The major policy goal is to increase the supply of affordable rental housing, not merely rearrange ownership of current stock.

### **7.4 Implementation**

A successful launch of an AHFC would, over time, create a new debt asset class for all investors seeking high rated bonds, since they would be priced at full market value; that is, the bonds would be priced to deliver appropriate risk-adjusted returns. In the first instance, however, they would likely be targeted at the industry superannuation funds and other investors whose social values align with the subsidiary benefits delivered by non-profit housing providers using the bonds to deliver affordable housing. Given the financial and legislative context within which these funds operate, they must approach 'impact investing' on a 'financial first' basis; that is, their investment mandate can include the pursuit of subsidiary benefits like expanding affordable housing opportunities, but only if the financial returns are commensurate with the risks assessed. (For a discussion of the distinction between financial-first and impact-first investing, see Charlton et al. 2013). As such, housing bonds would be clearly different from—and branded differently from—impact-first, ethical products.

Implementing Model A's AHFC would require a number of elements and a degree of policy leadership by government, ideally based on a formal agreement between the Commonwealth and the states and territories, perhaps through a COAG-style arrangement, resulting in a new or amended National Affordable Housing Agreement.

### 7.4.1 Practical steps forward

Steps towards developing in detail and implementing the AHFC are outlined in Table 12 below.

**Table 12: Key implementation steps and their responsible stakeholders**

<b>Key stage</b>	<b>Implementation tasks</b>	<b>Responsible stakeholders</b>
1. Creation of AHFC as a financial intermediary	Creation of a taskforce, chaired by a senior financial sector professional, jointly funded by the Commonwealth, industry superannuation sector, ACTU and the residential property sector peak associations. The Taskforce would be charged with creating and funding the corporate entity within the relevant legal form (the Financial Intermediary and Credit Management organisation depicted in Figure 1, hereafter termed 'the Corporation').	Leadership provided by Commonwealth DSS in establishment of Task Force of key financial and legal experts and resourced by relevant stakeholders as identified in tasks.
2. Overarching guarantee agreement	The Corporation would negotiate and sign an overarching agreement with government(s) offering an issue-specific default guarantee on bonds issued by the Agency. Government would need to give a clear commitment to continuity of funding eligible tenants via CRA, etc. and the term of the guarantee, so that potential investors can be confident of a pipeline of future bond issues.	AHFC with Commonwealth DSS and participating SHAs
3. AHFC Board establishes administration	The Corporation would establish its mission and strategic plan and recruit relevant expert and ancillary staff.	AHFC Board
4. Administers market scan	The Corporation would then carry out a market scan, identifying the potential borrower-provider and lender universes.	AHFC staff
5. Aggregates demand and bond rating	The Board of the Corporation would oversee the establishment of procedures for aggregating and assessing borrower demand and establishing procedures for issuing rated bonds.	AHFC Board, staff and Rating Agency
6. Reserve funds	The Corporation would establish internal procedures for creating borrower-specific and general reserve funds, as per the Model structure.	AHFC Board, staff and participating borrowers
7. Bond Issuance	The Corporation would engage specialist assistance (Lead Bank) to market the initial issue and establish a brand presence in investment markets.	AHFC staff with Lead Bank

## **7.5 Conclusion**

The proposed model, grounded in extensive national research of industry stakeholders and successful international experience, forges a new funding pathway to institutional investment in affordable rental housing, via regulated Community Housing Providers in Australia.

The AHFC Model overcomes many of the barriers cited by institutional investors, by offering suitable investment opportunities at an appropriate scale, simplicity and risk weighted return. The AHFC facilitates the Australian Government's commitments 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.

An independent and specialist intermediary with expert capacity to issue bonds with a guarantee, strengthens the AHFC Model. It also aligns with the government's aim to develop deeper, longer term bond markets in general. With strong government leadership and expert and adequately resourced implementation, the AHFC can strengthen Australia's housing choices and build a stronger, more secure, more equitable and more efficient rental housing market.



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# APPENDICES

## Appendix 1: Industry consultation

**Table A1: International contributors and interviewees**

<b>International expert</b>	<b>Position and organisation</b>	<b>Country or region</b>
Mr Stuart Broom	Specialist, European PPP Expertise Centre, European Investment Bank	Europe
Ms Catherine Aubey-Berthelot*	Director General, French Mutual Fund for Guarantees of Social Housing (CGLLS) and staff*	France
Mr Jean-Pierre Schaeffer*	Special Adviser to the National Council of Cities and former Chief Economist for the CDC	France
Ms Nathalie Gay-Guggenheim*	Managing Director, COO Global Markets, HSBC Bank	France
Dr Michelle Norris*	Chair of the Board, Housing Finance Agency	Ireland
Mr Barry O'Leary*	Chief Executive Officer, Housing Finance Agency Plc	Ireland
Mr Brad Gilbert*	Head of Financial Innovation at the Scottish Government	Scotland
Dr Peter Gurtner*	Chair EGW, Swiss Bond Issuing Cooperative*	Switzerland
Mr Dario Laterza*	Issuance, Debt Capital Markets, Zürcher Kantonal Bank	Switzerland
Mr Victor Schaap*	Director of Housing Markets, Department of Housing Corporations, Ministry of Internal Affairs	The Netherlands
Mr Erik Terheggen*	Manager of Policy and legal affairs, Social Housing Guarantee Fund (WSW)	The Netherlands
Mr Stephen Stringer*	Deputy Director, Expanding the Rented Sector Programme, Department for Communities and Local Government	UK
Dr Peter Williams	Director, Cambridge Centre for Housing and Planning Research	UK
Mr Piers Williamson*	CEO, The Housing Finance Corporation	UK



**Table A2: Australian contributors and interviewees\***

<b>Australian expert</b>	<b>Position and organisation</b>	<b>National or state focus</b>
Mr Hamish McDonald*	General Manager, Infrastructure Division, Federal Treasury	National
Dr Jeff Harmer AO*	Chair of the Advisory Group for the Australian National Disability Insurance Scheme, Chair of the Advisory Committee for the Reform of the Australian Government's Housing Assistance Programs and a member of the Australian Government's Social Inclusion Board. Former Director General, FaHCSIA	National
Ms Carol Croce*	CEO Community Housing Federation of Australia	National
Mr Bruce Bonyhady AM*	Chair, National Disability Insurance Scheme	National
Mr Bryan Palmer	Group Manager, Housing and Homelessness, FaHCSIA/ DSS	National
Ms Kathryn Mandla	Manager of Housing Affordability Programs Branch including National Rental Affordability Scheme, Department of Social Services	National
Mr Ian Learmonth*	Social Ventures Australia	NSW
Mr Rick Sodalini*	Executive Director, Education, Families and Communities Branch, NSW Treasury	NSW
Dr Stephen Nash*	Head of Research, Fixed Income Investments Group	NSW
Mr Ray Wilson*	Director, Plenary Group	NSW
Dr Owen Donald*	Chair, National Housing Supply Council	National
Dr Alex Dordevic*	Manager Strategy, Department of Human Services, Victorian Government	Victoria
Dr Marcus Spiller	Director, SGS Consulting	National (Vic)
Mr Saul Eslake*	Chief Economist Bank of America, Merrill Lynch. Member of (former) National Housing Supply Council	National (Vic)
Mr Damian Maloney*	CEO, Frontier Advisors	National (Vic)
Mr Mike Wyrsh*	Senior Consultant, Frontier Advisors	National (Vic)
Ms Anna Hughes*	Director Sovereign Ratings Team, Standard and Poor's	National (Vic)
Mr Anthony Walker	Sovereign Ratings Team, Standard and Poor's	National (Vic)
Mr Tom Garcia*	CEO, Australian Institute of Superannuation Trustees	National (Vic)
Mr Daniel Berger*	Investment Manager, Australian Super	National (Vic)

<b>Australian expert</b>	<b>Position and organisation</b>	<b>National or state focus</b>
Mr Brett Chatfield*	Investment Manager, Public Markets, CBUS Superannuation Fund	National (Vic)
Mr Peter Keogh*	Senior Advisor, Corporate Affairs, CBUS Superannuation Fund	National (Vic)
Mr Robin Miller*	Global Head of Debt Investments, IFM Investors	National (Vic)
Mr Bruce Potts*	Investment Director, IFM Investors	National (Vic)
Mr Tony Beck*	Group Executive, ME Bank	National (Vic)
Mr Nick Vamvakas*	Chief Risk Officer, ME Bank	National (Vic)
Mr Nick Edwards	Division Director, Macquarie Group	National (Vic)

Note: \* Interviews.

Nine tier 1 CFOs and CEOs of housing associations were also interviewed regarding their borrowing conditions and later consulted on draft sections of this final report. Their names are not recorded here, for details of type see Section 2.3.

**Table A3: Interview topics addressed**

<b>International stakeholder interviews</b>	<b>Australian stakeholder interviews</b>
→ models of housing investment guarantees, their ownership and risk sharing	→ public finance norms and guidelines with regard to public guarantees
→ start-up and on-going sources of funds	→ historical cases of the use of public guarantees in other fields
→ financial limitations (i.e. cost covering, non-profit)	→ perspectives on the potential role of any guarantee to channel lower cost investment towards social housing
→ relationship with government (private, public, sector-owned)	→ perceived need for an SHG by those requiring and providing funds
→ target group for certified loans (affordable ownership, rental etc.)	→ specific projects/development stages which would be assisted by a guarantee
→ role in financial mentoring, and their impact on the cost of investment in affordable rental housing	→ potential frameworks for assessing project eligibility and assessing creditworthiness for receiving guarantee certificates
→ models of funding operations and obligations	→ expertise and capacity to perform such assessments
→ asset rating by external ratings agencies	→ accountability
→ accounting and impact on public accounts	→ implementation and management issues
→ impact of guarantee on the cost of funding social housing	→ matching with current regulatory developments
→ independent evaluation of impact	→ risk allocation issues (including policy risk and political interference)
→ cost benefits compared to other forms of investment enhancement	→ potential framework for potential costs of a guarantee
→ financial monitoring and certification of guarantees provided.	→ funding of any potential claims made under the guarantee
	→ sharing of fund costs and benefits
	→ comparison of these costs with other forms of investment enhancement (tax breaks, direct grants).

**Table A4: Research Team and International Guest Speakers involved in Think Tank**

<b>Organisation</b>	<b>Research Team/ International Presenter</b>
Swiss Bond Issuing Cooperative	Dr Peter Gurtner Chair, Swiss Bond Issuing Cooperative (EGW)
The Housing Finance Corporation (UK)	Piers Williamson CEO, The Housing Finance Corporation (UK)
RMIT	Dr Julie Lawson, Hon. Assoc. Professor, RMIT AHURI (project leader)
RMIT	Dr Mike Berry, Emeritus Professor, RMIT AHURI
RMIT	Carrie Hamilton, Associate, Housing Action Network
UNSW	Hal Pawson, Professor, UNSW City Futures

Note: Hosted by Australian Super, 29 October 2013

**Table A5: Think Tank participating members**

<b>Organisation</b>	<b>Representative</b>
Australian Super	John Hopper, Head Fixed Income, Australian Super
Australian Super	Dan Berger, Investment Manager, Australian Super
CBUS	Brett Chatfield, Investment Manager, Public Markets, CBUS
CBUS	Peter Keogh, Senior Advisor, Corporate Affairs, CBUS
CHFA	Carol Croce, Executive Director, Community Housing Federation Australia (CHFA)
Commonwealth Treasury	Hamish McDonald, Principal Advisor, Infrastructure Division, The Treasury
Department of Social Services (formerly FaHCSIA)	Kathryn Mandla, Branch Manager, Housing Affordability Programs, Department of Social Services
IFM Investors	Lillian Nunez, Associate Director, IFM Investors
Industry Super	Dr Sacha Vidler, Chief Economist, Industry Super
Macquarie Group	Nick Edwards, Division Director Debt Markets, Macquarie (Melbourne)
Mission Australia	Cameron Robertson, Head of Corporate Finance and Treasury, Mission Australia
NSW Housing	Leonie King, Executive Director, Community and Private Market Housing Directorate, Housing NSW
Power Housing	Joe Sheehan, Head of Funding and Projects, Community Sector Banking, Melbourne
S&P	Anthony Walter, Senior Director Corporate and Government Relations, Standard and Poor's
WA Department of Housing	Graeme Searle, Director General, WA Housing
WA/CBRE	Ashley Kerfoot, Director, Structured Transactions & Advisory Services CBRE for WA Housing

## **AHURI Research Centres**

AHURI Research Centre—Curtin University

AHURI Research Centre—RMIT University

AHURI Research Centre—Swinburne University of Technology

AHURI Research Centre—The University of Adelaide

AHURI Research Centre—The University of New South Wales

AHURI Research Centre—The University of Sydney

AHURI Research Centre—The University of Tasmania

AHURI Research Centre—The University of Western Australia

AHURI Research Centre—The University of Western Sydney

Australian Housing and Urban Research Institute

Level 1, 114 Flinders Street, Melbourne Victoria 3000

Phone +61 3 9660 2300 Fax +61 3 9663 5488

Email [information@ahuri.edu.au](mailto:information@ahuri.edu.au)

Web [www.ahuri.edu.au](http://www.ahuri.edu.au)