



*Final Report*

# **Housing Supply Bonds—a suitable instrument to channel investment towards affordable housing in Australia?**

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## ACRONYMS

AAA	Long Term Prime Grade credit rating assigned by ratings agencies Standard & Poor's and Fitch
ABS	Australian Bureau of Statistics
ACT	Australian Capital Territory
ACTU	Australian Council of Trade Unions
ADI	Authorised Deposit-taking Institutions
AFMA	Australian Financial Markets Association
AHS	Affordable Housing Solutions
AHURI	Australian Housing and Urban Research Institute
AIHW	Australian Institute of Health and Welfare
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
BBB	Lower medium grade credit rating Assigned by ratings agency Standard & Poor's and Fitch
BBSW	Bank Bill Swap Rate
b	Billion
bp	Basis Points (100 basis points equal 1%)
CBA	Cost benefit analysis
CBUS	Construction Building Industry Superannuation Fund
CDC	Caisse des Dépôt et Consignations (France)
CHFA	Community Housing Federation of Australia
CHFV	Community Housing Federation Victoria
CHP	Community Housing Provider
COAG	Council of Australian Governments
CRA	Commonwealth Rent Assistance
CSHA	Commonwealth State Housing Agreement
EURIBOR	European Bond Rate
FaHCSIA	Department of Families, Housing, Community Services and Indigenous Affairs
FIIG	Fixed Income Investments Group
GFC	Global Financial Crisis
HCCB	Housing Construction Convertible Bonds (Austria)
HERA	Housing and Economic Recovery Act 2008 (US)
HHPRWG	Housing and Homelessness Policy and Research Working Group

HMAC	Housing Ministers Advisory Committee
HSB	Housing Supply Bond
IIBW	Institute of Real Estate and Housing
LIHTC	Low Income Housing Tax Credit (US)
LPHA	Limited profit housing association
LVR	Loan-to-value ratio
MRB	Mortgage Revenue Bond
NAHA	National Affordable Housing Agreement
NHSC	National Housing Supply Council
NPP	National Partnership Agreement
NRAS	National Rental Affordability Scheme
NSW	New South Wales
RBA	Reserve Bank of Australia
RMBS	Residential Mortgage Backed Securities
RSL	Registered Social Landlord (UK)
SA	South Australia
SIB	Social Impact Bonds
SEWPAC	Department of Sustainability, Environment, Water, Population and Communities
SHA	State Housing Authority
SHI	Social Housing Initiative
SMSF	Self-managed superannuation fund
SPV	Special purpose vehicle
THFC	The Housing Finance Corporation (UK)
UK	United Kingdom
US	United States of America
WA	Western Australia
WSW	Waarborgfonds for Social Woningbouw (Guarantee Fund for Social Housing—The Netherlands)

## EXECUTIVE SUMMARY

The aim of this study is to develop a special purpose financial instrument, identified in this report as Housing Supply Bonds, to finance the supply of affordable rental housing in Australia. It builds on international research evaluating alternative mechanisms to channel private investment towards affordable rental housing and focuses specifically on the well-established and successful bond mechanism that is used in Austria as a catalyst for development of an appropriate mechanism for Australian conditions.

To fulfil the aim of the research, the report addresses the following key research questions:

- What would be appropriate terms and conditions for an Australian Housing Supply Bond, to ensure that it is attractive to investors and raises sufficient low cost funds for borrowers?
- What type of financial intermediary would sell the bonds and how would funds raised be made available for approved projects?
- What type of institutional conditions and regulatory arrangements would ensure funds raised are channelled to the intended purposes?
- What other actions would be required to ensure success of this mechanism?

The research process involved extensive consultation with a wide array of stakeholders in Australia, including institutional investors, regulators, public finance specialists, housing providers and public policy officials. The outcomes of these consultations informed a draft proposal for a financial intermediary and suite of Housing Supply Bonds for Australian conditions. This draft proposal was developed in collaboration with international experts from Austria and Australian industry partners. It was tested in a one-day workshop with the expert advisors, stakeholders and academics with relevant expertise. A public seminar provided a wider audience with the opportunity to engage with the visiting international experts, and to ask questions about, and comment on, the emerging outcomes of the project. A more refined proposal was subsequently discussed with the Housing and Homelessness Policy and Research Working Group of officials, a standing committee of the Housing Ministers Advisory Committee, and other key government and industry stakeholders at their invitation.

The proposal for Australian Housing Supply Bonds outlined in Chapter 4 of this report presents the outcomes of this process. It complements other relevant policy discussions in the fields of financing social infrastructure, social bonds and growing Australia's corporate bond market and has received wide cross sector interest. The negotiations for a revised National Affordable Housing Agreement (NAHA) that are proceeding throughout 2012 provide an opportunity to capitalise on this positive synergy and take the proposal forward.

### Focus and justification

*Chapter 1* provides an overview of factors that have contributed to the need for an appropriate instrument and financial intermediary to finance the supply of affordable rental housing in Australia. First, housing markets have failed to deliver sufficient affordable stock to meet the needs of lower income households. Second, the increasing proportion of households unable to access home ownership has put pressure on a declining supply of affordable rental housing. Third, social housing supply has been unable to keep pace with demand, despite recent initiatives. Current

levels of funding cannot generate the required increases in the supply of affordable rental housing. Analysis shows that an additional 20 000 dwellings per year for 10 years would be required to return social housing to its 1996 share of the housing market.

While the Social Housing Initiative under the National Building and Jobs Plan (2008/09–2010/11) and the National Rental Affordability Scheme (NRAS) (2008/09–2015/16) have paved the way for new forms of partnership for financing and delivering affordable housing, the high cost of commercial loans to non-government housing providers limits their capacity to grow and reduces the utility of these public subsidies. Many organisations with NRAS allocations have been unable to obtain private finance at any cost. Additional measures are required to channel and sustain adequate levels of private finance to achieve supply targets.

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

The proposal for Housing Supply Bonds outlined in this report is consistent with these various developments and represents the first proposal for a financial instrument specifically targeted at affordable rental housing.

## **International research and the relevant experience of Austrian Housing Construction Convertible Bond (HCCB)**

*Chapter 2* of the report reviews international experience with the range of financial instruments governments use to steer investment towards affordable rental housing. It describes in some detail the features of one of the most successful mechanisms identified in previous research, the Austrian Housing Construction Convertible Bond (HCCB), which for two decades has delivered adequate, affordable and secure rental housing in one of Europe's most stable and affordable housing markets, as well as playing an important role as an economic stabiliser in that country.

The experience of federated Austria's HCCB and its sustained role in supplying low cost investment to a well regulated affordable rental housing sector is of potential relevance to Australian conditions. It suggests that an appropriate bond instrument, sufficiently backed by government, can attract a range of investors and keep the role of investor and provider at arm's length. Lower gross yield can be achieved via a modest tax incentive and/or a guarantee, increasing effective returns and providing a pool of cheaper funds to be passed on to the affordable housing sector. Funds raised by private bonds can meet clearly defined policy targets if loans are made available only for publicly approved projects. Under appropriate intergovernmental arrangements, Australian states and territories can continue to play an important role designing programs to respond to regional circumstances, as occurs across Austria's nine provinces.

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

## Adapting and testing the HCCB concept under Australian conditions

In depth consultation with a wide range of stakeholders provided information on the adaptations needed to develop a housing bond for the Australian, rather than Austrian, institutional environment. The consultation process substantially increased awareness of the concept and enabled consideration of the practical implications of housing bonds. This catalysed the design of an appropriate instrument for Australian conditions. Chapter 3 provides a detailed overview of the responses provided to the four research questions indicated above. These are summarised in Table 1.

**Table 1: Summary of responses by research questions**

<i>Terms and conditions of HSB?</i>	<ul style="list-style-type: none"> <li>→ A straight forward, low risk, low yield and long-term instrument required to provide cheapest funds.</li> <li>→ Enhancement required to reduce risk and enhance low yield.</li> <li>→ Tax incentives need to be devised so they are equally valuable to those with high and low tax rates.</li> <li>→ Guarantees are very interesting for low risk long-term investors—insurance funds, certain portfolios of super funds, banks, retail investors.</li> </ul>
<i>Financial intermediary?</i>	<ul style="list-style-type: none"> <li>→ To pool funds for scale.</li> <li>→ Specialist knowledge of sector.</li> <li>→ Special purpose vehicle to issue bonds, linked to CHO loan obligations.</li> <li>→ Optional forms: public, not-for-profit, for-profit.</li> </ul>
<i>Regulatory requirements?</i>	<ul style="list-style-type: none"> <li>→ Beyond benchmarks, ensure sector regulation meets investor standards.</li> <li>→ Strengthen financial capacity of providers and reduce risks to lenders.</li> <li>→ Use to promote innovation, collaboration and solutions rather than impede growth.</li> </ul>
<i>Related requirements?</i>	<ul style="list-style-type: none"> <li>→ Capacity to repay based on revenue stream.</li> <li>→ Rent assistance and eligibility policy critical.</li> <li>→ Long-term and consistent policy vision by governments.</li> <li>→ Facilitative planning and land supply to reduce development risk.</li> </ul>

## An appropriate mechanism for Australia

A concrete proposal for Australian Housing Supply Bonds (HSBs) is put forward in Chapter 4, with recommendations covering an appropriate financial intermediary, marketable terms and conditions for a suite of bond instruments, regulatory requirements and complementary reforms. This proposal builds on international experience and on the insights obtained from the consultation undertaken within

Australia. It is designed to complement existing and possible future funding arrangements in the affordable housing system.

The first recommendation concerns the establishment of an appropriate specialist financial intermediary. Its role is to link suppliers of capital with appropriate investment opportunities and to create aggregation benefits and efficiencies through lower transaction and search costs. Such an intermediary would possess specialised knowledge of the not-for-profit housing industry and be able to critically assess its business model and adherence to regulatory requirements. This knowledge would develop further efficiencies by strengthening financial management practices across that sector. An intermediary would be able to pool loan demands and ensure a smooth pipeline of projects and funding. It would provide a credible source of information to investors and providers concerning investment risk and likely returns.

A further role of the financial intermediary could be to assist in making providers 'investment ready'. It would provide access to funds for smaller players, thereby helping to maintain diversity in models of provision and help promote greater competition within the industry. The activities of the intermediary could be limited and steered in such a way as to contribute towards stability in housing and finance systems, such as via appropriate counter cyclical activity, as occurs in Austria. International experience suggests that there are a variety of models for a financial intermediary. Examples discussed in the report are the Guarantee Fund for Social Housing in the Netherlands, The Housing Finance Corporation in the UK and the Housing Banks in Austria. A not-for-profit specialist intermediary is likely to be more cost effective. This can be newly formed or build on one of those that have formed recently to facilitate access to funds.

A second recommendation relates to the marketable terms and conditions for housing bonds that this specialist intermediary would issue. A suite of HSBs is recommended with each bond type having risk and return characteristics and enhancements that are designed to attract different potential investors. The characteristics and enhancements of the proposed three types of HSBs are summarised in Table 2.

As shown in Table 2, three cost reducing enhancements are proposed matched to each investor segment:

1. Government support through the NAHA Growth Fund—via subordinated long-term zero interest loans—to provide collateral to underpin bond issues.
2. Additional support to fund a contingent liability fund covering the guarantees on AAA Housing Supply Bonds.
3. Tax concessions to investors in Tax Smart Housing Supply Bonds.

Whatever form of intermediary is developed, an important condition is that the intermediary, the bonds and the housing providers obtaining loans, are subject to appropriate financial regulation. Such regulation is required to ensure that: the intermediary is appropriately capitalised (or guaranteed); that funds raised by bonds issued are held in trust to ensure they are used for their intended purpose; that housing providers have the requisite management and financial skills; and that investors are aware of the characteristics of the bonds they are purchasing.

**Table 2: Target markets for HSBs and proposed enhancements**

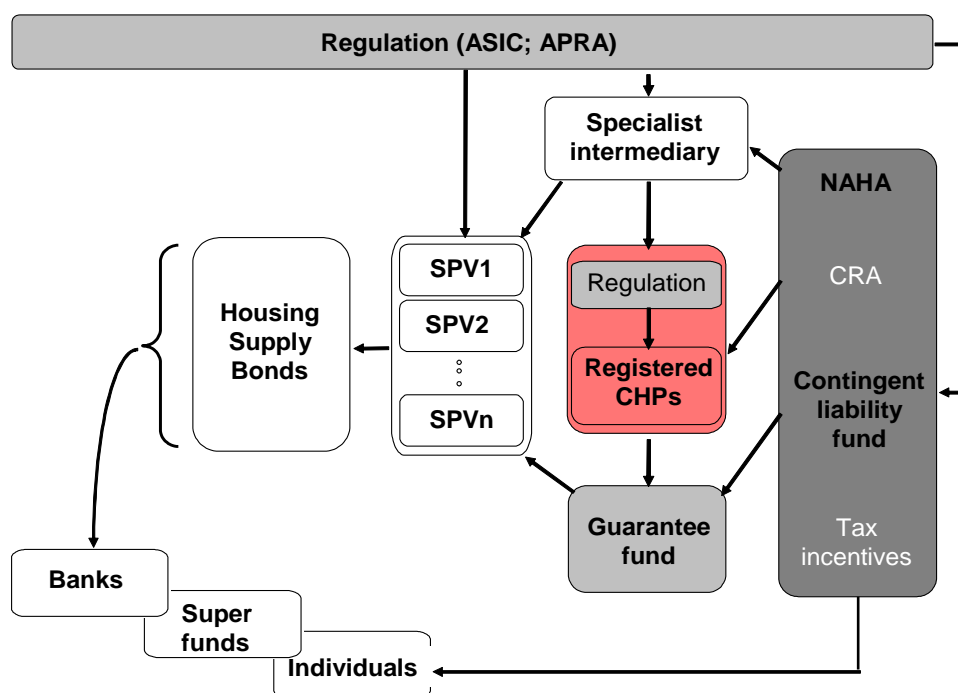
<b>Bond type</b>	<b>Characteristics and enhancements</b>	<b>Investor segment</b>
AAA Housing Supply Bond	A fixed interest, long-term (up to 10 years) AAA-rated bond—implying need for a government guarantee.	Super fund managers (15% tax rate)
Tax Smart Housing Supply Bond	A fixed term, fixed interest (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 report recommends a number of specific regulatory measures to reduce risks. These include: ensuring that standards of financial auditing comply with eligibility for funding; a sustainable business model and designated tax privileges. Performance based reporting must be sufficiently robust to ensure adherence to intended goals and appropriate sanctions must be in place to reinforce good performance. Coupled with the drive for national regulation of government assisted housing providers, it is recommended that the national government work towards legislation that sets out the basis of a feasible, efficient and risk reducing business model that would include realistic social policy targets (linked to eligibility for tax privileges). Austria provides an example of such a form of legislation. In the future, loans, grants and tax privileges could be allocated on a transparent and competitive basis to those operating this non-profit or limited profit business model, driving cross-sector development and innovation. Such an approach also enables regional jurisdictions to tailor loan programs (from NAHA growth funds) to suit local agendas such as social inclusion, key worker housing and environmental sustainability.

An overview of the financial architecture required to deliver housing bonds is provided in Figure 1 with the various levels of support provided by government indicated in the dark grey box, affordable housing providers in the central pink box, the specialist financial intermediary and the bonds issued indicated in white boxes and the regulatory framework governing this structure in light grey boxes.



Figure 1: The architecture of HSBs

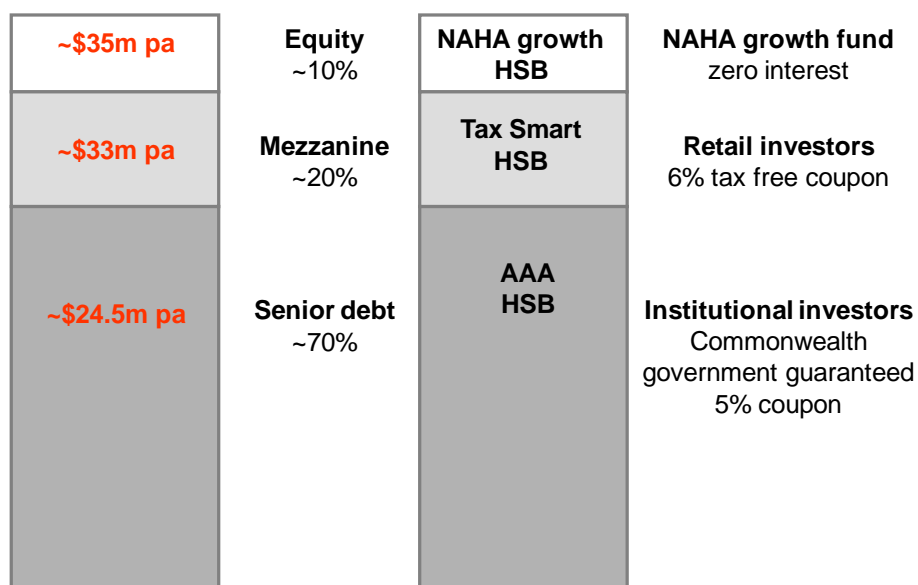


## Indicative costs

HSBs are designed to reduce the cost of funding available for community housing providers below that which is currently available from the private sector and, thereby, to enhance their capacity to increase the supply of affordable housing. However, they cannot generate private finance at a lower rate than would be available if affordable housing was funded directly through government borrowing. The HSB proposal incorporates a combination of public funding (providing direct subsidy) and private bond finance (indirectly subsidised through tax incentives and government guarantees). These are summarised in Figure 2 along with indicative costings. These costings have been based on interest foregone at 5 per cent per annum for NAHA Growth HSBs; tax foregone at an average 40 per cent income tax rate for Tax Smart HSBs and a 0.5 per cent default rate for the contingent liability fund providing the guarantee for the AAA HSBs. The proportions for each tranche are based on information provided by the industry partner for the project. They represent a presumed minimum amount required to provide a pseudo-equity underpinning before senior debt is likely to be available, and a trade-off between the cost-reducing enhancements and the likely yields of the AAA and Tax Smart bonds. The costings presented are based on raising \$7 billion to finance 20 000 dwellings.

HSBs are not intended as a replacement for existing forms of housing assistance for affordable rental housing, such as that provided by the National Rental Affordability Scheme (NRAS) and Commonwealth Rent Assistance (CRA), and under the National Affordable Housing Agreement (NAHA). Instead, they aim to complement and extend the value of such public subsidies in order to increase the long-term supply of affordable housing. HSBs of themselves will not deliver affordability outcomes for tenants regardless of their circumstances. Assistance currently provided through NRAS and CRA is still needed to ensure affordability outcomes for tenants of affordable rental housing and to assist with repayment of the bonds over their (presumed 10-year) life span.

**Figure 2: Indicative costing of HSBs to raise \$7 billion**



The costs in Figure 2 are indicative only and the report recommends a robust evaluation to determine the most appropriate combination of bonds with different enhancements and different trade-offs between yield obtained and cost to government.

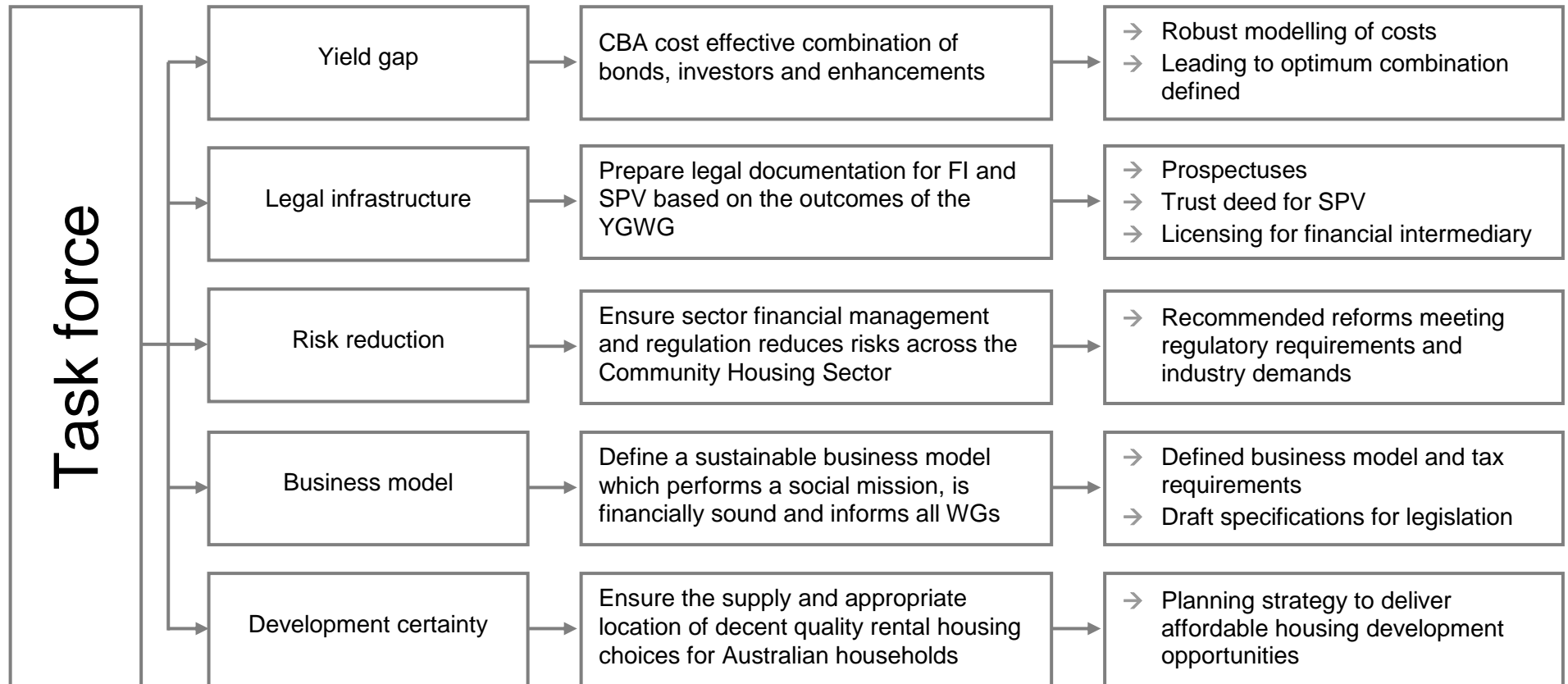
## From concept to implementation

The Housing Supply Bonds designed for Australian conditions offer the most developed response so far to multiple calls for reform and innovation in the field of affordable housing investment. After the research process followed in this study, this proposal is now ready for more detailed refinement and development. *Chapter 5* proposes an implementation strategy that is designed to guide more focused work on the bonds proposal and its associated financial architecture, with government and industry players working in close collaboration.

The proposed implementation strategy is intended to harness the good will and expertise demonstrated by stakeholders throughout this study and to promote an ongoing constructive exchange between them in order to produce achievable outcomes. It provides a way of promoting organisational learning within governments and developing greater financial capacity amongst housing policy-makers, while also building industry and political consensus about the best use of government subsidies to lever private investment and encourage long-term, sustainable growth in affordable housing supply.

The implementation strategy proposes a collaborative government—industry—third sector task force to steer and coordinate five expert groups with the overall goal of developing and refining the HSB concept, based on the broad proposal in this report. These expert groups have been named, provisionally, as: the Yield Gap Working Group; the Legal Infrastructure Working Group; the Risk Reduction Working Group; the Business Model Working Group and the Development Certainty Working Group. It is anticipated that the work of the task force could be completed within a six month time frame over 2012. The task force's core focus should be to develop a tradable housing bond and contribute directly to the plan for the enhanced NAHA with advice on consequential policy settings, public funding, legislative requirements and governance. This strategy and the roles of the respective groups are summarised in Figure 3.

Figure 3: Strategy for the implementation of Australian Housing Supply Bonds



# 1 INTRODUCTION

## 1.1 Purpose and context

While international efforts towards the provision of private finance for affordable housing accelerated in the 1990s, Australian policy has continued to rely heavily on government funding. Innovative policies and programs designed to encourage private investment have been sporadic and, so far, have failed to meet expectations, such as attracting institutional investment at scale. In response to this situation, this report provides the findings of a research project that has investigated the suitability of a bond financing instrument<sup>1</sup> to boost the volume and effectiveness of private investment in affordable housing in Australia, which has been shown in earlier research to be significantly undersupplied. Specifically, the project has explored the proposition that what is missing from current funding arrangements is a funding instrument and financial intermediary that are designed to channel much more substantial levels of cost effective investment towards social and affordable housing.<sup>2</sup>

A proposal for bond financing for affordable housing supply was first developed in Australia in the 1990s (Yates 1994) but the idea has not been taken up by successive governments. Acknowledging identified barriers to harnessing private finance for this purpose in Australia, this research takes as its stepping off point a successful private bond scheme, Housing Construction Convertible Bonds (HCCB) that has been operating in Austria since 1993. It asks the question: 'What is the potential for bond finance based on the HCCB given Australian conditions and what adaptations would be required for its successful implementation?'

Investigation of this question has been undertaken in greater depth than previously attempted in Australia. An extensive process of consultation and collaboration with a range of stakeholders and experts, including: international colleagues familiar with the HCCB model; local financial industry leaders and financial experts; regulators; and leading community housing providers and policy-makers, has been at the core of the approach to the research. Through this process, the project team and their advisers have developed the broad specifications for a bond instrument and financial intermediary that they consider would be capable of channelling substantial levels of lower cost private investment towards affordable housing, when linked to appropriate forms and levels of public subsidy and regulatory control.

A body of previous research has examined and compared international developments in private financing for affordable housing supply that operate alongside various forms of public assistance, such as grants, public loans, tax incentives and formal guarantees (Deutsch & Lawson 2010; Lawson et al. 2010a; Berry et al. 2004). The instrument given prominence in this study, HCCB, has been available in the Austrian financial market since the 1990s. HCCB are now held by an estimated 300 000 bond holders. These housing bonds are retailed by five competing housing banks that have

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<sup>1</sup> A bond is a debt security issued by governments and private companies to meet their financing needs. While bonds have many different characteristics, they all involve the obligation to make regular payments or coupons (at either a fixed or floating rate) over a defined term to bond holders. On maturity, the bond is redeemed. The yield to maturity is determined by all interest payments received plus any gain or loss on the purchase price of the bond. In general, the higher is the yield, the greater is the risk. Investors buy bonds to receive regular interest payments and to diversify risk in their portfolios.

<sup>2</sup> In the Australian context, social housing refers to deeply subsidised public and community managed housing that is allocated predominantly to low-income households and those with special needs. Affordable housing refers to a wider range of low cost housing options provided by non-government agencies using diverse forms of government and private funding. In this report the term affordable housing is used to encompass a continuum of below market rental housing, including but not limited to social housing.

generated around Euro 15 billion (AUD\$20.5 billion) of investment in affordable housing since their introduction. HCCB now contribute around 40 per cent of project finance for new affordable rental housing and the renovation of older social housing in Austria. Previous research has found that successful aspects of the Austrian HCCB include: their popularity with risk adverse investors; their efficiency in capturing longer term savings for lenders that in turn enables them to issue lower cost loans; and their cost effectiveness to government (based on provision of a modest tax incentive). Most importantly, HCCB have been able to raise substantial low cost funds to meet housing demand and to support the growth of an innovative limited profit delivery model that is well targeted to meeting need.

## **1.2 Background**

### *1.2.1 The supply of affordable rental housing in Australia*

#### **Housing market pressures**

Concerns with the need to increase the supply of affordable housing in Australia arise from housing market trends that have been unfolding over several decades. House prices began to diverge from average real incomes in the mid-1980s, as a result of demand pressures from increasing population and increasing household incomes and supply constraints brought about by limited supplies of urban land. From the 1990s until the onset of the Global Financial Crisis (GFC), this pressure on house prices was fuelled by increased borrowing capacity (arising from a decline in the cost of credit and an increase in its availability) and by increases in tax advantages associated with anticipated real capital gains.

These price pressures have been added to by the failure of the supply of housing to keep pace with demand. In its 2011 report, for example, the National Housing Supply Council (NHSC) estimated there was a gap between underlying demand (defined by demographic pressures alone) and supply of more than 180 000 dwellings in 2010 (Australian Government 2011a). Yates (2011a) discusses these trends and their underlying drivers in more detail.

The combined effects of these market drivers have created affordability pressures that have meant aspiring first home purchasers have been unable to attain the home purchase rates experienced by their counterparts prior to the mid-1980s, as those on low or moderate incomes have been unable to finance even a modest priced dwelling.<sup>3</sup> One outcome of this situation is that, compared with earlier generations, a higher proportion of younger low and moderate income households have remained in the private rental market.

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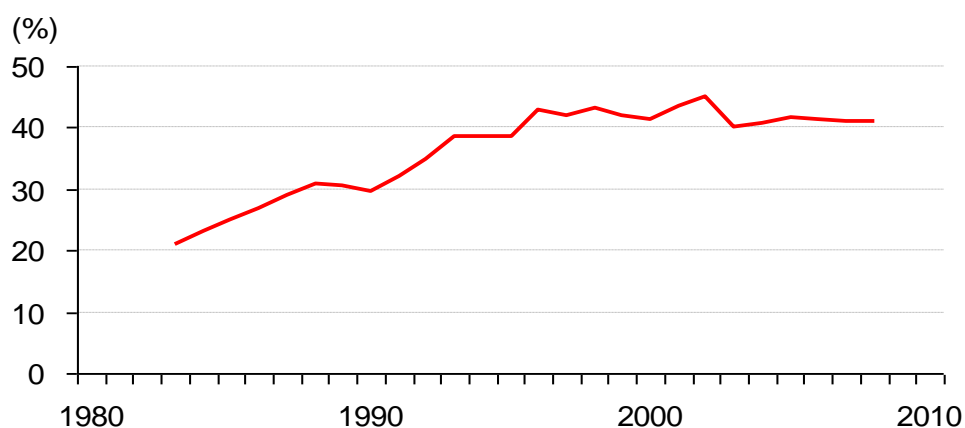
<sup>3</sup> For households in the prime household formation of 25–34 years old, home ownership rates declined from 61 to 51 per cent in the 25 years from 1981 to 2006 (for more detail and data for other age groups, see Yates et al. 2008, p.18). Flood and Baker (2010) show that, between 1996 and 2006, home ownership rates declined for every 10-year age group from ages 25 to 65. By the late 2000s, only 27.5 per cent of dwellings were affordable for households at the 60 percentile of the income distribution (which puts them above the income of a household on average weekly earnings) (COAG Reform Council 2010, p.59). Richards (2008) quotes a slightly greater figure of 30–35 per cent of transacted dwellings being affordable for the median household in the 25–39 year age group in four of the major capitals. Both of these estimates are likely to overestimate the size of the stock affordable to lower income households as they ignore the possibility that the limited stock of low-cost dwellings could be purchased by households with greater repayment capacities (e.g. higher income owners or investors). Both clearly indicate that there is an inadequate supply of affordable stock available for low and moderate-income would-be first home buyers.

## Private rental market pressures

This has put pressure on the rental market and has contributed to lower income households finding it increasingly difficult to find affordable private rental accommodation. By the late 2000s the pressure on demand for affordable rental stock by moderate income households meant that there was an estimated shortage of almost 500 000 rental dwellings for households in the bottom two quintiles of the income distribution (Australian Government 2011a). Wulff et al. (2011, p.14), for example, estimated that, in 2006, 79 per cent of very low income households (in the bottom income quintile) in Australia missed out on affordable rental housing and, in metropolitan regions, almost 90 per cent missed out.

This shortage of affordable private rental dwellings has contributed to significant affordability problems for lower income households (in the bottom two quintiles of the income distribution) with the result that an increasing proportion faced rental stress. Figure 4 shows the long-term increase in the proportion of lower income private renters who pay more than 30 per cent of their household income in meeting their rental costs (and defined as being in rental stress).

**Figure 4: Lower income households with rental costs greater than 30 per cent of income**



Source: Richards 2009, p.21

According to the 2007–08 ABS Survey of Income and Housing, there were over 400 000 lower income households paying more than 30 per cent of their household income in meeting their rental costs in the private rental market. Almost 200 000 of these were paying more than 50 per cent of their household income in meeting their housing costs (Australian Government 2010b, pp.101–2).

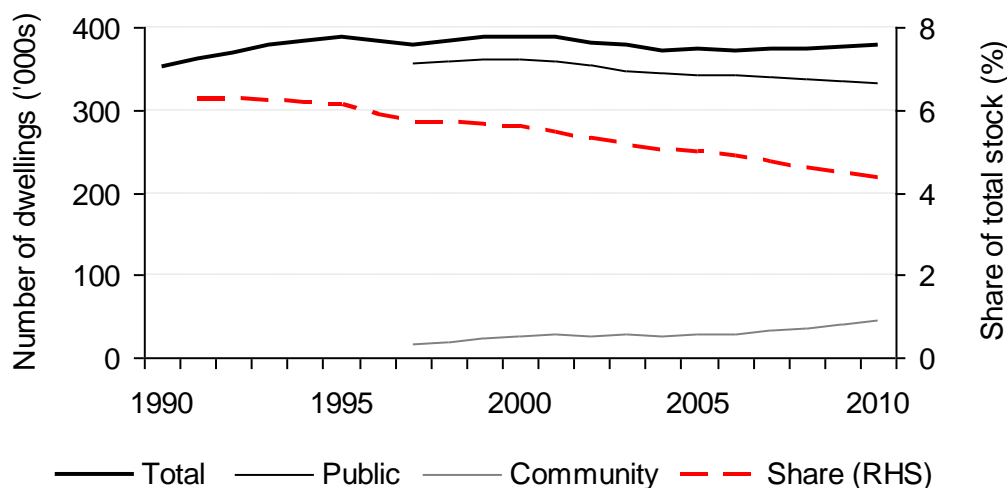
Estimates based on demographic projections suggest that the numbers of households in stress in the private rental market will increase in the next 20–40 years. Ageing households will be particularly affected (Jones et al. 2007; Yates et al. 2008).

## Social housing response

Market pressures on private rental market have been added to by failure of public and community (social) housing stock to keep pace with the growth in the numbers of lower income households. Funding reductions and cost pressures have meant that the social housing stock had not grown for almost 20 years prior to 2009 (see below) despite continued growth in the number of households traditionally served by such housing and despite recent growth in the community housing sub-sector. Jacobs et al. (2010) provide an overview of the broad drivers that have contributed to these outcomes.

Figure 5 shows the changing composition of the social housing stock over time. It also shows that the growth in community housing since the mid-1990s has not been sufficient to offset the declining contribution that social housing stock has made to the total housing stock since 1990. It highlights the fact that much of the growth of the community sector has arisen as a result of stock transfer from public housing and, as such, is a redistribution of, rather than an increase in, the total supply of social housing.

**Figure 5: Social housing dwellings: 1990–2010**



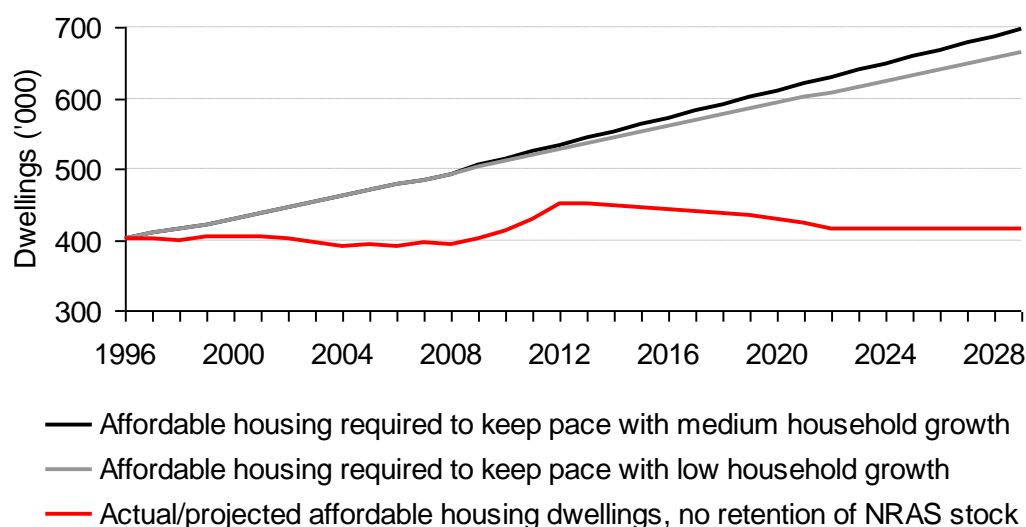
Source: AIHW (1997) from 1990; Productivity Commission (2011) from 1996; Australian Government (2010a) from 2001. Census data (interpolated for intercensal years) used for estimating share of social housing in total stock.

One outcome of the trends illustrated in Figure 5 is that the current social housing stock falls well short of that needed to fill the gap left by the failure of the market to meet the needs of lower income households for whom private rental housing is either unaffordable or inadequate.

On the basis of the medium population projections produced by the ABS, the number of households in Australia is projected to increase at a rate of around 160 000 to 165 000 per year for the next five years (Australian Government 2011a, p.24). Even if social housing only retains its current (low) share of 4.3 per cent in meeting this projected increase in household numbers, this will necessitate an increase of around 7000 social dwellings per year. For the stock to return to its historic share of 6 per cent, almost 10 000 additional social dwellings will be required each year. Neither of these projections makes any adjustment for the necessity for an increase in affordable housing to meet the needs of those currently unable to access affordable housing in the private rental market.

Figure 6 shows estimates by the NHSC of the current and projected shortfall in the supply of social and other forms of affordable rental housing compared with what would have been needed to maintain the same share of the housing stock as in 1996.

**Figure 6: Social and affordable housing demand and supply projections**



Source: Australian Government (2010a, p.89). Projections of the social rental stock from 2009 take into account 19 300 Social Housing Initiative dwellings and 35 000 NRAS dwellings distributed over 2009 to 2012; 600 A Place to Call Home dwellings distributed over years 2009 to 2013; and 1700 Social Housing National Partnership Agreement dwellings distributed over 2010 and 2011. It assumes that NRAS dwellings exit the affordable housing stock as they leave the scheme. For program information see Section 1.2.2.

These estimates suggest that the additional investment undertaken since 2008 will add substantially to the supply of affordable housing for lower income people. However, they also show that the relative market share of social and subsidised housing (and total supply) will not be maintained without continued investment. Despite the considerable investment that has taken place from 2008 to encourage expansion of the supply of affordable housing (see below), by 2011 there was a shortfall of some 90 000 dwellings between the growth needed to maintain social housing at its 1996 share and the number of social and affordable housing dwellings available. On current policies, this shortfall is projected to increase to more than 150 000 dwellings over the 10 years to 2021 when compared with low projected household growth, and to almost 200 000 on the basis of medium projections of household growth. To address this shortfall over the next decade requires an additional 20 000 social dwellings per year over the next 10 years. If funded upfront, this implies a funding requirement of roughly the size of the social housing stimulus (see below) each year for the next decade.

The NHSC projections of social housing numbers charted in Figure 6 do not take into account the increase in stock that might be possible if community housing providers are able to use the income stream from the existing tenant base, backed by a growing asset base, to finance increased investment in social and affordable rental housing. They also do not allow for the potential to leverage in some additional resources through means such as offering planning benefits, charitable contributions and social entrepreneurship.

In this context, attracting large scale institutional investment towards affordable rental housing has been seen as an important goal for the Australian not-for-profit housing sector as a means of increasing investment into social and affordable rental housing.



## 1.2.2 *Past and current approaches to funding social and affordable housing*

### **Past approaches**

The introduction of mixed public and private financing models for social and affordable housing is relatively recent in Australia. Traditionally (after 1945) public loans were the primary funding mechanism for the provision of public housing. From the 1980s public loans were replaced by grants because the delivery agencies—state housing authorities (SHAs)—had insufficient revenue to service debt. Subsequently, as trends to declining revenue per tenant deepened and operating costs rose, SHAs increasingly have had to rely on annual grant funds to meet their operating shortfalls, as explained in detail in Hall and Berry (2007). From 1996, declining grant levels have left little or no capacity for growth and even resulted in significant asset sales in some states (Hall & Berry 2007). One result of this long-term chronic under-funding of public housing has been that prevailing rates of investment in additional supply have for some time been insufficient to replace stock that is being sold or demolished (Yates 2011b).

Community housing—provided by not-for-profit organisations and intended to complement public housing—has been stimulated through a variety of programs since the late 1970s (see Jones et al. 2008). Implementation of these programs has varied across states and territories (see Milligan et al. 2004). For example, Victoria and South Australia introduced debt-financed schemes backed by government subsidies in the 1980s but these were not expanded. Other populous states (NSW and Queensland) have relied mainly on grants or special purpose vehicles<sup>4</sup> to fund supply, supplemented by head leasing of private housing and some small scale demonstration joint venture schemes. Until recent developments discussed below, by 2009 the small-scale and experimental nature of investment through the community housing sector had produced only about 7000 additional dwellings (Milligan et al. 2009, 2004). Altogether about 42 000 dwellings were being managed in the not-for-profit sector in that year, but most of this stock was owned by SHAs or leased from the private market (AIHW 2010).<sup>5</sup> Provision through this sector expanded from 6 to 11 per cent of social housing over the decade to 2008/09. At June 2010, the sector comprised 959 organisations but of these just 45 agencies managed 63 per cent of tenancies (Australian Government 2010c).

### **Recent developments in affordable housing policy and financing**

The 21st century has heralded much greater engagement by the leading not-for-profit housing providers in Australia positioning to be significant players in social and affordable housing investment. This shift has come about through policy, funding and regulatory changes and via initiatives taken by players in the sector itself, such as: organisational mergers and acquisitions to gain economies of scale; enhanced governance and capacity building, especially to obtain development and financing skills; rent restructuring; creation of special purpose financial and development vehicles; and forging private sector partnerships (Gilmour & Milligan, forthcoming). As will be highlighted below, some of the changes have been intentionally designed to support an expanded, more entrepreneurial third sector of housing provision (operating between the state and the market) while others have been opportunistic.

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<sup>4</sup> For example, arms length government founded companies (see Milligan et al. 2004 for details).

<sup>5</sup> There is also an Indigenous community housing sector and some community managed housing provided by other non-government organisations such as disability and welfare groups and aged care providers. These groups in total are estimated to manage/own a similar number of dwellings to the mainstream community housing sector.

Commencing in 2009, the centrepiece of Australian housing policy is the National Affordable Housing Agreement (NAHA). This intergovernmental agreement governs funding and administration of social housing and homelessness services across Australia, as well as establishing a whole of housing system policy focus (Gronda & Costello 2011). It is this latter aspect and a shift to accountability for the outcomes of housing policies and programs that distinguish the NAHA from its predecessor, the Commonwealth State Housing Agreement (CSHA).

Since 2009, specific initiatives under the NAHA in the form of fixed-term National Partnership Agreements (NPPs) have been directed to reducing homelessness, supplying additional social housing and driving a significant effort to improve housing for Indigenous people in geographically remote areas where mainstream housing markets do not operate. From the perspective of financing additional housing supply, the most significant of the NPPs has been the Social Housing Initiative (SHI)<sup>6</sup>, which was developed as a preventative measure to offset anticipated impacts of the 2008 GFC, especially the risk of a down turn in employment in the construction industry (Milligan & Pinnegar 2010). Funding under the SHI has provided for an estimated additional 19 300 social housing dwellings, the largest boost to social housing in Australia in several decades. Importantly to the core considerations of this report, Australian governments have agreed that 75 per cent of these new dwellings will be managed by not-for-profit providers and in several jurisdictions asset ownership will also be in that sector (Australian Government 2010c).

Operating alongside of the NAHA, is another large scale national initiative, specifically aimed at boosting private investment in the supply of affordable rental housing for a wider band of households than social housing serves. The National Rental Affordable Scheme (NRAS) launched in 2008 offers financial incentives to investors in new rental housing supply for 10 years subject to meeting regulatory requirements for letting at below market rents to low and moderate income households. Fifty thousand incentives are being made available, originally over four years to 2012 but now extended until 2015 (Australian Government 2008).

Participation in this scheme by not-for-profits has provided that sector with another significant business stimulus. Of the 39 292 NRAS funding incentives allocated or reserved until October 2011<sup>7</sup>, 55 per cent (21 635) have gone directly to 75 charitable not-for-profit organisations (Australian Government 2011b). Additionally, not-for-profits are the preferred managers of privately owned properties funded through the scheme.

The SHI and NRAS have both helped to demonstrate how the third sector can contribute to social and affordable housing supply at greater scale than in the past and have shifted political and policy focus towards the merits of a public private co-financing model. As well, directing new supply to not-for-profit providers paves the way for additional growth to be leveraged from their rapidly expanding asset bases and associated revenue streams in the longer term.

The initiatives discussed above involve supply-side interventions that directly boost available social and affordable housing. To complement these strategies, existing community housing providers have also been restructuring their rent setting policies to

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<sup>6</sup> The Social Housing Initiative is contained in the Nation Building and Jobs Plan National Partnership, Schedule C, Social housing. It has provided \$5.6 billion over three and half years, 2008–09 to 2011–12; \$5.238 billion for new construction and \$400 million for repairs and maintenance (Gronda & Costello 2011).

<sup>7</sup> Allocated incentives have been formally contracted with the recipient organisation. Reserved incentives are under offer to the intended recipient subject to the project(s) being feasible—such as by attracting finance. In October 2011, only 12 per cent of the 39 292 funding incentives on offer had been allocated (Australian Government 2011b).

draw in Commonwealth Rent Assistance (CRA), which is paid directly to many of their tenants.<sup>8</sup> In general this approach has enabled them to generate larger revenues<sup>9</sup>, from which to service debt on private finance. In a move that appears to have tacit Commonwealth support, a number of state governments are now considering large-scale transfers of occupied public housing dwellings to regulated not-for-profit housing providers with the aim of leveraging that asset base and the enhanced revenue that arises when tenants who are no longer deemed to be in public housing can access CRA (Milligan & Pawson 2010).

### *1.2.3 Broader developments in social financing for not-for-profit enterprise*

Paralleling the discussion about private financing of social housing through not-for-profits has been mounting interest in financial products that would be suited to raising and channelling finance to third sector enterprise more widely in Australia. In 2010, a Productivity Commission report on the not-for-profit sector (Productivity Commission 2010) highlighted that a lack of access to (private) capital and the absence of specialist financial intermediaries to service this sector were two factors hindering its overall development. Subsequently, a Senate inquiry has examined in more detail 'the barriers and options available to develop a mature capital market for the social economy sector in Australia' (The Senate Economics References Committee 2011a, p.xix).

The Senate inquiry has found that there are significant hurdles to overcome in order to attract investors into social enterprise, including the lower rate of return of social investment relative to alternatives in the commercial market and a lack of awareness among financial advisors and planners of products that may be suited to the industry. It has noted that the market for social products is currently somewhat limited to investment-minded philanthropists and argues that government support will be required to catalyse this market. A particular recommendation of relevance to this research is that the Australian Government (through the Departments of Treasury and Finance and Deregulation) should examine ways to create incentives for investment in a social bond market in Australia including the feasibility of tax exempt income returns, a government top-up on social bond coupons in the form of either cash or tax credit and the use of government guarantees (The Senate Economics References Committee 2011a, p.xxvi).

The Senate inquiry has reviewed a number of pioneering efforts towards raising funds though 'social bonds' in Australia; some successful, others not. This experience provides real lessons from the coal face concerning the potential appetite for special purpose bonds in this country. In particular the experience of the Goodstart Consortium, issuing bonds to raise capital to acquire the liquidated ABC Learning Centres in 2010, is valuable. With its specialist blend of philanthropic, development and financial market expertise, the consortium successfully raised \$22.5 million of social finance by offering a 12 per cent coupon rate to investors over eight years. This was effectively a mezzanine debt instrument,<sup>10</sup> which can convert to equity if the loan is not paid back in time and in full (The Senate Economics References Committee 2011a, p.138). However, a subsequent attempt by consortium member, the Benevolent Society, to raise funds for an affordable housing development in Sydney

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<sup>8</sup> Tenants of state-owned and managed public housing are not eligible for CRA. However all private tenants who receive social security payments (including those in community managed housing) are eligible for CRA, if their rent exceeds a floor amount. There is a set maximum payment level for CRA, which is uniform across Australia.

<sup>9</sup> Previously most community housing providers in Australia charged income-related rents.

<sup>10</sup> Mezzanine finance is a hybrid of debt and equity financing that is typically used to finance the expansion of existing companies or build development projects.

via a bonds issue was not successful; the proposed bond offered an annual yield of 5 per cent for up to eight years plus a bonus interest component linked to the cash flow performance of the project. Lack of investor appetite prompted that organisation to investigate what would have made a difference to investors and on that basis to recommend strategic fiscal reforms in its submission to the Senate inquiry (Benevolent Society 2011). Their concept of a partially franked social bond for self-managed super funds (SMSFs) and private ancillary funds is outlined in Appendix 4.

The report of the Senate inquiry also discusses in detail one specific product, Social Impact Bonds (SIB), reflecting efforts to research, develop, promote and establish this instrument in Australia by the Centre for Social Impact (University of New South Wales) and the legal and financial services industry.<sup>11</sup> A SIB needs to be differentiated from the kind of bonds that are discussed in this Final Report, which are more like bonds of the kind that currently play a key role in financing social housing in Austria, Switzerland and the UK (Lawson et al. 2010a). Given the purpose of those bonds for growing investment in social and affordable housing, the term social bonds can be used but in fact they are closer to conventional bonds, albeit with a lower yield, with government enhancement, and for a social purpose.

#### *1.2.4 Developments in the policy and regulatory arrangements for affordable housing*

This section considers developments in the planning and regulatory spheres of government policy that are designed to complement financing initiatives, utilising not-for-profit delivery vehicles.

Most state and territory governments have been implementing new regulatory arrangements that apply specifically to not-for-profit housing providers beginning in the early 2000s.<sup>12</sup> (For a summary of these arrangements, see Travers et al. 2010.) It is planned that a new uniform national regulatory model will come into operation in 2013. This aims to provide a consistent regulatory environment to support the growth and development of the community housing sector under national law. The national regulatory system aims to enhance the reputation of the community housing sector, providing accountability, consistency and transparency with the establishment of:

- A national public register.
- A single national regulatory code.
- A consistent approach to regulatory intervention across jurisdictions.

In keeping with Australia's federated system of governance, each state and territory jurisdiction will appoint independent housing registrars with consistent regulatory powers to apply the national law. Registrars will be able to delegate their role to lead registrars in another jurisdiction for housing providers that function in more than one jurisdiction but will offer guidance on local policy matters. The changes are being designed specifically to encourage larger scale national players, as well as to

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<sup>11</sup> SIB is an instrument with increasing policy cache in the UK, where the government is seeking alternative means to finance social services, such as prisons, youth services and family support. Investors are paid for the achievement of agreed social outcomes. The report of the Australian Senate Committee summarises the SIB process as follows. 'A bond-issuing organisation offers bonds to investors, based on a contract with government, to deliver improved social outcomes that generate future cost savings for government. The government uses these savings to pay investors a reward, in addition to their principal, if improved outcomes are achieved. If improved outcomes are not achieved however, the investor is not paid' (The Senate Economics References Committee 2011a, p.144).

<sup>12</sup> In some jurisdictions private providers can also register. Although the HSB proposal in this report is based on using not-for-profit delivery vehicles that have lower cost structures, private providers that abide by applicable regulations could also participate.

recognise locally based and niche providers. The new arrangements will create a level playing field for providers and allow for enhanced oversight of recent developments in affordable housing delivery (e.g. innovative financing models).<sup>13</sup>

Positive planning policies supporting the production and retention of affordable housing are also state-based and, consequently, have tended to be piecemeal and fragmented (see Milligan et al. 2009 for a summary of jurisdictional approaches and Calavita & Mallach 2010 for a review of international practice). Recently, several jurisdictions have made moves towards adopting a more comprehensive approach to supporting affordable housing through planning and land supply policy initiatives. The leading example is found in South Australia, which has a target legislative requirement that 15 per cent of housing in all significant developments<sup>14</sup> meets affordable price points, including one third of the target for those with high needs (Government of South Australia 2007a). Under a different approach, New South Wales (NSW) offers density bonuses (among other incentives) for infill developments that provide between 20 per cent and 50 per cent of gross floor area as affordable rental dwellings, to be managed by registered community housing providers.<sup>15</sup> In a number of jurisdictions, government land agencies have also been contributing to the affordable housing task through various mechanisms, including setting aside land for not-for-profit developers. (For more information on the role and potential of land agencies, see Davison et al. 2011.) Finally, a national review by public officials for the Council of Australian Governments (COAG) is presently considering future strategic planning of capital cities to address, inter alia, housing supply and affordability issues within the broader context of the operations of the housing market.

### *1.2.5 Role of private finance so far*

The extent to which private finance has been introduced into social and affordable housing in Australia to date has been limited and there is little information on financing sources, costs and conditions. The primary drivers for the schemes that have been introduced have been the financial incentives available under NRAS.

Approved schemes under NRAS so far have generally fallen into two main categories. The first category consists of private developers who have targeted retail equity investors attracted to the NRAS tax credit, through a sale and leaseback arrangement with a guaranteed market rent for 10 years. In most instances the management of the dwellings has been contracted to registered community housing providers. The second and larger category consists of community housing providers whose own projects are financed by a mix of private debt combined with public and/or private or own equity. NRAS cash grants (available only to not-for-profit providers) are used to service the debt secured against the projects for 10 years. By mid-2011, there had been no examples of institutional investment in NRAS housing (Yates 2011b; Australian Government 2011b).

National Rental Affordability Scheme has stimulated the emergence of a number of new financial intermediaries, both for-profit and not-for profit, which are engaged in attracting NRAS investors and managing the interface with government and multiple housing service providers. Examples of intermediaries receiving large allocations of

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<sup>13</sup> Further information regarding the proposed system, including the draft law and a report of the outcomes of public consultation (Housing Ministers Advisory Committee 2012), is available at [www.nrsch.gov.au](http://www.nrsch.gov.au).

<sup>14</sup> Significant developments are defined as those on government land, Declared Major Development sites and where there is significant rezoning or change in use to residential from non-residential uses (Government of South Australia 2007b).

<sup>15</sup> A bonus floor space ratio of a minimum of 0.2:1 and up to 0.5:1 (or 20%, whichever is greater) above local planning controls is allowed (NSW Government 2011a).

NRAS incentives include the Queensland Affordable Housing Consortium, the National Housing Company and Providence Housing (Australian Government 2011b).

New South Wales has recently established a program that requires larger housing associations operating in that state to leverage financial resources in partnership with private institutions by utilising an asset base and additional revenue to be obtained through properties transferred from public ownership (NSW Government 2011b). Anecdotal evidence from mid-2011 suggests that organisations that have been contracted under the program are finding that the interest rates, repayment cover ratios and lending conditions being imposed on them by lending institutions are such that outputs are likely to be lower than expected.

In Victoria, that state's auditor-general has examined a similar gearing model that has been operating for housing associations in Victoria since the mid-2000s (Victorian Auditor-General 2010). In relation to one of the financial goals of the program to leverage private finance from transferred assets, the auditor general found that only three of eight associations were using those assets to secure additional borrowings, and the target of 15 per cent leverage would either be delayed or achieved through other strategies. It is not clear what all of the contributing factors to this situation were, but a major factor was the poor condition of the dwellings transferred and the one-off costs of bringing these up to standard. In relation to another financial goal of achieving a leverage target of 25 per cent for new supply, the audit showed that, while this was occurring, it was at the expense of tight targeting to high needs households. In other words, associations had to adjust their tenant profiles in order to sustain the required level of private financing.

Four-fifths of all loan funds for the housing associations growth strategy in Victoria was secured from commercial lenders at retail rates (Victorian Auditor-General 2010). Interviews with Victorian providers for a Community Housing Federation of Victoria (CHFV) commissioned report found that organisations had taken on debt to fund new housing with loan-to-value ratios (LVR) varying substantially from 12 to 65 per cent and paying between 7 and 8.5 per cent interest—an average rate of 7.2 per cent per annum (Deloitte-Access Economics 2011, p.9).<sup>16</sup> The average premium was about 100 basis points (bp) over standard variable rates charged to large businesses, or about 30 bp over a BBB-rated corporate bond yield at the time. These higher financing costs reduce the utility of public subsidies. The report for CHFV goes on to argue that without support from government and a tenant mix that ensures a minimum rental income stream, community housing providers do not have a model that will allow borrowing against current assets to construct or purchase additional housing units (Deloitte-Access Economics 2011). Thus expansion of affordable housing supply commensurate with unmet need is unlikely under present conditions.

There has also been some instructive analysis of bank lending practices to community housing organisations. In the most recent overview report on this issue, Gilmour (2010) made similar findings to those discussed above and concluded that:

- The amount of debt that can be raised by the community housing sector has probably been over-estimated by policy-makers.
- Only a few, large providers have the capacity to borrow even quite modest amounts compared to their value of their assets.
- Australia's lenders have been slow to enter the market to lend to the sector and are relatively cautious, though this situation may be changing.

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<sup>16</sup> Lending conditions are likely to have become even more constraining with the subsequent uncertainties affecting global capital markets.

- The most important ratio that covers bank borrowing is 'interest cover'—that is, is there sufficient cash flow to repay borrowing.
- Providers need to increase their knowledge of how to borrow, and put in place clear risk and treasury management policies.

Along with the most recent NRAS performance report (Australian Government 2011b), which shows that 88 per cent of incentives that have been decided are yet to be allocated (as new dwellings are delivered), the evidence reviewed above suggests there have been difficulties in obtaining finance at any cost. The evidence also highlights the importance of obtaining private finance at lowest possible cost under appropriate and flexible lending rules, if social policy and growth objectives are to be optimised and risk premiums reduced.

### **Barriers to private financing**

A recent submission to the Australian Government by consultancy firm, KPMG, suggested that both macro and micro barriers are constraining access to private (debt) finance for affordable housing (KPMG 2010). Macro barriers arise from the post GFC state of the economy in general and from the response of financial institutions to this in particular. They include: the constrained access that Australian based financial institutions have to wholesale capital markets; the impact of Basel II on capital requirements for banks that encourages them to lend to higher credit quality clients; and increased uncertainty in the property market. The first and last of these are likely to be cyclical constraints that will be alleviated over time. The second has the potential to be a structural impediment. It is one that will not be reduced with the implementation of Basel III in a few years.

Micro barriers singled out by KPMG are variations on constraints identified up to a decade ago (AHNRC 2001; Allen Consulting Group 2004). These include: constraints arising from such investment being a new asset class (which means that institutions have no lending policies in place to assess lending options); counter party risks for financiers (associated with the role of community housing providers and the lack of comfort that such charitable organisations can provide to a lender because they either are limited by guarantee or have little contributed equity or retained earnings); issues of security enforcement (because of perception of a negative community response to any attempt to take over affordable housing assets in cases of default); low returns; lack of scale, lack of liquidity and high risks (associated with perceptions of significant rental risk, operational/management risk, asset condition risk and policy risk) (KPMG 2010, p.8).

Some of the policies implemented in the past few years have attempted to address some of these constraints, as discussed earlier in this chapter. They include development of a national regulatory framework, NRAS and the opportunity for building provider asset bases that arose out of the SHI. NRAS, in particular, has provided subsidies to help close the yield gap identified in many of the earlier studies, as has the capacity of community housing providers to maximise revenue from CRA.

#### *1.2.6 The future*

Considering the strategic directions and breadth of activities outlined above, Australia can be seen to have commenced charting a significant course towards increasing the supply of affordable housing, with not-for-profit providers at the centre of this strategy in recent years. However, key public policy and funding elements of this direction lack certainty and prevailing arrangements are unlikely to attract and sustain large amounts of private investment in the medium term. For instance, the NPPs under the present NAHA, other than the remote Indigenous program, are now fully subscribed.

Similarly, NRAS incentives will exhaust after 2015 and the 10-year duration of the affordability controls applying to funded dwellings threatens the longer term retention of that housing in the affordable sector. Additionally, while the design of CRA has been subject to numerous proposals for reform to enhance its effectiveness as a housing affordability payment to tenants and assured revenue stream for providers (see, e.g. The Treasury 2010; Burke 2006), a government response to such ideas has not been forthcoming to date. It is also unclear what view the Commonwealth might ultimately take of states and territories shifting an increasing share of the cost of public housing rent subsidies to them via the mechanism of tenanted stock transfers. In any case, leveraging that asset base, while possibly a part of the answer (subject to the issues discussed above), will by itself be too limited a strategy to address the quantum of housing supply that will be required (Milligan & Pawson 2010).

In this context, the 5-yearly renegotiation of the NAHA (to occur before 2014) represents a critical opportunity to set up a sustainable, long-term policy framework, and to design an enhanced strategy that would build on existing third sector capacity and be capable of supporting a regular supply of additional affordable housing commensurate with the level of needs discussed earlier in this chapter. In order to achieve this strategy, further development and reform of a variety of prevailing policy settings and subsidies that can support a mixed public and private financing model will be crucial. The recommendations of the recent Senate inquiry into capital raising and investment conditions for social enterprise more broadly (discussed above) opens the opportunity for strategic development of a market in social bonds with the housing sector as a key player and beneficiary. This report is specifically concerned with an appropriate mechanism for raising cost-effective volumes of private finance for such a purpose.

### **1.3 Research questions and methodology**

The aim of this research project is the development of a sustainable and low cost private financing instrument, potentially based on the adaptation of HCCB, in order to expand the supply of affordable rental housing and contribute towards meeting Australian housing needs in the medium to long term.

The core research question, 'What is the potential for bond finance based on the HCCB given Australian conditions and what adaptations would be required for their successful implementation?', has been broken down into four sub-questions:

1. What would be appropriate terms and conditions for an Australian Housing Supply Bond, to ensure that it is attractive to investors and raises sufficient low cost funds for borrowers?
2. What type of financial intermediary would sell the bonds and how would funds raised be made available for approved projects?
3. What type of institutional conditions and regulatory arrangements would ensure funds raised are channelled to their intended purposes?
4. What other actions would be required to ensure success of this mechanism?

#### **1.3.1 Methods**

The research methodology chosen to address these questions had a number of key components described below. These were conducted in accord with university ethical standards.



## **Collaboration with Austrian experts and local industry players**

The core academic research team have worked collaboratively throughout the project with two international consultants (Amann and Kratschmann) who have strong expertise in, and direct experience with, the HCCB financing model. Locally, affordable housing industry players, Affordable Housing Solutions (AHS)<sup>17</sup>, were engaged as partners (at no cost to the project) to advise on financial options and local financing conditions for not-for-profit housing providers and to help model a possible bond instrument. Both these groups of advisers also participated in stakeholder workshops, discussed below.

## **Interviews with stakeholders**

A selection of leading players from across the financial services industry, financial regulation sector, housing policy community, Treasury and public finance officials, not-for-profit housing providers and their trade bodies and specialist regulators were identified during the first phase of the project and a list of potential interviewees from these groups was drawn up, with numbers determined within the resources and time frames for the project. Potential interviewees were contacted by email in April and May 2011 and provided with information about the project, the HCCB and alternative instruments and their potential suitability for Australian conditions (see Appendix 1 for details). To establish the needs, expectations and requirements of each of these stakeholder groups, semi-structured, face-to-face interviews of approximately one hour each were conducted between 6 and 17 June 2011, in Sydney, Canberra and Melbourne, using an interview schedule that was tailored to each participant (see Appendix 2 for details).<sup>18</sup> The first task for each interview was to ensure interviewees were familiar with the concept of a Housing Supply Bond (HSB) and to respond to clarifying questions. The remainder of the interview focused on the interviewees' views and expert opinions on the design and implementation of a HSB. In total, 25 interviews were conducted during this phase of the research. All interviews were recorded with permission of the interviewees and transcribed to enable full analysis. In addition to informing the research team of industry practice, regulatory requirements and desired reforms from a range of stakeholder perspectives, this phase of the research helped to build familiarity with the concept of a HSB among stakeholders. It also encouraged ownership of the design process for such an instrument in the Australian context; and contributed ideas and information towards a feasible strategy for implementation informed by both housing policy goals and market realities.

## **Industry workshop**

Expert advisors and stakeholders (invited from among those interviewed) and academics with relevant expertise participated with the research team in an intensive full day workshop held in Melbourne on 29 September 2011, following the interview phase. The purposes of the workshop included exchange of more detailed information about the housing policy context and the HCCB—the latter was facilitated through AHURI-funded visits to Australia at that time by Amann and Kratschmann—and discussion among all stakeholders of the design and implementation of a specific bond instrument. Eighteen people participated in this workshop. In the week preceding the workshop, there was also intensive engagement between the research team, the international experts and the industry partners leading to development of a draft model (see below) which was presented at the workshop. A public seminar, with

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<sup>17</sup> Affordable Housing Solutions is a private company offering services to the affordable housing industry in Australia. For more information see <http://www.ahsolutions.com.au/index.php>.

<sup>18</sup> Three interviewees were unavailable during the primary interview period and were interviewed in July and August 2011. Two of these interviews were conducted by phone.

85 registered participants, held on the day following the workshop, provided a wider audience of housing and finance industry professionals with the opportunity to engage with the visiting international experts, and to ask questions about, and comment on, the emerging outcomes of the project.<sup>19</sup>

### **Modelling**

The draft model of a HSB for Australian conditions presented at the workshop built on an existing model that Affordable Housing Solutions had developed to support business planning for not-for-profit housing providers in Australia. The model and its underlining assumptions reflect Australian financial and housing market conditions and related policy and regulatory settings. The model developed for this project aims to demonstrate to governments and market players how the design, yield, subsidy and operational elements of a potential bond scheme of suitable scale could work in detail. The design features incorporated in the model attempt to reflect positioning on issues that have been raised directly with the research team through this project as far as possible.

### **Consultation with policy-makers**

On completion of a draft Final Report for the study, a concerted effort was made by the research team to inform and seek feedback from senior policy-makers and other stakeholders on the proposal for a HSB and its implementation.

The starting point for this process was the advance circulation of a draft Final Report to all members of the Housing and Homelessness Policy Research Working Group (HHPRWG) of officials in the second half of January and a subsequent presentation by the research team to their meeting of 3 February 2012 held in Sydney. To facilitate more considered and detailed feedback, a request was made by the researchers for written responses to the draft report before 16 February. The Chair of HHPRWG proposed that given the short timelines, jurisdictions could do so individually. A detailed written response was received from NSW officials and two other jurisdictions (Victoria and South Australia) sought additional briefings, along with the Commonwealth Housing Minister's advisor.

Requests for further presentations and discussion snowballed from this meeting. A draft executive summary of the report was prepared and distributed to respond to these requests and an intensive series of meetings and presentations took place over a 10-day period during February 2012. This included five separate presentations of the outcomes of the research to a total of about 80 people in Sydney, Adelaide and Melbourne and additional meetings with a large superannuation fund that had been involved in the research and the industry partner (AHS). Audiences at the presentations comprised policy-makers from housing, treasury and premier's departments, ministerial advisors and housing researchers.

As indicated by the intensive levels of participation in the research at all stages, there is strong interest among public officials across housing and central agencies and among industry players in the proposals for HSBs as set out in this report. The final round of consultations described above provided a valuable and timely opportunity to disseminate the draft research findings and to test the ideas for development and implementation of HSBs in Australia. Where feasible, refinements have been incorporated in this Final Report.

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<sup>19</sup> This seminar was co-hosted by AHURI Ltd and the Community Housing Federation of Victoria, the peak body representing housing associations in that state. All presentations made at the workshop and public forum can be accessed on the AHURI website, at [http://www.ahuri.edu.au/calendar/event\\_20110930.html](http://www.ahuri.edu.au/calendar/event_20110930.html).

### *1.3.2 About the research approach*

The research approach outlined above has several aspects that are critical to the potential success and influence of this project.

First, as the proposed HSB must be able to compete favourably with market alternatives, it was crucial that industry views were well understood early in the research process. The strategic interviews with relevant industry players aimed, therefore, to provide a solid foundation of intelligence upon which decisions concerning the design of a bond could be made, reflecting industry needs and buying patterns, and supplemented by a focused literature review. This industry-informed approach is sensitive to the actions of competitors, and more likely to be able to respond to the challenges of a rapidly changing global financial marketplace.

Beyond the market, however, ultimately a robust vision motivated by public interest and housing policy objectives must drive design of the financing instrument. Efficient, equitable and well-targeted use of public funds to increase investment in, and output of, affordable rental housing is paramount to achieving political and policy support, regardless of how funds are delivered. Engagement of public interest advocates such as policy-makers, subsidy providers and regulators in the fields of housing, financial regulation and taxation provided the basis for addressing this requirement.

Third, the research process informed key financial players in Australia about the housing supply bond concept and its potential role in housing investment, as illustrated by successful function of HCCB in Austria. Informed and focused industry involvement, through strategic knowledge exchange, promotes market awareness and constructive engagement, and represents one crucial step towards raising awareness and reducing institutional resistance to market reforms and new products.

Fourth, the consultation and engagement process has empowered key players to contribute to the design of a policy-oriented market instrument. More time than is common in research of this kind has been spent informing interviewees of the latest research and international developments, inviting their ongoing involvement in the project and facilitating the contribution of their expertise. With this approach, interviewees evolved as participants rather than passive informants, albeit as players with different perspectives and demands. Proposals in Chapter 5 of the report show how this approach can be continued and built upon.

## **1.4 Report structure**

This Final Report synthesises the outcomes of the research process described above. It is directed to assisting policy-makers who are responsible for renegotiating the National Affordable Housing Agreement to focus on how to steer much larger and more certain volumes of private investment towards affordable rental housing in Australia. Following this introductory chapter, Chapter 2 briefly reviews background research on international mechanisms used for a similar purpose. This is followed, in Chapter 3, by a report on the outcomes of the extensive field research conducted in Australia between June and October 2011. Chapter 4 makes use of this knowledge in putting forward a design concept for appropriate bond instruments with the intended capability to facilitate a significantly enhanced supply of affordable rental housing in Australia. It outlines the financial architecture of the instruments proposed, including: the terms and conditions of three types of bonds; the financial intermediaries suggested to channel these funds to regulated and accredited providers; appropriate institutional and regulatory conditions as well as other necessary reforms. Chapter 5 addresses issues critical to the successful implementation of the proposed mechanisms.

There are four appendices to the report. Appendix 1 lists the organisations to which interviewees and workshop participants belonged. Appendix 2 lists interview topics. Appendix 3 provides an outline of the use of housing bonds in the Austrian system of limited profit housing provision that has been provided by the Austrian experts involved in this research, Dr Wolfgang Amann and Dr Astrid Kratschmann. Appendix 4 gives an overview of the Benevolent Society's proposal for social bonds.

## **2 INTERNATIONAL MECHANISMS TO CHANNEL PRIVATE FINANCE INTO AFFORDABLE HOUSING**

Affordable housing does not tend to attract capital investment without adequate government incentives and support. This chapter reviews the experience of international governments that have attempted to make financial and capital markets work better in terms of financing good quality affordable rental housing for low and middle income households.

### **2.1 The instruments that governments use**

To ensure that housing markets serve the broad needs of their populations, governments intervene in those markets utilising a wide variety of mechanisms that may include: direct subsidies; tax incentives; insurance; guarantees; the promotion of a strong well regulated rental sector; and sponsorship of a social housing system.

The types of instruments that are typically used by governments in developed economies to promote the supply of affordable housing are summarised in Table 3.

**Table 3: Financing instruments promoting affordable housing**

Mechanism	Brief outline
Grants	Directly able to influence housing supply, but limited to available funds and political commitment to housing. Often used to lever and secure other sources of funds.
Discounted land price	Traditionally a key vehicle to manage urban development outcomes, where governments are major land holders. Can be applied specifically to affordable housing goals. Subject to land availability and market conditions.
Public loans	Traditionally the primary financing strategy for social/affordable housing. Cost-effective fund-raising. Revolving liquidity (through loan repayments) can offer longer-term reinvestment potential. Recently, curtailed by public sector borrowing limits and the attractiveness of low private mortgage rates. So-called 'soft' loans may not require same security as for private finance.
Protected circuits of savings for specified investments	Used to achieve a dedicated flow of affordable credit for affordable housing programs. Sustained in some countries, while others have dismantled the approach to improve competitiveness of local banks amid foreign competition.
Bank loans	Increasingly play a role in financing affordable housing, either partially or entirely. Vulnerable to changing financial conditions and alternative investments. National approaches vary in cost-effectiveness and the appropriateness of the fund-raising and distribution mechanisms.
Interest rate subsidies	Useful in the early phase of a credit-foncier mortgage to offset higher costs of principal and interest repayments. Containing the cost to government over time relies on steadily rising wages and house prices and stable interest rates.
Tax privileged private investment	Used to channel investment towards affordable housing and to compensate investors for lower rates of return and profit restrictions.
Government-secured private investment	Government-backed guarantees to reduce risks to financial institutions investing in affordable housing, passed on at a lower cost of finance.
Tax privileges for providers of affordable housing	Tax privileges compensate providers of housing achieving the social policy objectives of governments, such as housing low-income households or meeting high environmental standards Tax privileges for registered organisations delivering a social service: income and investment deductions, depreciation allowances, reduced sales and property taxes, exemptions from capital gains tax.
Use of own reserves and surpluses	Mature housing organisations can leverage their balance sheets, reserves and surpluses to invest in additional housing. Funds raised may be pooled to support weaker organisations or to promote innovation and competition. Limited profit systems require reserves to be reinvested in affordable housing.
Use of tenant equity	Some funding models incorporate a small tenant equity contribution. Governments may assist low-income tenants to make this contribution. Larger contributions may lead ultimately to tenant purchase of dwellings.

Source: Milligan et al. 2009, p.28

## 2.2 Overview of international approaches and outcomes

While international examples cannot provide ready-made solutions for issues faced by Australia, they can inspire creative policy development towards the design of instruments and institutions suitable for local conditions.

Since 2006, the Australian Housing and Urban Research Institute (AHURI) (funded by Australian governments and partner universities) has supported comparative research in this field which has examined a wide array of established social housing systems and their financing strategies in both continental Europe and North America. For example, Milligan and Lawson (2007) compared national policy trends in social housing and Lawson et al. (2009) discussed four different bond models and developed a preliminary concept for an Australian Housing Supply Bond.

Follow-up research for the West Australian Government (Lawson et al. 2010a) investigated a number of specific mechanisms for channelling private investment to affordable housing in more detail. This research covered six national approaches:

1. The French Caisse des Dépôts (CDC), which pools tax-privileged savings and issues low cost loans to housing providers.
2. The Swiss bond issuing co-operative for raising finance for housing cooperatives backed by a public guarantee.
3. The Austrian Housing Construction Convertible Bonds, as elaborated elsewhere in this report.
4. The UK mixed public and private financing model for housing associations.
5. The US low-income housing tax credit scheme (LIHTC), which is used to attract equity investors into low-income housing offered by various for-profit and not-for-profit providers.
6. The jointly-funded Dutch government and third sector guarantee fund (Waarborgfonds Sociale Woningbouw—WSW) that operates to reduce the cost of bank finance for housing associations in the Netherlands.

Detailed case studies were also produced on two specialist intermediaries: the special purpose housing banks in Austria that are licensed to sell tax privileged bonds for limited profit housing development; and The Housing Finance Corporation (THFC) in the UK that operates as a not-for-profit financial intermediary pooling the investment demands of smaller providers of affordable housing. Financial intermediaries such as these play a crucial role in channelling investment and distributing funds. They can be considered as the hub of specialised circuits of savings and investment.

A consistent finding of previous research has been that capital markets need the reassurance of adequate cash flows in order to lend to affordable housing providers. Also, adequate risk mitigating strategies need to be present, secure and measurable. The systems examined previously show that such reassurance can be given via some combination of public collateral, guarantees, sound financial management and regulation as well as via revenue support (usually in the form of rent assistance). However, private markets can also quickly divert resources away from investment in affordable housing or increase the cost of that support. Such instability creates tensions and cost risks within each housing system. Social housing systems where governments continued to play an integral role and were responsive to changing patterns of risk during the financial and economic crises of the late 2000s have provided more stable housing outcomes, as discussed in Section 2.2.1 below.

Beyond the AHURI-funded work reviewed above, there are many more examples from a wide range of countries of government backed developments in housing finance. Boxes 1 and 2 provide current illustrations from the US and the UK.<sup>20</sup>

**Box 1: US taxes housing bonds favourably**

In the US, state and local governments sell tax-exempt housing bonds, commonly known as Mortgage Revenue Bonds (MRBs) and Multifamily Housing Bonds, and use the proceeds to finance low-cost mortgages for lower income first-time homebuyers or for the production of apartments at rents affordable to lower income families (in combination with the 4% LIHTC scheme). The US tax authority (Internal Revenue Service Code, Section 103) allows purchasers of bonds to deduct interest income from bonds from their federal gross income taxes. Thus the interest rate on tax-exempt bonds is lower than conventional bank financing (typically by about 2%). This saving contributes to housing affordability. By 2009, MRBs had made first-time homeownership possible for over 2.6 million lower income families, approximately 100 000 every year. Multifamily Housing Bonds have provided financing to produce nearly 1 million apartments affordable to lower income families.

Multifamily developments utilising housing bond finance must set aside at least 40 per cent of their apartments for families with incomes of 60 per cent of area median income (AMI) or less, or 20 per cent for families with incomes of 50 per cent of AMI or less.

The Housing and Economic Recovery Act (HERA) of 2008 provided \$11 billion in new Housing Bond Authority money to be available to US states through 2010 and made a number of additional changes, including exempting interest on housing bonds from the Alternative Minimum Tax. These changes were designed to help overcome diminished investor interest in MRBs in the context of the recent economic crisis.

Sources: CSH 2012, NCSHA 2012.

**Box 2: A new circuit of investment in UK social housing—pension funds?**

Bringing together the portfolio needs of pension funds with the long-term low cost financing needs of social housing providers has been a feature of several European countries. Current trends in the UK suggest that pension funds may play an increasingly important role in social housing investment, despite declining government support as outlined below. Developments there should be closely monitored.

In the UK, the credit crisis and tighter regulation of banks under Basel III have reduced the capacity and willingness of commercial banks to offer low rate long-term loans to Registered Social Landlords (RSLs). Following the GFC and deep cuts to housing grants and demand assistance by the Coalition Government, financing social housing has been in a state of flux, with re-financing costs rising sharply for providers. In September 2011, the Communities and Local Government Select Committee launched an inquiry into the future financing of social housing, with the chair seeking evidence on the role of, and potential for, greater institutional investment, as traditional market players withdrew. However, in the final months of 2011, a new trend began to emerge in lending to RSLs with pension funds and insurance companies showing greater interest in the sector and offering bank-style loans.

According to 'Inside Housing' reports on this issue, East Midlands-based housing association, Derwent Living, finalised a £45 million deal with Aviva Investors to fund

<sup>20</sup> In Russia, as an example of an emerging market with a less developed private housing finance market, pension funds invest in affordable housing only through a wholly government-owned and fully guaranteed intermediary. See <http://www.ahml.ru/en/investor/> for online information.



the purchase of 839 properties from Home Group through the asset manager's REALM social housing fund (Inside Housing 16/09/11). This investor was attracted to the low-risk, long-dated income streams provided by long-lease property of the association. In November, Canada Life Investments started providing loans with maturities of up to 35 years to social landlords (Inside Housing 25/11/11). In late 2011, MGN launched a £1 billion social housing fund, with two unnamed pension funds. The MGN-backed fund has predicted a return of around 2 per cent over the retail price index, capped at 5 per cent (Inside Housing 1/12/11).

A model of index-linked institutional investment is being encouraged by the government (Inside Housing 1/7/11). According to the reports cited above, such investors are seeking a 2 per cent return above the retail price index (RPI) and offering long-term index-linked loans. However, The Housing Finance Corporation, which issues fixed income bonds for housing investment and welcomes the role of pension funds, cautions against an index-linked approach, arguing that low inflation, heavy cuts to subsidies and the rising costs of providers can erode income streams and, in this context, RPI-linked investments could fail to deliver required returns.

In a recent report, Hull et al. (2011) provide a mixed assessment of the potential and (post-crash) likelihood of institutional investment in housing supply the UK. They identify local authority pension funds as possibly being a better potential source of untapped funds for housing than insurance companies in the long run. In Australia, pension annuity funds may have comparable characteristics that are amenable to government incentives, as discussed in Chapter 3.

Sources: Inside Housing ([www.insidehousing.co.uk](http://www.insidehousing.co.uk)) for dates specified above.

### *2.2.1 Use of government guarantees*

Governments can also facilitate capital market investment in social housing by providing guarantees to lenders. An overview of a guarantee mechanism is provided in Box 3. Given low or zero default rates, these guarantees actually cost governments very little.

#### **Box 3: Government guarantees for private investment in affordable housing**

A mortgage guarantee on capital market loans provides an alternative to government loans and/or is used to reduce private financing costs by reducing risks to lenders in many European countries. A mortgage guarantee offers security for loans, which are taken out on the mortgage or capital market by social landlords so that they can purchase, renew or build a dwelling. Such a guarantee only comes into operation when the mortgage holder is no longer able to meet the payment obligations towards the mortgage provider. Where default would otherwise result in a loss (e.g. if the revenue from the compulsory sale of the house is not enough to meet the outstanding debt), the guarantee fund pays the difference to the lender.

Two models are possible: either the guaranteed loans are granted to institutions (social landlords) who meet a set of criteria related to solvency and cash-flow, or they can be project-based. The guarantee can be designed to promote investment in specific segments of the housing market. In Switzerland, for example, the guarantee applies to loans raised by a bond-issuing co-operative of housing associations to finance limited profit rental housing. In the Netherlands, it applies to registered housing associations providing rental housing for tenants within a defined income range. In France, the guarantee can apply to a variety of publicly subsidised housing schemes from shelters for homeless people to first home buyers, and in Belgium to publicly co-financed social rental housing.

Sources: Elsinga et al. 2004; Lawson et al. 2010a

Perhaps the best developed guarantee system underpinning capital markets funding for housing associations is that of the Netherlands. The Dutch social housing guarantee fund (WSW) features a triple guarantee, with central government and local authorities limiting themselves to being the so-called 'safety net' or backup guarantors, in the event that the housing association sector as a whole is unable to meet any claims.<sup>21</sup> In Switzerland, the Federal government backs the loans issued by a bond issuing co-operative, Emissionszentrale (EGW) and potential costs are simply recorded by agreement in the accounting notes attached to the government budget.

The international standard for treatment of loan guarantees on public balance sheets suggests that where the guarantee obligations, in the event of a loan default, are uncertain in both the timing and amount, an estimation of the probability of events is required. If a payment due to default is probable, then an appropriate provision should be recorded in the balance sheet. If payment from the fund is improbable, it is treated as a contingent liability and not recorded in the balance sheet (see International Public Sector Accounting Standard 19).

The certification process for obtaining a guarantee is crucial. It must not only verify, but also work to strengthen, the financial capacity of the borrowing associations, in order to prevent default and ultimately to improve borrowing conditions. In the Netherlands, a zero default record and AAA rating has been achieved for several decades via a six level monitoring process of financial solvency and business planning. Since 2010, however, there have been two incidents involving derivatives. One of these has required assistance from the guarantee fund. Negotiations are ongoing with the other. This recent experience highlights the importance of regulation and transparency at a detailed level, including the finer clauses of lending contracts, and one of the key partners in the WSW, the Association of Dutch Municipalities, recently has called for much stricter financial frameworks (e.g. those that apply to local governments) to apply to Dutch housing corporations.<sup>22</sup> In Austria, the sector has an independent arm, which audits associations for a fee each year for a three week period, assessing their adherence to the limited profit housing provision system and their financial solvency.

The costing of any guarantee on housing bonds (see Chapters 3 and 4) would be according to international accounting standards as they apply in Australia.<sup>23</sup> In essence, financial liability would be based on best available estimates of default and recorded in the balance sheet of the guarantor equal to the expected cost of calls on guarantees. Default rates for the social housing sector in the UK, Switzerland and France could be reviewed, but the specific system of provision in Australia should form the primary basis for estimating default.

### *2.2.2 Lessons from the Global Financial Crisis*

As argued above, investment in affordable rental housing requires dynamic and responsive government intervention. Experience with specialised financing instruments during the GFC of 2007–08 provides one lens through which the robustness of different financing approaches can be compared. In many countries quick action was required during this crisis to keep investment flowing into new

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<sup>21</sup> A committed pool of funds established at the commencement of the scheme has been funded jointly by housing associations and the government. This fund, together with the large asset base of the sector, underpins the guarantee. More details on the WSW can be found in Lawson et al. (2010a) or Standard & Poor's (2011).

<sup>22</sup> Translated from the Dutch Association of Municipalities, VNG Magazine, 14 March 2012. At <http://fd.nl/beleggen/956801-1203/wsw-ontkent-falen-bij-vestia-debacle?visited=true>.

<sup>23</sup> International accounting standards are discussed in more detail by Golland (2006).

projects and renovation, to secure employment in the construction sector and to stabilise regional economies.

In terms of impact on affordable housing provision, the GFC's effects have been strongly mediated through the design of a particular country's financing approach and the openness of mortgage credit markets to social housing (Lawson et al. 2010b). The mix between debt, equity and grant in funding affordable housing and the extent governments implicitly or explicitly underwrite finance obligations have also been important factors, as illustrated in Table 4.

**Table 4: Performance of private financing instruments during the GFC, selected countries**

Main private financing instruments	Performance
Austria. Public grants and loans combined with low interest commercial loans, raised via tax-privileged HCCB sold by housing banks.	HCCB combined with subsidy programs and cost rents have provided a long-term way of stabilising housing markets and moderating mortgage interest rates. However during the GFC, HCCB were not protected by the Austrian government's savings guarantee and were less attractive to bond holders. The volume of investment shrank for the first time since 1993.
England. Bank finance in an open, well-developed and competitive market complemented by public grants and housing benefit. Limited use of bonds either raised directly by a housing association or syndicated by the THFC.	After onset of the GFC, terms of commercial loans considerably worsened and competition for association business declined. However, THFC bonds operated counter-cyclically during the GFC, as a 'safe haven' for investors and a lower-cost form of borrowing for housing associations. Low cost European Investment Bank (EIB) funds were directed via the THFC to sustaining investment in a large number of regeneration projects. <sup>24</sup>
France. Savings (Livret A) are pooled and parcelled into low interest tax privileged loans (via the financial intermediary CDC) for investment in public infrastructure, including affordable housing. Complemented by various public subsidies.	The off market circuit of savings and loans buffered social landlords from shrinking credit markets during the GFC. Further, the guarantee on Livret A savings attracted many small deposits, growing the pool of available funds, enabling the CDC to increase activity and underpin housing markets and construction employment during the crisis (see RICS 2011).
Netherlands. Bank finance in a public bank-dominated market backed by triple government / third sector guarantee (WSW). Complemented by self-financing by large financially robust housing associations with variable reliance on active sales strategies.	The guarantee fund (WSW) <sup>25</sup> was used during the credit crisis to assist a stagnant housing market. Housing associations were encouraged to absorb excess dwellings for sale in the private market via increased WSW coverage. Public sector banks increased their provision of credit to associations during the GFC, raising competition concerns with some associations wary of the public banks' monopoly position. Associations reliant on sales for their financial continuity became vulnerable. Recently, several associations faced problems relating to risky investments in derivative products. This has led to calls for their tighter financial regulation.

<sup>24</sup> More about the role of the THFC and the EIB can be found at [http://www.thfcorp.com/eib\\_funding.htm](http://www.thfcorp.com/eib_funding.htm).

<sup>25</sup> A credit rating agency view of the WSW can be found at [http://www.wsw.nl/uploads/media/105\\_Moodys%20rapport%202010.pdf](http://www.wsw.nl/uploads/media/105_Moodys%20rapport%202010.pdf). Accessed 29 November 2011.

Main private financing instruments	Performance
<p>Switzerland. Bank finance and low interest public loans from a joint state/sector revolving fund. Loans from bond finance issued via a bond issuing co-operative (EGW)<sup>26</sup> with state guarantee.</p> <p>United States. Low-income housing tax credits (LIHTC) main mechanism for attracting private investors to affordable housing since 1986, underpinned by legal obligations for financial institutions to invest in 'poorly served' areas (the Community Reinvestment Act). The equity finance raised by syndicated sales of credits is complemented by various other project subsidies and by mortgage finance. A tax exempt bond program (see Box 1) complements the LIHTC.</p>	<p>This model was established at a time (1990s) when conditions in the mortgage market were unfavourable to not-for-profit housing developers. During the GFC, lower commercial interest rates were offered to limited profit builders and the role of the EGW actually declined.</p> <p>Demand for LIHTC was severely depleted after 2008 because of unfavourable housing market investment conditions and low profitability (and hence low or negative tax burdens) of major investors. Since the crisis, rescue plans for affordable housing under the HERA have included enhancements to tax credit provisions to increase investor appetite and supplementary federal grant funding programs to bridge the funding gap. This has helped to restore the yield for tax credits in some markets (JCHS Harvard 2010; Schwartz 2011).</p>

Source: Adapted from Lawson et al. 2010b, Table 3 and other sources as indicated in table.

### 2.3 Austrian special purpose housing bonds

The Lawson et al. (2010a) study referred to in the previous sub-section highlighted the possibility that the Austrian Housing Construction Convertible Bond (HCCB) could provide an appropriate starting point for developing a financial instrument suited to Australian housing policy, institutional and market conditions. Using a consistent evaluative framework that was applied to the six national approaches examined, that study concluded that the Austrian strategy had proved to be stable and cost effective and had reduced both the cost of private finance and rents. Austria also offered the most comprehensive example (among those studied) of an approach to housing development promotion and planning as well as to business model practice and regulation. For these reasons, this research project used the Austrian approach as a catalyst for the development of appropriate instruments suitable to Australian conditions, as elaborated on in Section 2.4.

This section provides a brief overview of the role of the HCCB. A more detailed account of the Austrian system of social housing provision and the role of the HCCB, based on material provided by Dr Wolfgang Amann (IIBW) and Dr Astrid Kratschmann (Erste Bank), is provided in Appendix 3. Further information can be found in Deutsch and Lawson (2010).

Austria possess a sophisticated affordable rental housing system, operating in a federated context and using a national legislative framework to promote the supply of cost rent housing, at the same time as enabling (through provincial agreements) regional housing programs to be responsive to local needs and priorities.

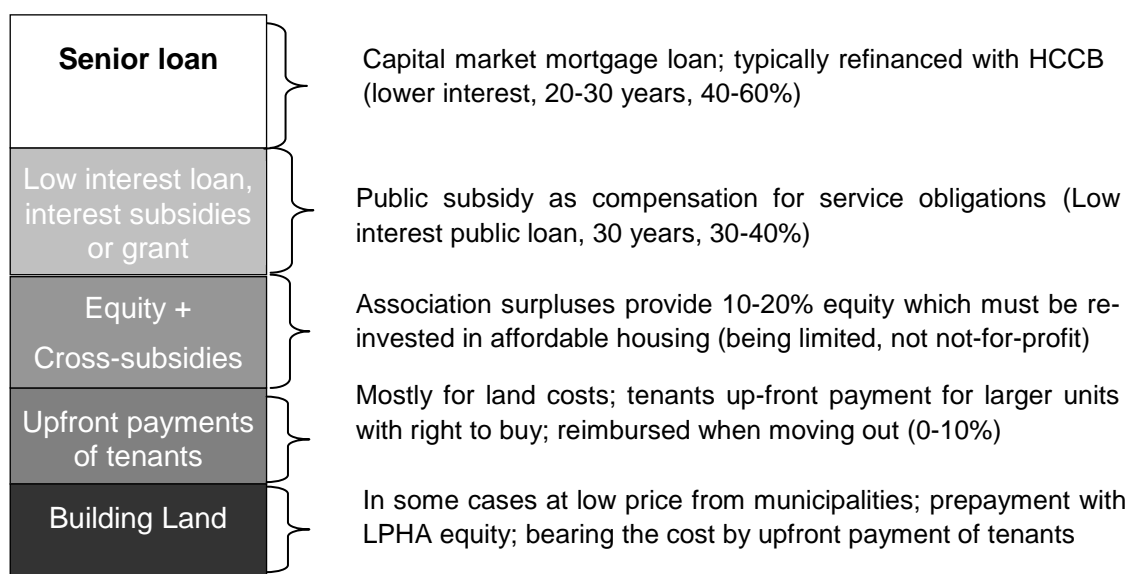
In Austria, the limited profit housing sector comprises 23 per cent of the housing stock and 48 per cent of the rental stock. A competitively allocated public loans and grants system drives efficiency and quality between providers, contributing a stable supply of between 14 000 and 16 000 dwellings per year (typically around 30% of all new supply). In the context of rising costs and some decline in public funding, this has been supplemented in recent years by tenant down payments that add to project equity and provide a right-to-buy to tenants on a delayed basis. Complementing these

<sup>26</sup> The website of the Emissionszentrale, <http://www.egw-ccl.ch/>, offers details (in French and German) of bond issues for limited profit housing projects in regular bulletins.

financial measures, planning policies and public land agencies facilitate access to sites for affordable housing projects (e.g. about 6000 sites per year are provided in Vienna).

The HCCB, available to retail and institutional investors in Austria since 1994, is a special purpose private bond that raises low cost funds for the development of affordable rental housing delivered through the for-profit and limited profit sectors<sup>27</sup>. It represents one extremely important component of the total package used to finance limited profit affordable housing associations (LPHA) in Austria. Significant amounts of different forms of government assistance make up other components of this package and provide the collateral that underpins private finance. The different layers of this package each contribute to determining housing outcomes, as depicted in Figure 7.

**Figure 7: Funding of limited profit affordable rental housing in Austria**



HCCB provide between 40 and 60 per cent of the finance of new or redeveloped affordable rental housing projects. They provide lower cost funds for commercial loans with 20–30 years maturity at 0–30 bp above the Euribor rate, at either a fixed or a variable interest rate.

In the interests of sustaining the supply of affordable rental housing in a cost efficient and well-targeted manner, legislation defines the business model and realm of activities pertaining to limited profit housing provision, and Austrian tax law permits the waiver of capital income tax on the first 4 per cent of HCCB coupon rates for investment in this sector. Normally, returns on obligations are subject to a 25 per cent withholding tax in Austria. Low or middle income holders of long-term bonds (over 10 years) can partially deduct the cost of bonds purchased from their income for tax purposes. This tax advantage effectively makes low yield bonds attractive and, at the same time, enables loan interest rates between 60 and 70 bp below the market rate; including loan operating costs and risk premiums.

Five competing Housing Banks, which are subsidiaries of major Austrian banks, have been issuing bonds since 1993 (now over AUD\$18 billion) and, in turn, their mother

<sup>27</sup> Under Austrian law the 'profits' of limited profit housing companies are limited to six per cent and are not distributed but reinvested in the housing activities of the sector (Lawson et al. 2010a).

banks have been providing an increasing volume of capital market loans to the affordable housing sector.

HCCBs provide a yield that is 1 per cent lower than capital market bonds. When combined with a tax advantage, however, the bond offers an attractive long-term low-risk, ethical form of investment that is widely held in Austria. The HCCB has no government guarantee but is backed by public loans and grants as set out above. Additionally, the sound financial position and robust regulation of the limited profit sector gives comfort to investors.

Since its foundation, the system has expanded steadily, peaking in 2007. However, in the context of the GFC and in the absence of a government guarantee on the bonds (in contrast with bank deposits that act as a close substitute), annual sales have declined since (as indicated in Table 4).

## **2.4 Potential relevance to Australian conditions**

Currently, the Australian affordable housing sector is small and diverse and requires substantial volumes of both public and private financing if it is to expand to meet the level of needs outlined in Chapter 1. Public funds, however, are limited and private finance has not been forthcoming at scale. What is available is expensive in the absence of a dedicated vehicle for raising and channelling low cost finance. The effectiveness of any public loans, grants or incentives (e.g. NRAS) directed to housing supply, and of any demand side housing subsidies, would be much enhanced by increasing the availability of lower cost private finance.

The HCCB provides a well-established model of how a special purpose bond can provide well targeted, longer term and lower cost financing. For reasons that are discussed in more detail in Lawson et al. (2010a), the concept could provide the basis for the development of an appropriate instrument for Australian conditions.

A special purpose bond for affordable rental housing could provide a standardised investment mechanism for retail and institutional investors. Current NRAS arrangements are complex, administratively cumbersome and time-limited. In operation they may rely on the existence of other tax instruments, such as negative gearing only available to retail investors, to bolster modest yields. A standardised bond instrument, with sufficient government backing, could attract a broader range of institutional investors and keep the role of investor and provider of affordable housing at arm's length, as applies in Austria.

A relatively low gross yield on such a bond could be made attractive to investors via a modest tax incentive (suitable for retail) and or a guarantee (suitable for institutions), increasing effective returns. Such bonds could provide a pool of cheaper funds to be passed on as lower cost loans to the affordable housing sector. To ensure that the funds raised by the bond meet clearly defined policy targets, loans would be made available only for publicly approved projects.

The share of bonds in the Australian financial sector is significantly lower than similarly developed markets overseas. Prudential standards under Basel III will require higher quality reserves to back financial institutions in the future, placing increased demands on local bond markets and, in particular, on investment grade bonds. Treasury aims to increase the role of bonds in the Australian financial system, in part by making it easier for financial institutions to issue covered bonds (see Box 4) and by making bonds more accessible to retail investors, who currently rely heavily on more risky equities for investment income.

In its submission to the Senate inquiry into competition within the Australian banking system, for example, the Australian Government linked the issue of covered bonds to

accessing funds in superannuation and argued that development of this market would help direct superannuation funds into productive investment in all sectors of our economy (The Senate Economics References Committee 2011b, p.268).

#### **Box 4: Covered bonds**

Covered bonds are bonds secured by a pool of high-quality assets on the issuing financial institution's balance sheet. The main feature of covered bonds is that if the issuer can no longer service the periodic bond payments, investors have a preferential claim on this pool of assets and the associated cash flows. If the cover assets are not sufficient to meet the bond payments in full, covered bondholders also have an unsecured claim on the issuer to recover any shortfall. In that case they would stand on an equal footing with the issuer's other unsecured creditors. This is known as dual recourse.

Because of strict regulations and the two-fold protection of investors' interests, covered bonds are considered to be the safest form of bank debt. As a result, they typically carry a higher credit rating than that of their issuer, and allow the issuer to access cheaper and more stable long-term funding from the wholesale debt markets.

The funding advantages of covered bonds are currently attracting attention in Australia. In December 2010, the Australian Government announced that it will establish a legal framework that will permit all authorised deposit-taking institutions (ADIs) to issue covered bonds.

Source: RBA 2011, Box A

With significant proportion of savings in Australia being held in superannuation funds, however, it is important that available instruments are also acceptable to these institutional intermediaries if a significant volume of funds is to be raised. In the main, institutional investors have preferred secure fixed income investments as a balance to their more dominant equity holdings. However, as Debelle (2011b) has argued, 'a world where the only source of funding available is secured is just not sustainable'. Because some markets are more functional than others at different points in time, it is useful to have a diverse range of funding instruments available.

Development of housing supply bonds, as a private bond with a government provided credit enhancement to generate a high quality rating and/or with assistance to improve yield, could complement these goals, as well as meeting other housing policy and economic objectives. Such bonds could build on the lessons learned from the Austrian experience with HCCBs.

They could assist in the government's goal of expanding the bond market to provide long-term, lower risk supply of funding for economic development and to strengthen Australia's ranking as an international financial centre (Australian Financial Centre Forum 2009). See Box 5.

### Box 5: Developing a corporate bond market

The announcement of the establishment of the Australian Financial Centre Forum (AFCF) in 2008 was designed to position Australia as a leading financial services centre. Having a financial sector that meets the financing and investment needs for consumers, businesses and governments as efficiently and competitively as possible was seen as increasing the nation's capacity to grow. The announcement emphasised the need for ongoing dialogue and partnership between government and the financial sector in achieving this objective.

The AFCF report (the Johnson Report) on 'Australia as a Financial Centre: Building on our Strengths', issued in 2009, assessed the strengths and weaknesses of Australia's financial sector. It identified the domestic corporate bond market as one area of relative weakness and claimed there were strong arguments in favour of a deeper and more liquid corporate bond market, arguing that 'one of the lessons of the financial crisis for companies has been the desirability of maintaining a diversity of potential funding sources.' It considered that a deeper, more liquid and longer maturity corporate bond market was in the national interest and, amongst many recommendations, considered that the government should encourage the development of a wider range of 'capital stable' and annuity type products more suited to investors close to retirement.

A Treasury discussion paper, released in 2011, invited submissions on the proposition that a sustainable corporate bond market be facilitated by: reducing the regulatory burden on/barriers to issuance facing potential issuers while maintaining appropriate investor protection; ensuring that investors are made aware of the key features and risks associated with buying a particular bond from a particular company while reducing the complexity of prospectuses and making them easier for investors to understand; and ensuring that there is an appropriate liability regime in place which balances investor protection against ensuring that directors are not unduly burdened.

Sources: AFCF 2009, p.5, p.40, p.93, Australian Government 2011c, p.1

There are, however, a number of factors that need to be highlighted when considering application of the HCCBs to Australia. In the first place, there is a significantly greater culture and acceptance of affordable housing in Austria than hitherto has been the case in Australia. Both individual and institutional investors in Australia may need to be persuaded of the economic and social desirability of such investment. The needs of investors in Australia are covered in Chapter 3.

In the second place, the focus of Austria's special purpose housing bonds has been retail 'Mum and Dad' investors. These bonds have served as a tax advantaged form of savings for such investors. Equivalent treatment in Australia would require the introduction of further tax concessions for savings directed to a specific socially determined use (e.g. already occurs with superannuation and owner-occupation). The Austrian model provides little insight into how to attract institutional investors into the financing of affordable rental housing. Again, the needs of such investors are addressed in the following chapter along with a discussion of the ways in which an Australian housing supply bond might differ from the Austrian bond.

Finally, the system of financing affordable rental housing in Austria is underpinned by significantly greater levels of subsidy than are currently available in Australia directly or indirectly from government sources. As indicated in Figure 7, only 40–60 per cent of the cost of providing affordable rental housing is sourced from HCCBs. The remainder is provided in the form of land contributions, tenant provided equity, reinvestment of housing association surpluses and low interest government loans. In the absence of such additional support, there is no guarantee that the use of lower



cost private finance to fund affordable rental housing in Australia will result in rents that are affordable for tenants on low incomes. This issue is returned to in Chapter 5.

### 3 OUTCOMES OF STAKEHOLDER CONSULTATION

Consultation with stakeholders, working as financial regulators, bond market specialists, financial investors, social and affordable (community) housing providers, housing policy-makers and public finance specialists, has played a central role in this project. The consultation process, outlined in Chapter 1, provided an in depth opportunity to inform these relevant stakeholders of the housing supply bonds concept, to obtain their preliminary reactions, and to engage them in the longer term process of designing and implementing such a bond. This chapter summarises their views on the four specific research questions identified for the research project and covering the following four areas:

1. The concept, terms and conditions of a housing supply bond.
2. The nature and role of a financial intermediary.
3. The necessary regulatory and incentive structures.
4. Complementary reforms to sustain investment in affordable housing.

Sections 3.1 to 3.4 begin with the specific research question associated with each of these four areas, provide an overview of the general information obtained from each stakeholder group and indicate their views on each of the question put to them. Because of the interdependence between these questions, much of the responses to later questions are addressed in response to the first. As a result, the material in Section 3.1 is considerably longer than in the following three sections. Each section concludes with a brief overview of the points raised. A final section (3.5) briefly summarises key points from all four questions that have been taken into account in the bonds proposal developed in Chapter 4.

#### 3.1 Stakeholder views on the HSB concept, terms and conditions

This section concerns the views of the various stakeholders on the research question:

- What would be appropriate terms and conditions for an Australian Housing Supply Bond, to ensure that it is attractive to investors and raises sufficient low cost funds for borrowers?

##### 3.1.1 *Financial regulators*

Consultations were undertaken with the regulators of Australian financial institutions and products, the Australian Prudential Regulation Authority (APRA) and Australian Securities and Investments Commission (ASIC), because any HSB and its financial intermediary would need to be regulated by these or equivalent institutions.<sup>28</sup>

ASIC administers the Corporations Act, is responsible for approving prospectuses before the sale of investment products, enforces standards for disclosure for securities issued on the wholesale and retail market, and licences trustees with Australian Financial Services licences. In any prospectus ASIC requires the disclosure of bond characteristics such as the term of the bond, the level and type of interest paid, and a schedule of payment dates. It also requires key financial information on the issuer of the bonds, such as gearing ratio, interest cover, working capital ratio, senior debt outstanding, and information about the effects of the transaction on the company.

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<sup>28</sup> A comprehensive overview of the respective roles of these regulators can be found in Grant (2005).

In Australia wholesale investors are able to purchase unlisted bonds without a prospectus. Those investing more than \$0.5 million are considered to have the capacity to assess risk in-house. However, ASIC does require such a prospectus for issues directed towards smaller wholesale investors and investors of under \$0.5 million. Retail investors are only able participate in the secondary market for bonds without a prospectus. This differentiated requirement provides a disincentive to serve the smaller retail market. Thus, unlike Austria where individual investors have a strong tradition in holding bonds, Australian bond issues have not been pitched at the retail market in recent decades. Consequently, ASIC suggests that any new housing supply bond should, in the first instance, be targeted towards wholesale investors and in longer term be sold to retail investors (via the secondary market). Other reasons, such as the different treatment of taxable income between bonds and equities, are discussed in Section 3.1.3.

Australian Securities and Investments Commission (ASIC) stressed that current Australian Government policy was to facilitate and significantly expand the corporate bond market and retail access to this. In an effort to promote Australia as a centre of international finance, facilitate corporate fund raising and deepen Australia's bond market, ASIC introduced standardised prospectus requirements for simple ('vanilla') bonds in 2010 to remove unnecessary impediments to the retail market. Vanilla bonds are unsubordinated obligations which pay regular interest at defined times over a period of less than 10 years. Interest may be paid at either fixed or a floating rate with the latter pegged to a specific margin above a well-established market indicator. Under these new regulations, detailed corporate financial data is not required, provided that it is available via continuous disclosure requirements. Further details can be found in Davis (2010). ASIC also has issued new regulations to facilitate the raising of corporate debt that apply to bond issues above \$50 million, an amount considered necessary to achieve secondary market liquidity for investors.<sup>29</sup>

Australian Prudential Regulation Authority (APRA), the national regulator of deposit takers, insurance companies, and superannuation funds, ensures that prudentially regulated financial entities maintain a minimum level of financial soundness. Following the GFC, under Basel III requirements, more attention is being paid to the minimum capital ratio based on the risks to which banks are exposed. Banks must report on their capital structure, capital adequacy, risk management and measurement practices to APRA. In November 2011, APRA released its draft prudential standards on bank liquidity to maintain portfolios of high-quality liquid assets sufficient in size to enable such institutions to withstand a severe liquidity stress.<sup>30</sup>

For a range of reasons, it is possible that there will be a shortage of high quality bonds in the Australian market to serve the demands imposed by Basel III. Highly rated bonds will be in high demand. A Housing Supply Bond with a government guarantee could in theory have a AAA rating. It is APRA's task to examine how a bank or fund investments in HSBs would impact on capital adequacy requirements and risk exposure, based on the risk profile of the bonds and the nature of the guarantee provided.

Both ASIC and APRA considered that the financial governance, reporting and regulation of the community housing sector would need to comply with APRA and ASIC disclosure and risk reporting requirements. Further, any bond issued would

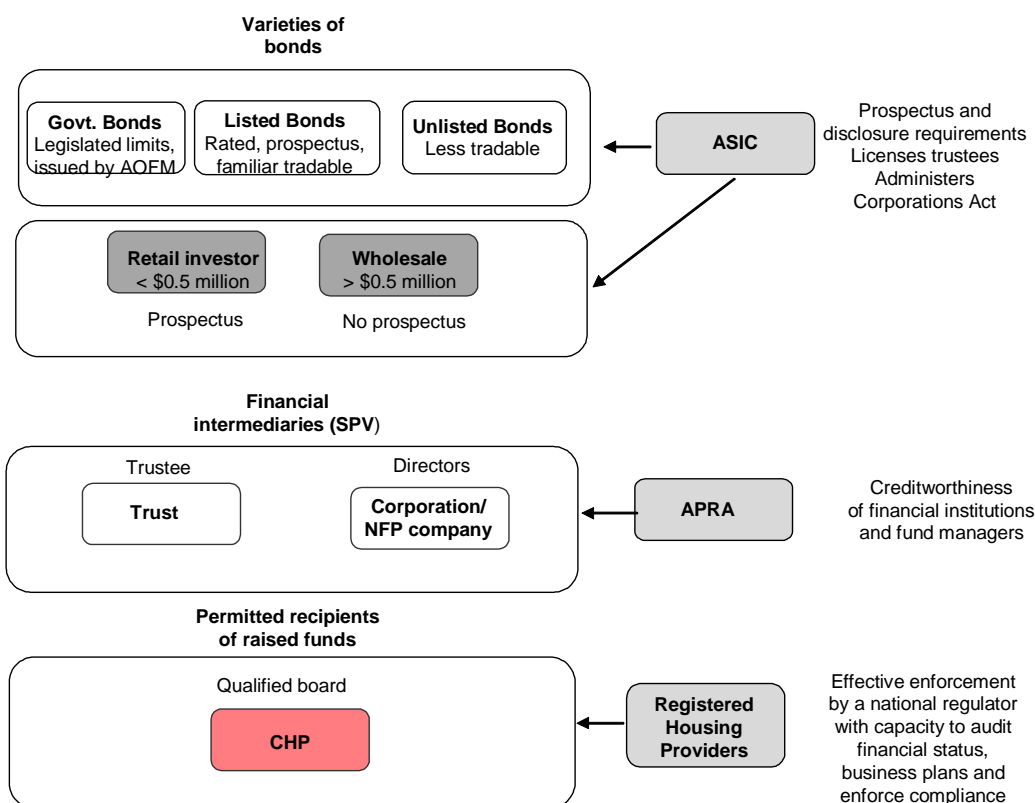
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<sup>29</sup> See, for example, MR 10-98, available at <http://www.asic.gov.au/asic/asic.nsf/byheadline/MR10-98+Prospectus+relief+to+help+corporate+bond+market?openDocument>) and the guide to facilitating debt raising at [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rq213-a.pdf/\\$file/rq213-a.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rq213-a.pdf/$file/rq213-a.pdf).

<sup>30</sup> This can be accessed at [http://www.apra.gov.au/adi/Documents/Draft\\_APS\\_210\\_November\\_2011.pdf](http://www.apra.gov.au/adi/Documents/Draft_APS_210_November_2011.pdf).

require a prospectus and, if provided, the nature of any guarantee would also be scrutinized. One interpretation of their views of the bond market and any proposed housing bond is provided in Figure 8, which highlights the role of the regulatory agencies in relation to bond instruments, issuing intermediaries and end users of funds raised.

**Figure 8: Financial regulators' perspective**



### 3.1.2 Bond market specialists

Consultations were undertaken with bond market specialists with a range of perspectives in the field of bonds and fixed income investments to better understand the characteristics of the Australian bond market and, in particular, characteristics that would affect HSBs. Stakeholders interviewed included the Australian Financial Markets Association, representing wholesale investors; the Fixed Income Investments Group, a buying group for retail investors; the Grattan Institute, with expertise on banking and economic policy; the Financial Services Council, with working groups on superannuation and taxation and Frontier Asset consultants, who advise investment funds and managers of fixed income portfolios.

Overall, the Australian bond market is dominated by the issuance of private debt, partly due to the low rate of public debt since the mid-1990s but also to the growth of corporate debt issued by companies (Debelle 2011a). Bonds are issued by private and public financial institutions, other private corporations, asset-backed issuers and non-resident issuers of Kangaroo (Australian-dollar denominated) bonds. Credit rating agencies (Standard & Poor's, Moody's Investors Service and Fitch Ratings in Australia) use their expertise and knowledge to assess the quality of these bonds as

anything from AAA (e.g. assigned to Australian Government Bonds) to BBB (e.g. assigned to so called Junk Bonds).<sup>31</sup>

Of critical importance to bond markets is the level risk and return. In the Australian market, bond pricing generally relates to a benchmark rate defined by the Bank Bill Swap Rate (BBSW). One expert argued that bonds with an interest rate of 100 bp above the BBSW were of little interest to retail investors, while those of 300 to 400 bp or more above BBSW began to attract interest. As an example, Commonwealth Bank bonds, which are senior, floating interest rate bonds that are highly rated and tradeable, but with a yield of only 160 bp over BBSW, do not attract the interest of SMSFs.

The concept of Housing Supply Bond received critical and constructive attention. It was considered that such a bond would fit attractively with the desire to expand the long-term bond market (to at least 10–15 years) and to increase access to retail investors. Some experts were aware of efforts to launch Social Bonds and thought that HSBs provided a feasible and realistic variation. They were empathetic towards a product that would generate affordable housing, especially in urban areas where housing is no longer affordable to middle income households. One expert suggested that HSBs could act as a form of superannuation saving and be taxed at a lower rate. This would be consistent with the Australian Government's goal of promoting super savings and could be more cost effective for the government. Others saw the creation of a HSB market as passing the responsibility for social housing from the government to the private sector and were wary that governments may not respect the terms and conditions required in such public-private finance deals.

The main mechanism by which housing supply bonds would be generated would be via the pooling of loans to registered not-for-profit housing providers and their securitisation into different tranches of bonds from highly rated last loss lower yield to unrated, first lost highest yield. As such they would be similar to residential mortgage backed securities (RMBS). While the RMBS market has declined significantly following major problems in the US market, Australian RMBS are of high quality and, according to the RBA, likely to be favoured over covered bonds by domestic investors (Debelle 2011b).

Any HSB would require a certain spread above the BBSW, possibly on an after-tax basis. In the mid-2011 environment, Housing Supply Bonds would have had to offer a yield of around 8–9 per cent yield to attract the self-managed retirement funds. Any lower yield would have to be offset either by some form of tax concession advantage substantial enough to lift yields to an adequate level of return or by a high rating, reflecting a low risk.

Getting the risk-to-return ratio right will be crucial in attracting the large and rapidly growing self-managed superannuation funds sector. To date, involvement of this sector in the Australian bond market has been negligible, possibly due to the preferential tax treatment of equities (via franking) and impediments to issuers of disclosure requirements. Individuals and fund managers, such as banks, insurance companies and super funds, who buy bonds have different portfolio requirements (discussed in Section 3.1.3). Most funds prefer AAA rated bonds, such as a government bonds, although some allow higher risk and higher yield bonds in their portfolio. A general perception amongst bond market specialists was that demand exceeds the supply of AAA rated bonds and that considerable work goes into structuring debt to obtain a desired AAA rating through securitisation.

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<sup>31</sup> Chikolwa (2007) shows debt coverage and financial leverage ratios have the most profound effect on listed property trust bond ratings in Australia.

In order to obtain the characteristics of a AAA rated product, the risk of non-payment of interest and of bond redemption must be very low. Because payments on HSBs would be derived from the net revenue stream from rental income, bond market specialists stressed the need for security of gross rental income (and of any rent assistance that underpins it) and strict controls on costs to minimise any credit risk stemming from cost blow outs associated with vacancies, excessive operating costs and unanticipated maintenance expenditures. The stronger the financial solvency and capacity of the housing manager, the higher the potential credit rating of any bond funded by income from the properties they manage.

The possibility of an indexed bond instrument designed to reflect an increasing income stream from rent revenue was also raised. An example could be an inflation or CPI linked annuity bond with rents indexed to these indicators. Payments on an HSB would then be the index rate plus a margin.

All experts mentioned the value a government guarantee to reduce risks to lenders and thereby reduce the cost of the bond and any funds generated from it. Where this was granted to well functioning registered organisations investing in approved projects, the AAA rating would ensure strong demand for the HSB, particularly amongst wholesale fund managers and banks (who are increasingly required to hold quality assets that are in short supply).

On the issue of a wholesale or retail market for the bonds, several experts suggested that HSBs be sold on the wholesale market and after 3–5 years, as the terms get shorter, rolled out to the retail market via the secondary market. At this stage, any potential taxation incentive for retail investors should be in place and the bonds well-known, established in the market and familiar to smaller investors. Retail investors keen to invest in property, could be attracted to the HSB as an alternative way of being a part of Australia's property owning investment culture.

Several experts expressed a willingness to be involved in a focused task group to fine tune the design of any potential HSB.

**Figure 9: Bond market specialists' perspective**

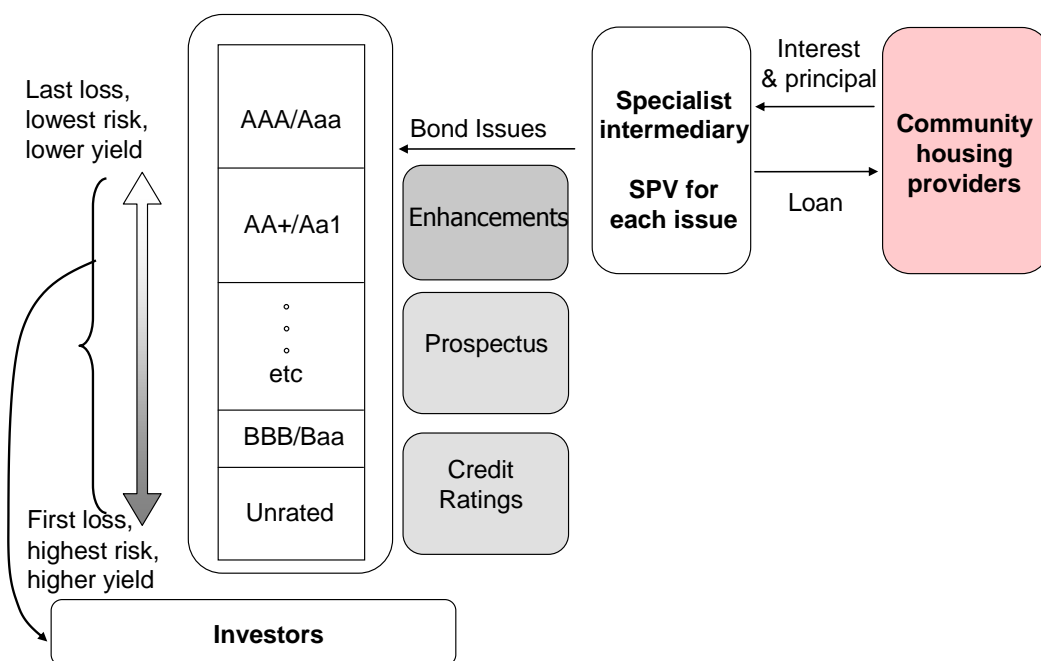


Figure 9 provides an indication of bond market specialists' proposed architecture for the HSB. From right to left: community housing providers (backed by sound cash flow management, including rental management and by well-defined rent policy reflected in viable business plans, professionally audited and operating under an enforced regulatory regime) obtain loans from a specialist intermediary. This intermediary pools these loans and uses the income received to fund bonds issued directly or through a specific purpose vehicle. Bonds, with whatever enhancements are needed (e.g. provided by insurance, guarantees or tax incentives) to make them acceptable to the target market, are issued with a prospectus lodged with and approved by ASIC. They are rated by credit rating agencies on the basis of the ability of community housing providers to repay interest and principal and any other enhancements according to a hierarchy of AAA (low risk, low yield, last loss) to BBB (higher risk, higher yield, first loss). Bonds are sold into a segmented investor market skewed by a tax regime favouring equities, and a retail market impeded by regulatory requirements.

### *3.1.3 Investors in bonds*

Information about the potential investor market was obtained from financial institutions, fund managers, 'fifth column' banks (ME and MECU) currently playing an active role in lending to the affordable housing sector, and superannuation funds (Australian Super, CBUS and Australian Ethical). Major banks contacted for this study were not available for an interview. There are, of course, other bond investors, such as insurance funds, self-funded retirees, large industry funds and other wholesale funds, which potentially have an interest in high quality fixed interest securities. As there was no opportunity to consult with all types of investors, insights from relevant literature has been sought to cover their perspectives. However, direct consultation with those not interviewed is recommended.

Investors in bonds have a much stronger preference for high-quality assets than they did in the pre-crisis period (Debelle 2011a). Australian Government bonds are highly rated (AA3 and AAA) but, since the mid-1990s, their volume has declined steeply as a result of tight fiscal policy and a strict course of budgetary discipline (with legislated caps on the raising of government debt by the Australian Government). In recent years, therefore, the corporate bond market has become important, with a total of \$767 billion issued by non-government entities in 2010 (Black & Kirkwood 2010). These bonds were purchased predominantly by foreign investors (69%), but also by Australian ADIs (11%), superannuation funds (10%), insurance companies (4%) and governments (6%). Only a very small proportion (less than 1%) was purchased by households. The RBA has explained the low participation by households and the retail sector as follows:

First, Australia's compulsory superannuation scheme produces a pool of household savings that is invested via the funds management industry rather than directly by households. Second, the disclosure requirements for issuers that raise funds from retail investors mean that it has usually been more cost effective to raise debt funding from institutional investors, although the Australian Securities and Investments Commission has recently announced initiatives to make it easier to issue to households. (Black & Kirkwood 2010).

Interviews with the RBA and bond investors highlighted the considerable variability in the tax regime of the income from different types of assets (equity, bonds, rental property) for SMSFs, rental property investors, private individuals and corporations. These differences play an influential role steering patterns of investment by different categories of investors as do differences in portfolio strategies, regulatory constraints and alternative investment opportunities.

Tax concessions on any HSB, such as the tax free threshold on interest earned from HCCBs in Austria, received interest from the Australian retail investment community and particularly for high-income private individuals taxed at the top marginal rate. A tax exemption was less interesting to those operating within a low tax regime, such as superannuation funds with a 15 per cent tax rate. FIIG and the Benevolent Society proposed franking credits. Recent regulatory and tax reforms were recognised but there was a sense that these needed to be more strategic to ensure investment flows towards required investments, such as affordable housing. Amongst banks and super funds, an HSB with government security and thus a higher quality rating, would be of considerable interest and would help to achieve both social and also broader economic objectives.

Response across the bonds investor sector was that the HSB concept for affordable housing investment had significant potential in filling an investment 'gap' in housing, proving a potential path breaker in the market for bonds and, ultimately, promoting longer bond terms. Given current circumstances, interviewees considered that any new housing supply bond would, in the first instance, best be targeted towards wholesale investors and potentially in longer term, marketed towards the retail sector as reforms facilitate retail investment. There also was widespread acceptance of the need to boost housing supply, and particularly affordable housing supply, in major capital cities.

Specific issues relevant to and raised by the different segments of the potential market for HSBs are briefly indicated in the following sub-sections.

### **Retail investors**

Any effort to attract retail investor towards HSB must compete with the significant benefits of negative gearing and advantages of franking on equities. The government has recently announced a small tax break for bond investors.

### **Self-managed super funds**

Some charitable organisations and investment groups have argued for a tax discount on income from bonds for social infrastructure, such as affordable rental housing in inner city areas, on the grounds that this serves a socially useful purpose. A summary of yields and the impact of franking of social bonds proposed by the Benevolent Society is provided in Appendix 4. More information on these proposals can be found in the Senate Economics References Committee report (2011a).

### **Superannuation funds**

The superannuation funds interviewed were conscious of community and government pressure to employ social or environmental investment strategies but considered a commitment to an economic rate of return was more important than social dividends to the wider community. HSBs would have to be competitive with infrastructure bonds which, with their long maturity and high yield linked to inflation, were looked upon favourably. One example given was the CPI indexed Reliance Rail bond in NSW, which provided an 8 per cent margin above inflation.

However, super funds stressed the need to consider individual project characteristics, such as the level of security, liquidity and asset security. For smaller funds, such an assessment takes excessive time and resources relative to other more straight forward types of investment.

Some funds (and consultants in the asset assessment industry) considered that government was shirking its own responsibilities in expecting funds to step in and to undertake investment with a social purpose. Many interviewees expressed concern at



the government's apparently fickle and fragmented commitment to affordable rental housing, mentioning the problems perceived with NRAS, which was seen as being too complicated and too risky for super funds because of too many moving parts.

Super funds would be comfortable with well-rated bonds with a guarantee that transferred credit risk to government. This was a widely favoured strategy, mentioned by banks, superannuation funds and representatives of the financial services industry.

Interviewees recommended that both fund managers and their asset consultants be engaged in a task group early on in the design of any potential HSB. In partnership, the government should devise a regulatory structure that will satisfy investors, reduce risks and offer appropriate incentives to purchase HSBs, where yield is required to be low.

## **Banks**

Banks interviewed considered that revised prudential standards, as promoted by Basel III, may substantially increase demand for well-rated assets in a tight market and recognised the potential that guaranteed housing supply bonds could have as a supplement to government bonds.

Interviewees from the smaller banks expressed an interest in being involved in an HSB task group to refine and market test a model.<sup>32</sup>

## **Governments as investors**

Given Australia's strong public finance position, several investors called for greater commitment and action to support the development of a suitable investment vehicle for affordable rental housing in Australia, with appropriate government support. They argued that the cheapest, simplest and most direct way to raise funds for affordable and social housing would be via a public bond issue.

Overall, the bond investors' perspectives highlighted the need for bonds with different enhancements. Tax incentives are likely to attract retail investors; guarantees are more likely to attract institutional investors. These enhancements affect, differentially, the yield and risk characteristics of bonds. Bond investor perspectives, therefore, were reflected in the left hand side of Figure 9.

### *3.1.4 Public finance managers*

Public finance managers and government experts on financial markets (RBA, Treasury) were interviewed on the concept of a housing supply bond and its potential role in expanding the supply of affordable rental housing. Treasury argued for an explicit and direct means of funding affordable housing with subsidies justified by housing policy agencies as essential expenditure from the public budget.

Officials from both Treasury and the RBA recognised that the government could simply use its AAA status to raise funds and on lend these at the lowest rate to social housing providers and that this would be the cheapest, simplest and most direct way to raise funds for affordable and social housing. However, it was also assumed, that despite the demand for such bonds and the cost advantages to affordable housing providers, the Australian Government would be unwilling to issue bonds on their behalf. Reasons for this included a pervasive policy of fiscal constraint and a preference for encouraging private investment in social infrastructure.

Further, the negative experience of NSW and Victoria during the 1980s in affordable home loan programs was evoked by some government officials. Successfully

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<sup>32</sup> Several of the major banks have established affordable housing specialists within their institutions who might also be involved but none of these were available for the consultations undertaken for this report.

established programs expanding social housing in the ACT via a \$50m revolving fund (ACT Government 2007), and via innovative shared equity and home loan programs in WA and programs to promote innovation in SA were less well known.<sup>33</sup> Views that public debt could be regarded as: an investment in services in the general economic interest; a means of stimulating an emergent community housing sector; and as a way of addressing housing market failure were overwhelmed by a pervasive public finance orthodoxy of fiscal constraint.

Treasury, however, did report that the current Australian Government has an active interest in deepening the corporate bond market, and in improving liquidity, terms and conditions in order to provide a stable source of investment for growing the Australian economy. These goals would be complemented by the development of a long-term housing supply bond for affordable rental housing supply.

Various measures to reduce the cost of private finance raised through a HSB were discussed. In general, some form of guarantee was preferred to tax incentives. Discussion of a range of guarantee structures (including the Swiss Bond Issuing Co-operative, which has a federal government guarantee; the Dutch Social Housing Guarantee Fund, which provides guarantees to financially sound housing associations; and the conditional public loans providing collateral to HCCB in Austria) led to the conclusion that a guarantee as in the Netherlands and Switzerland might be a feasible solution to meeting the needs of the wholesale market in Australia. The issue of costing of any guarantee arose during the interview and international examples were discussed. It was suggested that these warranted closer examination. This notwithstanding, Treasury continued to prefer a direct outlay approach to a less quantifiable contingent liability, although faced with fiscal constraint, saw both as unlikely.

The wholesale market was seen as the best market for a HSB (with pension funds being a key player). For HSBs to succeed, a critical mass of bonds would need to be issued. Some sort of pooling mechanism was raised as a possible example of how this could be achieved. Because strong demand from industry would also be required, consultation with, and marketing to, industry was considered essential. Large super funds should be helpful and able to resource a leading role in the design of any HSB. Consultation was therefore recommended with large insurance funds, such as AMP, to determine the market preferences of these funds.

A bond targeted to retail investors was seen as having a small market as there is no distribution mechanism for retail bonds and they would be unlikely to be competitive with term deposits and equities. Efforts to expand the retail bond market were seen as not yet having been successful.

Public finance managers' views of how housing supply bonds might work in the market are interpreted in Figure 10. This is based on the assumption that private finance, although more costly, is more politically feasible under current policy settings than public funding and that, to attract wholesale investors to bonds with a yield low enough to make affordable housing provision financially viable, some form of public enhancement is needed. In Figure 10, this public enhancement is provided through a guarantee fund, funded either wholly by government (the Swiss example) or co-funded by community housing providers and governments (the Dutch example). This fund plays an important multi-faceted role. It monitors the financial performance of community housing providers; issues guarantees to lenders for approved project finance; and builds the financial capacity of affordable and social housing sector

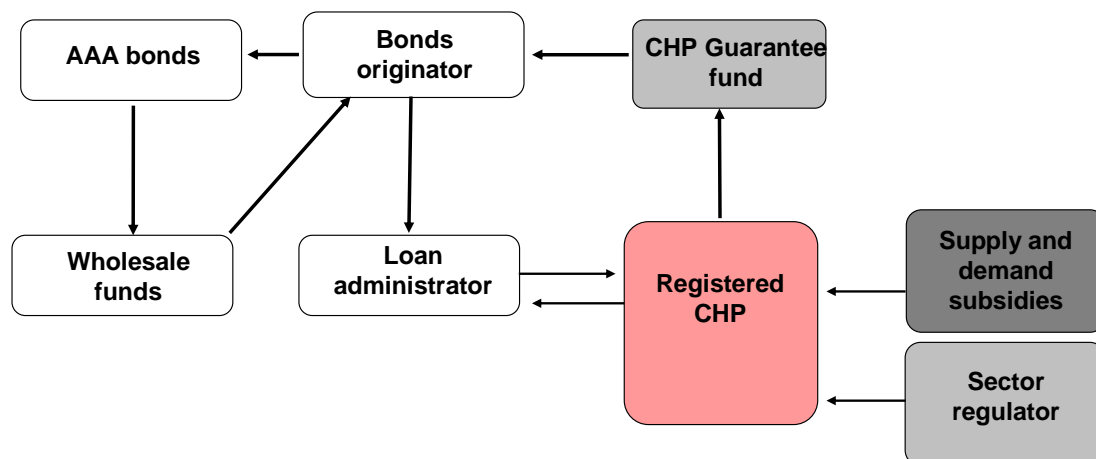
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<sup>33</sup> Information on WA programs can be found at <http://www.housing.wa.gov.au/Pages/default.aspx> and on SA programs at <http://www.dfc.sa.gov.au/pub/Default.aspx?tabid=438>.

through auditing of cash flow and business strategy. Importantly it guarantees that obligations to investors by registered housing providers will be met.

A bonds originator would pool income from loans to registered community housing providers and issue AAA bonds backed by this income stream and by the guarantee underpinned by the guarantee fund.

**Figure 10: Public finance managers' perspective**



Registered community housing providers are assumed to be backed by sufficient equity and adequate rent revenue, which is likely to require a certain amount of public co-funding as well as ongoing rent assistance. A sector regulator would need to ensure defined tasks were fulfilled and financial reporting standards met.

### 3.1.5 Community housing providers

The affordable housing providers interviewed for this project were from the community housing sector and their representative (peak) bodies. These interviewees were keenly aware of the challenges they face in obtaining low cost private finance and the impact this was having on their capacity to increase the supply of affordable housing. They saw the HSB as a potentially useful standard instrument that could engage superannuation funds and improve credit conditions substantially. Access to lower cost long-term finance was critical in order to expand affordable rental housing supply. However, they were pessimistic about the current pace and level of support from governments in this area and were concerned that the Commonwealth seemed to be withdrawing from its policy commitments. Despite a brief period of investment following the GFC and via NRAS, they felt that public finance constraints had frustrated the development of the sector over several decades.

Providers had extensively investigated lending conditions for their sector and stressed that bank borrowing conditions were very costly, and represented a significant constraint on their growth. Some banks were only willing to provide community housing providers (CHPs) with a loan of no more than 15 per cent of the value of the property and covenant agreements imposed constraints on their capacity to seek additional funds. In Victoria, providers could obtain loans from major and fifth column banks for up to 25 per cent of total property value but smaller banks, while willing lenders, were limited to a maximum of \$25 million in any one package. Community housing providers reported that some banks were concerned about reputational risk from defaulting loans which, potentially, could involve evicting tenants.

Aside from banks, it was perceived that other financial investors held a less constraining attitude towards housing provider risk and governance and super funds

were considered to be a potentially willing financial partner who could provide more flexibility and a competitive alternative source of funds. However, in order to move in this direction, loans would need to be pooled and the financial capacity of CHPs as a whole needed to be further developed. Further, revenue and activities remain very constrained by the requirements to relate rents to incomes and to house tenants meeting public housing eligibility requirements. Leverage is, therefore, based on who is housed, and possibilities are extremely limited when tenants have very low incomes and rents are tied to income. A more mixed model of tenure and tenants would improve the financing and, in some cases, the social sustainability of projects. Projects which serve the needs of very low income tenants will always need greater subsidy, but a one-size-fits-all definition of not-for-profit housing provision was impeding sector dynamism and growth.

Discussion with CHPs tended to focus more on the supplementary forms of assistance that could be provided rather than on technical issues associated with bond instruments. They argued that commitment on planning and access to land were important supplements to low or no cost public funding for growth, if increased private investment is to be obtained. After the impact of SHI stimulus funding has worked through the system, community housing providers anticipate no growth in the sector. They are looking to the new NAHA to deliver both growth funds and a financial mechanism to sustain private investment in the sector. Some providers feared that the rapid transfer of poorly maintained and outdated public housing stock may impose heavy burdens on their budgets and their ability to manage their business on a sustainable basis.

### *3.1.6 Housing policy officials*

During the consultation process undertaken between June and September 2011, housing policy officials across Commonwealth and state agencies provided a range of views on current and prospective conditions for obtaining housing growth funds. In this overview, these views have been supplemented by various reports prepared by different agencies.

One general concern was that despite the current Australian Government's apparent interest in promoting private investment in affordable housing, the level of financial literacy and confidence in those parts of the public service with responsibility for implementing innovative housing finance initiatives, such as NRAS, is considered to have been inadequate.<sup>34</sup>

Lack of effective action on this issue so far has not been assisted by the recent splintering of responsibilities for housing policies and programs across departments, and the policy of fiscal constraint, which led several interviewees to presuppose that confining reform to the existing NAHA envelope was not negotiable.

Nevertheless, there was recognition that the current model—constrained by very limited growth funds and public housing operating deficits—did not offer a suitable foundation for a strong and sustainable affordable housing system. There was a lack of clarity, however, about what type of business model would sustain community housing and a vague hope that public housing asset transfers (accompanied by CRA payments to tenants) would fix the problem by leveraging private investment. For the next NAHA, policy officials did contemplate the possibility of ring-fencing growth funds for not-for-profit providers.

On the positive side, there has been considerable interest shown in innovation in the housing finance field in several states, particularly WA, Victoria, NSW and the ACT.

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<sup>34</sup> Milligan and Tiernan (2011) draw a similar conclusion.

The ACT Government was considered to be a quiet achiever in terms of integrating planning, land supply and housing finance, with a comprehensive and flexible policy model offering growth in affordable housing supply (ACT Government 2007). In particular, the establishment of a \$50 million, 30-year public revolving fund for expansion of affordable housing for rent and purchase, utilising a special purpose not-for-profit housing company in Canberra, was viewed favourably. Other relevant initiatives that were seen in a positive light included the NSW Government's decision to trial and further investigate a Social Impact Bond and WA's many housing and land supply initiatives, as well as that government's housing strategy, which recognises the need to develop new financing structures and products, such as a bond, to foster investment in affordable housing (Government of WA 2010, p.20).

Housing policy officials expressed considerable interest in the Austrian model. Areas of most interest included: its perceived relevance in relation to the insights it provided for operation of a federal agreement distributing funds across nine states while allowing for additional policy measures to be defined at state level; the strategic role of land bankers and planning measures in delivering sites for affordable housing; and the legislation that underpinned the operations of the limited profit providers of affordable housing. There was also considerable interest in the role of Housing Construction Convertible Bonds as a means to fund and operate affordable housing in the future. Many interviewees were unaware of the range of bonds that might be available (including both tax privileged or guaranteed bonds). In such cases, the consultation process served an educative, rather than informative, role.

Some interviewees considered that actual business models in housing organisations were shaky and felt that they needed to be far more robust. Transfers were occurring but the issue of relinquishing control was frustrating progress and confidence in some states. Beyond this there was a lack of clarity concerning the means by which community housing organisations would grow in the future.

Both housing policy officials and community housing providers had a broad overview of how a future affordable housing system could operate and be financed. The affordable housing system is seen as providing both a social service but also as serving the interests of urban, economic and environmental policy. Its role is seen as being considerably broader than that of public housing. To ensure social mix and strong communities, for example, affordable housing would need to accommodate a broader range of tenants than public housing has done in the past. Rent assistance would be provided to those who need it, but tenants would not lose their tenure when they did not need assistance.

Affordable housing providers would need to have a clear and sustainable business model and would need to operate efficiently and to fulfil policy needs. They would be subjected to regulation to ensure these requirements were met. In terms of meeting broader objectives, affordable housing providers potentially could lead by example in terms of innovative design in medium to high density development.

Their ability to supply the affordable housing needed would depend on having access to cheap land and public funds for growth. The former would be assisted by pro-active and coordinated planning (e.g. through preferential development rights or ensuring sufficient sites are available through inclusionary zoning or density bonus schemes). The latter would be assisted by growth funds for their co-financing, laid down in the NAHA. Additional funds would be channelled towards them by a suitable cost effective financial instrument and intermediary.

### 3.1.7 Summary of stakeholder responses on bond characteristics

The following summarises a number of critical responses from the six key stakeholder groups interviewed concerning the terms and conditions that an Australian HSB needs to meet to ensure it is attractive to investors and raises sufficient low cost funds for borrowers. These are to be taken into account in the proposal outlined in Chapter 4.

- Simplest approach is for government to issue bonds but, in absence of this, some form of enhancement (though tax incentive and/or guarantee) is needed for a HSB to be competitive in the market.
- Bond characteristics will need to vary according to the target market; needs to be 300–400 bp over BBSW to attract retail interest.
- Tax incentives have different value for different market segments.
- Risk adjusted rate of return is more important for institutional investors than social dividends.
- Both inflation linked annuity bonds and long-term fixed income bonds would be attractive to super funds and insurance funds.
- AAA rating will ensure demand but there is demand for any well-rated bonds.
- Structured approach likely to be needed to offer highly rated securities to institutional investors; may need government to purchase junior notes.
- Likely to have to compete with (more risky) infrastructure bonds for institutional investors and with other long-term bonds for retail investors.
- Risk, return and commitment from government are critical.
- Revenue stream must be robust (rental stream seen as weak given target tenants and requirement for below market rents); credit rating will reflect security of this; government guarantee a way of achieving this and potentially more effective than a tax incentive to underpin return.
- Some sort of insurance to cover default would assist.
- Need to remove policy risk.
- Need certainty of government backing on supply, rent policy and other revenue sources.
- Liquidity will help (may be achievable by selling long-term bonds initially to wholesale market and developing a secondary market once term has shortened).

## 3.2 Stakeholder views on the financial intermediary for a HSB

This section concerns views of the various stakeholders on the research question:

- What type of financial intermediary would sell the bonds and how would funds raised be made available for approved projects?

### 3.2.1 Financial regulators

The financial regulators interviewed for this study, considered that a suitable financial intermediary for the bonds would be special purpose vehicle (SPV) or managed investment scheme (MIS), with assets held by a licensed trustee. The SPV could issue housing supply bonds and administer loans to registered housing providers.

The SPV can be stand alone or be associated with a single financial institution. It was considered that the SPV for issuing bonds for specific regulated projects would have

to be quarantined in some way from the host intermediary (e.g. a bank). Although a major bank would be an obvious host intermediary, an existing bank is not the only host option. A not-for-profit organisation or existing corporation could equally serve this purpose. Regardless of what host intermediary is employed, assets (titles of assets owned by the CHPs and revenues generated from these assets) and liabilities (bonds issued) could be held in trust. A trust has a legal structure, with a deed which spells out the conditions of its business operation. In this case, the purpose would be the raising of funds for the promotion of affordable rental housing. The trust would hold legal title to the right to receive payments from one or more CHPs. In turn, proceeds of the bond issues would be used to fund the CHPs.

Both regulators considered a trust structure optimal and cost effective (as there are no directors or meeting requirements, documentation is straightforward, and there is no claim on the host intermediary's capital). However, the cost of establishing a trust can be high and regular fees must be paid to ASIC for licensing. A more cost effective option is to simply hire a trustee to run a trust. In this case, the trustee performs the role of gatekeeper and is there to maintain the interests of the investors.

According to the regulators, a Managed Investment Scheme (MIS) could also govern bond issuance and investments. Such schemes, also known as 'managed funds', 'pooled investments' or 'collective investments', rely on a responsible entity to manage a pool of funds such as mortgages or property trusts. Such an entity must be a registered Australian public company and have a financial services licence. MIS must also be registered prior to operation with ASIC.<sup>35</sup>

### *3.2.2 Bond market specialists*

For investors, scale was important for liquidity to ensure a tradable asset. They were not interested in issues below \$50 million. For this reason alone, there would need to be a mechanism to pool funding demands from CHPs to enable larger, structured bond issues. It was recommended that a fully licensed pilot intermediary should issue appropriately documented bonds for market testing and evaluation. This could be implemented through an existing organisation and provide the basis for the introduction of new issues over time, with bonds being refined as experience dictates. Scale would limit the number of financial intermediaries that could be involved in bond issuance.

### *3.2.3 Investors in bonds*

Investors recommended a single vehicle (SPV) to sell housing supply bonds to ensure scale and to undertake securitization to achieve bonds with various characteristics of risk and return. Bonds should be tradeable to make them attractive, the more liquid the better and the size of the parcel needs to be known. If funding demand from CHPs is limited, the bond parcel size and prospectus requirements may constrain the type of investors in the Australian market.

The SPV would issue the bonds. A bank or some other specialist financial intermediary could create an SPV, managed by a separate trust. There is currently no one in the Australian setting who would regulate such an SPV to ensure that funds raised from the special bonds go towards approved projects and a regulatory process or entity is needed to ensure this happens.

Institutional investors were not interested in the design of such a regulatory environment but required that a trusted framework be in place because due diligence

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<sup>35</sup> See <http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/Managed%20investment%20schemes>.

assessment for each specific bond issue by an SPV would be too costly and time consuming.

### *3.2.4 Public finance managers*

As discussed in the previous section, public finance managers did not support the direct funding of affordable housing by government borrowing. An alternative to the Australian Office of Financial Management issuing government bonds as part of the Commonwealth Government Securities market, however, is for the government to provide a guarantee on specific purpose bonds (e.g. HSBs) issued by a financial intermediary.

Banks or issuing intermediaries could pay a fee for this government guarantee and precedent has been set by the recent guarantee on debt issued by Australian banks and other deposit-taking institutions. The guarantee was a contingent liability and did not appear on the government's budget. Such an approach to the HSB would reduce financing costs significantly compared to current interest rates paid by CHPs on loans from commercial banks.

### *3.2.5 Community housing providers*

Despite evidence about its unwillingness to do so, a strong view prevailed amongst CHPs that the government should issue bonds to fund expansion of affordable housing. In the absence of this form of funding, they saw benefit in the development of a specialist financial intermediary that could promote more long-term financial independence and stability in the broader housing finance market. Such an intermediary would need to be financially self-sustaining by drawing on the revenues from well run, financially sound and secure CHPs. This was seen as requiring close financial monitoring of CHPs.

It was thought that a number of existing not-for-profit intermediaries might serve this purpose and could be able to provide a pilot issue of HSBs.

Constructive relationships with housing regulators, concerning financial solvency and business/development planning, were seen as being essential to meet the standards required before any government guarantee could be provided.

### *3.2.6 Housing policy officials*

Housing policy officials perceived that government guarantees are difficult to obtain but thought that bonds issued with a guarantee would be an attractive financial proposition, would be liquid and would remove investors from direct project development roles.

They were interested in pooling funding demands and the launch of a bond through an intermediary which could be in the third sector.

### *3.2.7 Summary of stakeholder responses on a financial intermediary*

The following summarises a number of responses from the six key stakeholder groups interviewed concerning the type of intermediary that might sell bonds and on how funds raised would be made available for approved projects. These are taken into account in the proposal outlined in Chapter 4.

- Need an aggregator to pool demands so that larger bond issues (or critical mass of bonds) can be offered.
- A single vehicle is desirable to ensure scale and undertake securitisation.
- Could have SPV created by a host institution and managed by a trust.



- Could make sense to start with one pilot intermediary.
- Currently no organisation in Australia that could ensure funds raised were used for intended purpose.
- Government could issue bonds.
- Banks could administer loan deals.

### **3.3 Stakeholder views on institutional conditions and regulatory arrangements**

This section covers stakeholder responses not covered above to the research question:

- What type of institutional conditions and regulatory arrangements would ensure funds raised are channelled to the intended purposes?

#### *3.3.1 Financial regulators*

The regulatory roles of ASIC and APRA were broadly covered in Section 3.1.1. ASIC would regulate bond prospectus and licence financial service providers and trustees with regulation depending on whether unlisted or listed bonds are involved. New benchmarks have been issued for unlisted bonds requiring increased standards both of disclosure and for advertising. A new regulatory guide to simplify disclosure requirements for listed entities offering simple (vanilla) corporate bonds to retail investors has also been issued. Both are potentially relevant for HSBs.

ASIC is not currently set up to specifically regulate SPVs with a special purpose such as not-for-profit housing investment. To facilitate the development of a bond instrument and a suitable financial intermediary a standard Prospectus and Trust Deed for an SPV could be developed, with ASIC playing an advisory role.

APRA would regulate prudential limits and capital requirements of any financial intermediary involved in issuing housing supply bonds and examine the nature of any offered guarantee. It would not be interested in directly regulating housing supply bond instruments, which it sees as ASIC's role.

Regulation of community housing providers to make sure that all proceeds from the SPV are properly expended was seen as being left to a specialist in the field, such as the current industry regulators and proposed national regulator. Given that CHPs will have undergone compliance requirements to be eligible for government grants or loans, any SPV could simply require a periodic certificate of compliance from the CHP. Investors should be able to sue CHPs for a breach of any tax or regulatory requirements.

#### *3.3.2 Bond market specialists*

Bond market specialists had similar views to the financial regulators regarding the need for adequate and appropriate documentation and a prospectus to access the retail market for every HSB issue. They pointed to the high costs of providing this as one reason for needing to pool demands and issue much larger bond issues than would be required for just one or two providers.

They suggested that the issue of how to deal with mixed income and mixed tenure projects, involving for-profit elements, could be resolved simply by clearly defining required outcomes and by auditing these, as is the case in the US with the LIHTC scheme.

### 3.3.3 *Investors in bonds*

For investors it was important to keep any new measure simple, to reduce the risk of any political influence and potential for bureaucratic delays or failure. Complexity not only deters investors but also obstructs investment and adds to cost by increasing financial risks.

### 3.3.4 *Public finance managers*

Public finance managers attributed the nature of the bond market, and the minimal role of retail investors in this, to the disclosure requirements and the tax regime affecting investors. A guarantee would be required to reassure investors that coupons would be paid. They also suggested that, because the taxation on superannuation is very low, changes in tax incentives for this group are unlikely to change their behaviour.

### 3.3.5 *Community housing providers*

Consultations with community housing providers and their peak bodies focused more on the impact of existing regulations on provision than on regulations that might be required for implementation of a HSB scheme. CHPs reported they are currently tightly constrained in their activities through various regulatory measures and there was widespread concern that the current business model did not provide a foundation for growth.

Current state based regulatory arrangements vary in approach and effectiveness with some taking a 'lighter touch' (to promote innovation) and others being more prescriptive. Serious problems identified include the lack of account taken of the impacts of constraints imposed by the tax system, and those arising from a rent setting regime based on incomes and narrow eligibility requirements. The latter restrictions are particularly problematic for cases where public housing stock has been transferred to community housing providers under prescriptive conditions.

The current tax treatment of CHPs was seen as inefficient and punitive, requiring unrealistically short reinvestment timelines and separate accounting for-profit and not-for-profit activities. Further, not-for-profit housing organisations must only serve those who would otherwise be homeless if they are to fulfil the ATO's definition of charitable activities without jeopardising their charitable tax status, which gives them access to valuable tax concessions.

There are so few variables in our income stream that we can control. You screw us down tightly about what rent we can charge and tighten this further through our tax status, which means we can't charge any more than 74.9 per cent of market rent in order to keep our Public Benevolent Institution status. (interview transcript, June 2011)

The ATO is of the belief that affordable housing is not a charitable activity ... even if you're income eligible for public housing that doesn't really mean that you're living in poverty and you're not really alleviating poverty by providing affordable housing. They [the ATO] have a very strict definition of the relief of poverty which goes back to Elizabethan law. So we're battling already the fact that providing housing to people who are not homeless pretty much is not considered a charitable activity and already is jeopardising our not-for-profit status. (interview transcript, June 2011)

While consideration of the details of the proposed national regulatory framework is beyond the scope of this report, this was widely discussed in interviews conducted with providers. The critical need for this framework to adequately cover overall

financial solvability, ongoing viability, capital structure and risk was recognised. However, concerns were expressed that regulations may be directed to individual organisations only and not focused upon broader market functioning or overall sector development.<sup>36</sup> Providers felt that careful consideration needed to be given to what respective roles national and state regulators and administrators should play in supervising financial continuity, sector development and in providing adequate comfort and disclosure to lenders. Closer co-operation with ASIC on this issue would be helpful.

Further suggestions on changes that might be made are outlined in Section 3.4.

### *3.3.6 Housing policy officials*

Consultations with housing policy officials pointed to a variety of regulatory and other recommendations to attract further private finance into affordable housing that have been received by FaHCSIA but which have not yet been acted upon. Examples were the recommendations in the KPMG report (KPMG 2010, p.10).<sup>37</sup> The Commonwealth's slow progress on the financial instruments and intermediaries required was attributed to fragmentation of administrative roles and responsibilities, underfunding and uncertainty, all of which had disrupted policy momentum and continuity.<sup>38</sup>

State officials sought increased independence in program design and flexibility in responding to implementation issues. Commonwealth officials expressed concern over the separation of planning, land supply and affordable housing supply but recognised that some jurisdictions (specifically the ACT and WA) had overcome this admirably. One official was very keen to promote planning reforms such as inclusionary zoning, density bonuses and better land banking for affordable housing.

There was a concern that current regulatory systems may not be adequate for requirements of investors and that tax incentives are not funding housing for tenants most in need of assistance.

### *3.3.7 Summary of stakeholder responses on institutional and regulatory requirements*

The following summarises a number of responses from the stakeholder groups on the regulatory arrangements required to ensure funds raised are channelled to the intended purposes.

- Regulatory requirements will differ depending on whether the finance instrument is listed or unlisted.
- A standardised instrument will simplify preparation of any prospectus required and make it easier for investors to be adequately informed.
- Current regulatory environment is not set up to regulate not-for-profit SPVs.
- Regulatory structure will be needed to ensure SPV (and that any guaranteed funds) finance only approved projects.

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<sup>36</sup> This is achieved in the Austrian system through its regulatory body, land tendering processes and design competitions.

<sup>37</sup> These included provision of a government guarantee upon default of loans to providers; government rental income subsidy to ensure adequate revenue streams; sector education, to improve their financial management capacity. They also included the development of housing supply bonds.

<sup>38</sup> The senior Commonwealth policy officials interviewed either left their position or their positions were abolished after the interviews were conducted. This interrupted continuity in flow of information between the interviews in June and the interactive workshop in September.

- Industry regulation of CHPs needed with prudential limits set on CHP borrowing and appropriate cash management tools developed.
- Regulatory framework needs to be simple (as too many hurdles increase risk) and to reduce political influence and potential for bureaucratically induced delays.
- Regulation needs to be flexible to promote innovation and independence and should relate to level of risk inherent in business.

### **3.4 Stakeholder views on complementary reforms**

Beyond the architecture of any bond instrument, reforms strengthening the affordable housing sector are also very important. This section brings together the many constructive suggestions for reform made by stakeholders during the interviews and workshop, towards a more sustainable model for growing investment in and supply of affordable housing in Australia. It provides an overview of stakeholder responses to the fourth research question designed to cover any points that might have been missed by responses to the three questions covered in Sections 3.1 to 3.3:

- What other actions would be required to ensure success of this mechanism?

#### *3.4.1 Financial regulators*

A number of regulators suggested that existing tax exemptions available to investors in rental housing could be targeted to investment in (affordable) housing bonds. This would ensure these assisted in providing housing for lower income tenants rather than serving to price other investors, such as superannuation funds, out of the housing finance market. This would require the amendment of negative gearing provisions in the Tax Act. Likewise, current initiatives by the Australian Government offering a tax break to retail investors to increase their involvement in the bond market should be tailored to bonds with a social infrastructure purpose (e.g. HSBs). The government would need to support the marketing of any such bond to kick start expansion of the retail bond market by educating retail investors about this market.

Fiscal constraint was not considered an appropriate excuse for no action on channelling investment towards the affordable housing sector, particularly in light of the capacity for a bond to attract far more investment towards such a policy goal than would realistically be achieved directly through budget outlays.

Work on estimating the relative costs of alternative ways of providing government support for affordable housing was recommended as was greater transparency and certainty in the level of support provided. A predictable level of government support would assist providers in developing sound and sustainable business models and, thereby, reduce risks to investors. Regulators pointed to the need for strong financial talent and professional skills in management within the CHPs to ensure the development of sound business models and to the need for effective enforcement by a national regulator with authority to ensure compliance to financial and regulatory requirements.

Officials from ASIC indicated they could be willing to cooperate in devising appropriate prospectus and Trust Deed documents defining the business of operating of a SPV to issue HSBs.

#### *3.4.2 Bond market specialists*

Bond market specialists considered that, in conjunction with NRAS, there was scope for a HSB to be attractive for large investors. NRAS, alone, however, was not seen as being adequate. They suggested that having a housing target for a HSB issue

provides an important marketing tool for the program. This should not be too high, but realistic and feasible.

They re-iterated the benefits of a standardised prospectus (which, in turn, implies the need for a standardised HSB) to reduce what are high costs involved in preparing a prospectus. Any tax incentive associated with such a bond, therefore, would need to be simple and straightforward, particularly if retail investors are to be attracted to these bonds.

They suggested that tax incentives encouraging bond purchases as a form of superannuation saving (redeemable on retirement) might be a way of reducing immediate funding costs to government. Bond market specialists would be able to determine what products people are buying and returns under super or private wealth accumulation strategies, to determine potential size of the market. They were in favour of active and constructive dialogue with Treasury to estimate the potential risk and cost of any HSB enhancements for bonds targeted both at retail and wholesale investors.

Bond market specialists expressed a need for, and willingness to be involved in, an implementation task group or task force to progress the HSB proposal further. Such a group must have members with expertise in fixed income assessment and legal requirements of issuing bonds and should include both the self-managed super fund sector and the association of fund managers. Larger industry funds, such as Industry Funds Management and construction related funds, may also be interested in assisting early in the development stage because of their current involvement in the RMBS market and social welfare ties back to their membership.

### *3.4.3 Investors in bonds*

As did bond market specialists, investors in bonds suggested that far more than NRAS tax credits is needed to ensure a sustained private investment in affordable housing.<sup>39</sup> Superannuation funds saw current NRAS arrangements as being unnecessarily complicated with too many bureaucratic hurdles that increased investment risk. Bond investors expressed a concern that, after the Economic Stimulus package, the Australian Government had 'shut up shop' on social and infrastructure responsibilities and was simply expecting the private sector to meet these needs. They cited various public-private partnership projects (e.g. toll roads) as having contributed to increasing investment risk and undermining confidence in governments because conditions had been breached by government or were too complex.

There was a plea to overcome administrative fragmentation and lack of communication between isolated government departments. This will require greater co-ordination of efforts to increase housing supply with more attention being paid to how to make investment in affordable housing attractive. They were in favour of a government guarantee that made HSB equivalent to government bonds and therefore attractive for banks to hold under Basel III requirements. Further, there should be a rule that the guarantee on HSBs only applies to regulated, prudentially monitored housing organisations. Bond investors also raised the possibility that funds with favourable taxation arrangements should be required to invest in affordable rental housing and that retail investors be appropriately informed about the HSB and be given incentives to invest.<sup>40</sup> Government capacity and political commitment needs to

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<sup>39</sup> For a concise overview see Johanson (2011).

<sup>40</sup> Bond investors supported bond market specialists' views on the perverse effect of negative gearing on, and proposals for directing any benefits to, investment in new affordable rental housing.

be increased to effectively devise appropriate instruments, and a long-term commitment, beyond headlines and electoral cycles, is required. Governments are seen as being unable to reform or build appropriate institutions.

They raised the possibility of building on the work of the Australian Securitisation Forum and the work of Joye and Gans (2008), which has proposed that Aussie Mac act as an SPV.

Finally, as did other interviewees, investors in bonds expressed an interest in and willingness to be involved in the design of bond instruments. They also suggested early involvement of asset consultants (who assess fixed income opportunities for fund managers) was important, as many funds rely on asset consultants recommendations for their investment decisions. Some suggested also involving the Australian Superannuation Funds Association and the Australian Council of Trade Unions (ACTU).

#### *3.4.4 Public finance managers*

Public finance managers suggested that, as housing is an important social welfare and economic issue, it should be a concern to all relevant areas of government policy and administration. They sought clarity about the advantages to different stakeholders (investors, providers, tenants and governments) of the various incentive measures for HSBs and proposed that information regarding the cost and benefits of alternative bond strategies (as well as those of better targeting of negative gearing investments) be shared between state and federal treasuries.

They supported the idea of a target both for the amount of finance to be raised by bonds and for the numbers of dwellings and households to be assisted as a way of motivating policy-makers and politicians. They suggested that the Commonwealth Government could partner with community housing providers, the state housing authority and treasury in one state to pilot a bond scheme.

Ministerial advisors to the Minister for Finance have expressed a strong interest to industry partners in this project in there being a further workshop to evaluate and develop the bonds proposal outlined in this report (personal communication, AHS). Treasury Revenue Group could participate in this by estimating the relative costs of any guarantees and tax concessions designed to encourage investments in affordable rental housing and, therefore, could provide valuable input regarding the most desirable combination of the various instruments proposed (public bonds, or private bonds enhanced by a guarantee or tax incentive).

#### *3.4.5 Community housing providers*

Housing providers had many concerns about the current environment within which they operate and many constructive suggestions for complementary reforms.

At a strategic level, they argued that affordable housing is an essential service and its supply should be a key component of policy platforms, and thought that housing should be given higher priority because it was both a crucial area of social welfare and integral to economic prosperity. They felt that the Commonwealth needed to be re-engaged in an active housing agenda, and that state governments must have a more realistic appreciation of, and approach to, development planning and implementation. They argued for good co-ordination between FaHCSIA, SEWPAC, Treasury, the ATO and SHAs at the Ministerial and senior policy-maker level to overcome fragmentation and achieve NAHA objectives. They felt that government needs to address its significant lack of expertise in housing and housing finance in particular and that there is a need for the (housing) policy development process to be beyond the narrow Housing Ministers Advisory Committee (HMAC) process.

More introspectively, they argued that CHPs needed to increase their financial sophistication and to develop sound business models and strong cash management tools. Business models need to be carefully analysed to see what is feasible and what must be reformed. A longer term, strategic approach to development rather a focus on specific individual projects should be considered. CHPs need to be run more like a commercial entity (albeit limited profit) rather than a welfare service and have flexible governance in order to facilitate development, rather than impede implementation of any scheme. They must be allowed and able to generate small surpluses to cover their risks, which, in the medium term, would be reinvested in new affordable rental supply.

Achievement of these goals would be assisted by legislation to overcome taxation hurdles faced by not-for-profit housing associations that are currently threatening their viability. A further reform proposed to improve financial viability was a re-assessment of the revenue and eligibility constraints associated with current allocation and rent policies. While CHPs want an increased say in who they housed, they were comfortable with targets being set to ensure a mix of tenants.

CHPs were extremely cognisant of their dependence on financial (and other forms of) assistance from various levels of government and strongly supported the need for secure subsidies both on the supply side as well as the demand side. They were in favour of having CRA being paid directly to the landlord to provide more security for their revenue streams but were concerned that couples and singles (without dependents) were not well served by CRA. They also argued strongly that an increased operational subsidy, beyond CRA, is required for those on a very low income or with special needs.

On the supply side, they argued for a dedicated growth fund within NAHA and suggested that consideration be given to making this a revolving fund (as in the ACT). They saw a competitive system of allocation of these funds as important for promotion of quality, efficiency and innovation in delivery of affordable housing, and suggested that CHPs compete with SHAs for these funds on a level playing field. They saw significant benefits in promoting good communication and co-operation between sector peaks in sharing knowledge and improving lending conditions and competitiveness.

To facilitate development of sound business models, they also need certainty regarding the level and form of assistance provided on both the demand side and supply side. They felt that governments needed to have a realistic plan as to how the COAG goal of up to 35 per cent of social housing being owned or managed by the community housing sector (by 2014) is to be met and expressed some concern about current approaches of transferring under-maintained and outdated public housing assets. Some were concerned that this policy, along with rigid regulations imposed on how assets were to be used, could undermine CHP financial viability.

They were supportive of the HSB proposal and looked to government to actively support and market this (or any) scheme designed to increase the supply of affordable housing. They are more than willing to engage with federal policy-makers to assist in promoting awareness of its establishment and to establish a target for dwellings to be financed with HSBs (as was done with NRAS).

#### *3.4.6 Housing policy officials*

In commenting upon what complementary reforms might contribute to a more sustainable model for investment in affordable housing, housing policy officials suggested that the role of peak bodies might be expanded so that they could provide project development, finance, legal assistance, training and other services (at an

appropriate charge) to CHPs. This would provide scale economies in provision of these services (and would provide smaller niche providers with access to them).

They were in favour of CHPs developing closer alliances with leaders in building innovation to assist them in building cost effectively (and at scale).

They commented on the desirability of reducing development risks by bringing planning and housing objectives closer together (via instruments such as inclusionary zoning or density bonuses) and of government land agencies leading by example with innovative provision of affordable housing. They highlighted the importance of a longer term approach to securing well located sites for affordable housing via the planning system. They raised the possibility that development certainty could be increased by setting realistic targets for a affordable housing across a range of dwelling types (and costs) and suggested these targets could be achieved in well located sites (e.g. E-gate and Fisherman's Bend in Victoria or other major government urban renewal projects). They pointed to WA and the ACT as good examples of where the housing department and land corporations work closely together in delivering affordable housing outcomes and suggested that their work be actively promoted.<sup>41</sup> Housing officials recognised that, because development costs vary considerably within and between cities and regions, there is a need to match the level of subsidy and planning instruments to price and market conditions. This suggested a need for more flexibility in rent setting and housing assistance policies, as well as the need for a mix of deep and shallow subsidies, depending on location and tenant needs.

They expressed concern about poverty traps and disincentives to paid employment in income-related rent policies and tight eligibility requirements for affordable housing, and were supportive of CHP desire for more flexibility in setting rents and allocation policies. There was a strong preference for facilitation of home ownership and for CHPs using private finance to provide a pathway to home ownership through shared equity arrangements.

### *3.4.7 Summary of stakeholder responses on complementary reforms*

The following highlights a selection of key responses made by the various stakeholders on complementary reforms that could assist with promoting investment in affordable housing.

- Implement analysis of comparative cost effectiveness of public and publicly enhanced private bonds.
- Involve asset consultants, super funds and insurance funds early in the development of a housing supply bond.
- Simplify and standardise disclosure requirements for issuing a prospectus for housing supply bonds.
- Consider whether financial regulatory arrangements need to be amended to cover not-for-profit organisations.
- Develop financial management skills in CHPs.
- Educate investors.
- Overcome administrative fragmentation and lack of communication between relevant government departments and agencies.

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<sup>41</sup> The City of Vienna's planning strategy and its land banker, Wohnfond, provides an international example.



- Re-engage the Commonwealth and develop expertise in housing and housing finance, expanding the HMAAC process.
- Ensure long-term funding commitments (beyond electoral cycles).
- Provide assurance that community housing assets will be appropriately managed.
- Secure operational subsidy for tenants on very low incomes or with special needs.
- Provide CRA subsidies to landlord, not tenant to secure revenue.
- Provide dedicated growth fund (potentially a revolving fund) as part of NAHA.
- Reform tax rules defining not-for-profits, clarify definitions of charitable activities.
- Develop a plan to achieve the target of up to 35 per cent of social housing owned or managed by CHPs.
- Actively market any government created scheme or instrument.

### **3.5 Conclusions**

The consultation with the various stakeholders described in Sections 3.1 to 3.4 highlighted a number of features that any product designed to reduce the cost of private finance for affordable rental housing in Australia must possess if it is to meet the needs of investors and contribute to expansion of the affordable rental stock.

Such a product must be simple and long term. It must recognise that different enhancements are attractive to different market segments. Tax incentives, for example, are more attractive to highly taxed private individuals and government guarantees (or other forms of credit enhancement) are more attractive to larger, long-term investors, such as insurance funds and super funds. A low yield bond enhanced by a tax incentive, therefore, should be designed to attract investment from more highly taxed private individuals and private fund managers. A highly rated but lower yield bond with a government guarantee should be designed to suit the portfolio strategies of large long-term wholesale investors. It is more likely to generate funds at scale if these are sourced from wholesale investors, at least in the first instance.

Whatever products are developed, risks to investors and the cost of finance will be reduced by a well regulated community housing sector underpinned by strong business models for each provider. When interest and principal are to be borrowed against the revenue stream generated from affordable rental stock (rather than against capital value or asset sales), rent policies, rent assistance and eligibility policies will be critical. There needs to be minimal risk of policy change.

## **4 A PROPOSAL FOR AN AUSTRALIAN HOUSING SUPPLY BOND**

### **4.1 Introduction to proposal**

This chapter builds on the experience of earlier research described in Chapters 1 and 2 and the insights obtained from the consultations undertaken for this project described in Chapter 3. It proposes a suite of bond instruments (Housing Supply Bonds) suitable for financing affordable housing under Australian finance, regulatory and policy conditions and sets out a financial architecture that defines the way in which such bonds might be delivered. Bonds are to be issued by a specialist financial intermediary with funds raised on-lent to affordable housing providers. Both the bonds and the architecture proposed are intended to provide the basis for further development through on-going industry and government input as proposed in Chapter 5.

This proposal has been stimulated by the successful HCCB in Austria and adapted and further developed in response to the issues and ideas contributed by key stakeholders. It has benefited from the expertise of directors and staff of Affordable Housing Solutions (AHS), the Erste Wohnbau Bank and the IIBW who were brought together by the research team for three intensive days of modelling in the second half of 2011. It has been designed to complement and extend existing and possible future funding arrangements.

The HSB proposal outlined in this chapter incorporates a combination of public funding (providing direct subsidy) and private bonds that are indirectly subsidised through tax incentives and government guarantees. HSBs are not intended as a replacement for existing forms of housing assistance for affordable rental housing, such as that provided by NRAS and CRA, and under the NAHA. Instead, they aim to complement and extend the value of such public subsidies in order to increase the long-term supply of affordable housing. HSBs of themselves will not deliver affordability outcomes for tenants regardless of their circumstance. Assistance currently provided through NRAS and CRA is still needed to ensure affordability outcomes for tenants of affordable rental housing. A proposed role for NAHA growth funds is provided in the following section.

HSBs are designed to reduce the cost of funding available for community housing providers below that which is currently available and, thereby, to enhance their capacity to increase the supply of affordable housing. However, they cannot generate private finance at a lower rate than would be available if affordable housing was funded directly through government borrowing. An important step identified in Chapter 5 is the need to evaluate the cost effectiveness of the various ways in which private finance can be employed by comparing the costs of mixed public-private finance proposals, such as that outlined in this chapter, with the costs of direct public funding and to identify what is the optimum proportion of direct and indirect subsidy (or, in terms of the proposal below, of government, guaranteed and tax privileged bonds).

The HSBs proposed are intended to provide a standardized instrument for retail and institutional investors, to encourage investment in affordable rental housing and to keep at arm's length the respective roles of investor in, and provider of, affordable housing. The bonds are issued by an intermediary, not by individual providers, in order to achieve this standardisation. The funds raised are then on-lent to providers. It is proposed that only regulated providers of publicly approved projects should be able

to apply for finance raised by these bonds to ensure that clearly defined policy targets are met.

The capacity of government to facilitate the supply of affordable housing in a meaningful way via the suite of bond instruments outlined below is strengthened by the strong financial position of the Australian Government, with its internationally low debt to GDP ratio. Government efforts to develop and maintain Australia's leading position as a centre of international finance would be enhanced by the deepening of its bond markets and lengthening of terms.

The following section provides an indicative outline of a financial structure that would be needed to deliver HSBs. Section 4.3 describes the suite of bonds proposed. Section 4.4 provides an indication of the potential costs of delivering finance for affordable housing in the manner proposed. Section 4.5 provides a brief example of how these bonds can facilitate an increase in the supply of affordable housing.

## **4.2 Overview of HSB architecture**

### *4.2.1 Specialist financial intermediary*

A key to the financial architecture proposed to deliver HSBs is the creation of a specialist financial intermediary (or intermediaries) to channel raised funds towards affordable housing delivered by registered providers. A financial intermediary, in general, links suppliers of capital with appropriate investment opportunities and creates aggregation benefits and efficiencies in doing so. A specialist intermediary, in particular, can:

- Develop further efficiencies in undertaking due diligence because of its specialised knowledge of the business.
- Lower transaction and search costs considerably (as these are much the same for raising \$25 million as they are for raising \$250 million).
- Ensure a pipeline of projects and funds is available, which reduces search costs by preventing projects being lost because funds are not available when required.
- Inform and educate both investors and providers about risk and returns<sup>42</sup>.
- Assist in making CHPs investment ready; and provide access to funds for smaller players (and those who are financially excluded) that are unable to directly raise private sector finance and, hence, maintain diversity in provision.

A specialist financial intermediary can also contribute to stability in the housing and housing finance systems. Mainstream finance for housing tends to be pro-cyclical with demand often driven by dwelling price cycles and expectations of capital gains. One result of this is significant cycles in the housing construction sector with resultant inefficiencies associated with loss of skilled labour in downturns and lack of skilled labour in upturns. A specialist financial intermediary, on the other hand, can provide funds in a counter-cyclical manner if this is desired. The stimulus provided by the SHI in 2008–10 provides a good example of the benefit of such funding.

Such an intermediary might take a variety of forms. While it could provide one option, the Austrian approach based on specialist Housing Banks that are subsidiaries of the major Austrian banks, is not necessarily an obvious a solution for the Australian case because of its reliance on deposits in authorised deposit taking institutions as the major source of finance. Given the broader target investor base for the bonds

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<sup>42</sup> This is a two-way street. Much attention has been paid to a perceived lack of financial skills amongst community housing providers but less attention has been paid to the lack of knowledge in existing financial institutions about the community housing sector.

proposed in this chapter, a not-for-profit specialist intermediary is likely to be more cost effective. This might be newly formed or build on an established intermediary. Examples of existing intermediaries that might serve as a starting point are those currently receiving large allocations of NRAS incentives and undertaking fund raising activities in the private sector (see Chapter 1). Whatever starting point is used, it is important that the intermediary is purpose designed in terms of its governance and operational structures. In this report, this purpose relates to the issue of bonds. In different market conditions, or in different parts of the economic cycle, consideration might be given to whether its role should be broadened to include equity or hybrid instruments as well.<sup>43</sup> A proposal for developing such an intermediary is presented in Chapter 5.

#### *4.2.2 Regulatory framework*

Whatever form of intermediary is developed, an important condition is that it, and the financial instruments it issues, are subject to appropriate financial regulation. Such regulation is required to ensure that the intermediary is appropriately capitalised (or guaranteed) and that funds raised by bonds issued are held in trust to ensure they are used for their intended purpose.<sup>44</sup> The task of regulating the corporate sector in Australia is mainly the responsibility of three key agencies—the Australian Competition and Consumer Commission (ACCC), the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA).<sup>45</sup>

Consultations with the various stakeholders suggested that only ASIC and APRA would need to be involved. ASIC would be responsible for regulating bond issuance and any licensed trustees. APRA would be responsible for ensuring the capital adequacy of any specialist intermediary and the proposed social housing guarantee fund. There are, however, some questions as to whether current regulations under which ASIC and APRA operate would need to be amended for social enterprises such as the proposed specialist financial intermediary. The Senate Economics References Committee report (2011a, p.xxv) on development of a capital market for the not-for-profit sector in Australia recommended that their proposed Social Finance Taskforce take into account the regulatory and legislative framework needed for such a market. Linking to this proposal is discussed further in Chapter 5.

A guarantee fund is proposed to underpin the returns offered on the housing bonds described below. This fund must have adequate capital to cover all risks and meet any potential obligations. It would be subject to prudential requirements to ensure it operates according to sound business practices, has specialist knowledge of the sector and complies with an appropriate legal framework. It can also be used to ensure that prudential requirements are met by the specialist intermediary. The guarantee fund could be financed in a number of ways. A potential starting point is a co-funding arrangement similar to the Dutch Social Housing Guarantee Fund (WSW), funded by fees from social landlords and backed by government. The WSW is a not-for-profit private foundation that guarantees loans provided by lenders to Dutch social housing associations (see Chapter 2). Participating associations must meet WSW's

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<sup>43</sup> A hybrid instrument blends characteristics of debt and equity markets. Convertible bonds that offer a fixed income stream but also the possibility of converting securities to shares are an example.

<sup>44</sup> The regulatory requirements and capitalization or guarantees required for the intermediary issuing bonds do not imply that the same are required for providers. As indicated below, providers will be subject to regulations under the new national regulatory framework and may require considerably greater capitalisation to ensure they can generate sufficient revenue to repay loans provided on the basis of bond finance raised by the intermediary.

<sup>45</sup> The respective roles of these regulators are based on the comprehensive overview in Grant (2005).

strict assessment criteria, primarily concerning solvency, and are regularly monitored by the fund. Under the guarantee the government is bound to provide unlimited, interest-free loans to top up WSW's capital when called to do so. However, it must first use the committed capital from participating associations. The WSW has long held a AAA rating.

An important additional challenge for any investment proposal concerns regulation of the allocated funds. Where private funds are intended for a specific policy purpose and special public enhancements are involved, there needs to be appropriate regulation of delivery vehicles in place to ensure that defined policy goals and targets are met. The process by which funds raised are allocated to affordable housing providers must be transparent. One of the lessons of the Austrian model is that bonds must be structured not only to generate low cost private finance but also to ensure that this produces developments that serve intended target groups and meet affordability requirements or any other specified policy objectives. Conditionality of allocated funding in Austria is carried via a variety of channels such as limited profit legislation, conditional co-financing public loans, auditing and reporting requirements and rent laws which apply to subsidised dwellings. This package of regulatory mechanisms demonstrates the important and ongoing role government plays in setting policy requirements, monitoring performance and regulating outcomes.

In the proposal for Australia outlined in this report, additional regulatory activity would provide governments with an important role in designing conditions attached to bond financed loans. Governments can ensure that funds raised with direct and indirect government assistance are allocated only to registered organisations providing housing services to ensure that affordable housing outcomes are optimised. They can, for example, specify the proportions to be allocated to various tenure forms (e.g. rental, shared equity or homeownership), impose specific housing standards and place a cap on the procurement cost of housing funded and, importantly, place rent limits on housing services provided. However, they must also ensure that sufficient funds are provided to ensure housing providers can actually meet specified goals and that regulation promotes and strengthens capacity rather than stifles desired outcomes.<sup>46</sup> A complementary goal for such regulatory reform, identified during the stakeholder consultations, is the need to create a more viable development environment for not-for-profit housing developers. This has been critical in the Austrian model, as discussed in Chapter 2.<sup>47</sup>

During the consultations, numerous stakeholders (policy-makers, providers and investors) also suggested that regulations are needed to strengthen the business models underpinning housing provision by community housing providers. In Austria a cost-rent, cost-capped, limited profit model is the basis of rental and ownership housing providing below market housing services. This model is bound by a legislative framework and the regulated providers who deliver housing are audited frequently to

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<sup>46</sup> State and territory governments may wish to make contributions to supplement finance derived from housing bonds to drive other important policy objectives such as urban planning, energy efficiency, economic management or social inclusion goals. In this way, sub-national governments in Australia can play a formative role in program design as part of a federal agreement on housing.

<sup>47</sup> A number of mechanisms might reduce development risk associated with affordable housing projects and will add to certainty for providers and investors. Recognition of the need for stronger affordable housing policies in planning systems and facilitation of their implementation via measures such as inclusionary zoning, density bonuses and effective use of land corporations, for example, will assist as will action to assist charitable institutions (which are some of the largest inner city land holders) to develop acceptable ground lease arrangements in order to support them in playing a key role in affordable housing provision.

ensure they comply with regulations. This approach not only reduces risk for the sector and its tenants but also gives comfort to investors.

For this reason, the proposal in this chapter and the strategy for its implementation outlined in Chapter 5, presume that statutory legislation will be required to provide a sound business framework for an affordable housing sector in Australia. This would establish the legal and regulatory structure for affordable housing providers and cover any tax reforms needed, such as to allow charitable not-for-profit housing providers to accumulate reserves. It would require organisations to provide and maintain decent housing to an agreed standard and at rents which reflect any supply and demand side subsidies received. It could also require any profits generated by such organisations to be retained by the provider and reinvested in new supply within an agreed time frame (e.g. 10 years) to reinforce the financial viability of these organisations and increase the effectiveness of government assistance provided. In principle, the system of national regulation of community housing providers currently being developed could provide the regulation and prudential supervision that will be needed.

A robust national affordable housing market needs an effective regulatory framework that is flexible enough to accommodate the diverse needs and structures of both existing and emerging housing providers.

Regulation must support growth, maintain high standards of tenancy management and enhance the sector's capacity to operate across multiple jurisdictions. Regulatory controls must be proportionate to the level of risk, encourage the adoption of optimal business models, and develop a market that suits large-scale institutional investors.

State-based regulatory systems seek, among other objectives, to protect the funder's interests in respect of operations in the individual jurisdiction. The need for not-for-profit housing organisations to be able to operate across state and territory borders raises the problem of developing effective national regulations that protect the interests of all jurisdictions.

The potential exists for growth providers (both not-for-profit and for-profit) to control a significant share of the affordable housing market, increasing the risk to the sector should these providers become financially unstable. National regulation has the potential to act more effectively in cases where organisational failure becomes a cross-jurisdictional problem. (Australian Government 2010c, p.12)

### **4.3 Housing Supply Bond structure**

The specialist intermediary would issue a suite of Housing Supply Bonds in a structured finance arrangement where each tranche has different risk and return characteristics, with more senior rated tranches having higher credit ratings than lower rated tranches.<sup>48</sup> Different enhancements, designed to suit different segments of potential investors, are proposed to generate different risk and return characteristics.

The target markets and proposed enhancements for the Housing Supply Bond are as follows:

1. For super fund managers, subject to a 15 per cent tax rate, a fixed interest, long-term (up to 10 years) AAA bond is proposed, implying the need for a government guarantee. This is the AAA Housing Supply Bond.

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<sup>48</sup> Structured finance enables issuers to offer tranches of securities and assets of different terms of maturity, structure, security design and asset types commensurate with an individual investor's appetite for risk (Jobst 2005, p.2).

2. For retail investors, subject to varying tax rates, a fixed term, fixed interest (or indexed) lower yield long-term bond with an appropriate tax incentive to generate a competitive after tax yield is proposed. This is the Tax Smart Housing Supply Bond.
3. For governments, a zero interest bond that converts a direct grant into a long-term revolving loan is proposed. This is the NAHA Growth Bond.

AAA Housing Supply Bonds, with their guaranteed credit support, are the least risky of the proposed finance arrangement and represent the senior tranche. Tax Smart Housing Supply Bonds represent a mezzanine tranche where more generous after tax returns are offset by higher risk (although this is limited by the asset value of dwellings financed). NAHA Growth Bonds represent the equity tranche that absorbs any initial losses (which could arise if declines in dwelling price meant that liabilities exceeded asset values if there was a default on bond repayments). All are proposed to be long-term bonds (with terms of around 10 years).

The enhancements—a guarantee on corporate bonds lifting their rating and reducing yield required; a tax exemption on income earned from retail housing bonds to reduce the before tax yield required; and a zero interest government loan—are designed to reduce the cost of funds raised below that applying to current loans for affordable housing. As such, they will reduce the yield gap between the cost of finance and rental yields on affordable housing and reduce additional subsidies needed to ensure affordability outcomes for lower income tenants. The enhancements needed and specific types of bonds that are appropriate may vary with market conditions. The structure above and example below reflect an assessment of the current economic environment.

The suite of bond instruments proposed is founded on basic property finance principles. Senior term debt is supplemented by a component of quasi-equity or 'mezzanine' finance and a capping component of equity.<sup>49</sup> Each type of bond proposed has a risk profile mirrored by its repayment priority.

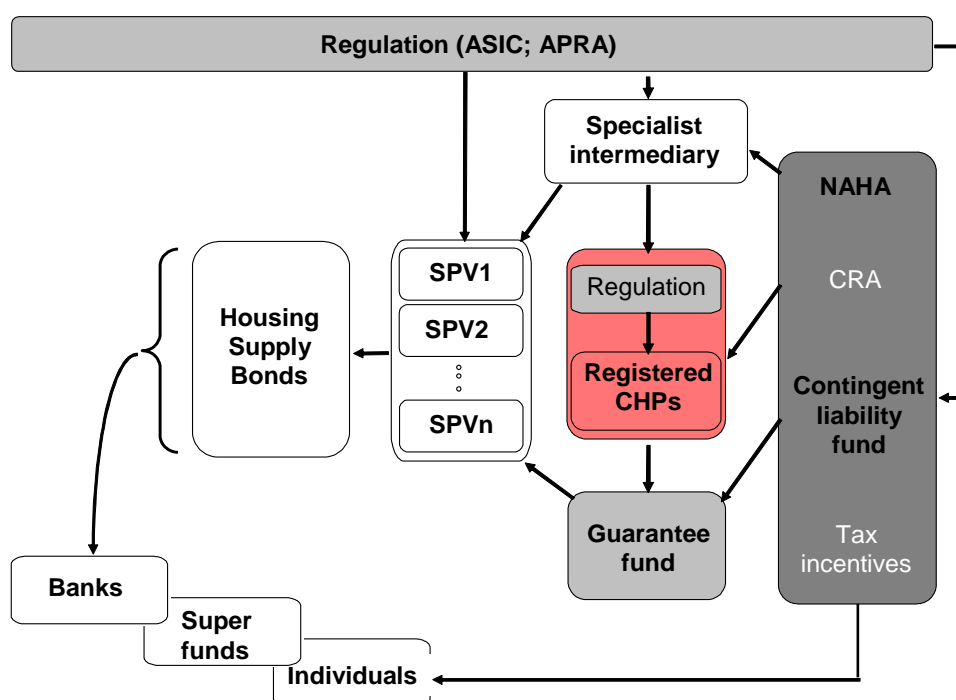
Each tranche of bonds would be issued by the financial intermediary through a special purpose vehicle (SPV) that isolates the assets and income streams associated with each tranche and holds these in trust to provide comfort for the investors in the bonds. The expectation from the consultation process is that these would be not-for-profit trusts.

An overview of the financial architecture required to deliver housing bonds is provided in Figure 11 with the various levels of support provided by government indicated in the dark grey box, affordable housing providers in the central pink box, the specialist financial intermediary and the bonds issued indicated in white boxes and the regulatory framework governing this structure in light grey boxes.

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<sup>49</sup> Senior debt is that which has higher priority compared to another in the event of liquidation. NAHA bonds are junior or subordinate to AAA and Tax Smart bonds. NAHA bonds have equity like characteristics and thus rank below the other two layers of finance with regard to claims on assets or earnings.

Figure 11: An overview of the HSB architecture



Government support through the NAHA Growth Fund (via subordinated long-term zero interest loans) is proposed to provide collateral to underpin the bond issues. Additional support is also required to fund a contingent liability fund covering the guarantees on AAA Housing Supply Bonds, and to fund the tax concessions to investors in Tax Smart Housing Supply Bonds.<sup>50</sup>

Government funds are first in but last out. They provide collateral in the form of a revolving fund and bear the risk that usually would be borne by equity finance. Unlike conventional equity finance, however, there is no compensating return for this higher risk.<sup>51</sup> CHPs are expected to repay these loans as and when possible to maintain the intended revolving fund nature of this government contribution. Individuals provide mezzanine or pseudo equity finance in the sense that Tax Smart bonds are junior bonds, subordinate to AAA bonds in case of default. They provide an additional form of credit enhancement for senior bonds. Institutional investors (e.g. superannuation funds) are the intended targeted of AAA bonds, which are protected by the guarantee fund, by the collateral provided by the revolving fund and by their senior debt status.

The specialist financial intermediary (which is regulated by ASIC and APRA) aggregates (or pools) investment opportunities supplied by registered CHPs. It issues HSBs to the different segments of investors and on-loans funds raised to these providers for the purchase or development of new affordable housing.

Their management and financial performance is covered by a national regulatory framework implemented through existing corporate (ASIC) and financial (APRA)

<sup>50</sup> If a payment due to default is probable, then an appropriate provision should be recorded in the government's balance sheet. If payment from the fund is improbable, it is treated as a contingent liability and not recorded in the balance sheet (see International Public Sector Accounting Standard 19). European governments account and provide for their social housing guarantee funds in different ways (Elsinga et al. 2004).

<sup>51</sup> This refers to financial return. Government obtains a social return through a greater increase in supply of affordable housing than would otherwise occur.



regulators, state based community housing registrars and, if required, any additional monitoring by the guarantee fund.

Housing providers may be required to contribute to the guarantee fund that protects investors in AAA Housing Supply Bonds.<sup>52</sup> They will have last-call access to this fund to ensure bond repayments are met (in other words, they can use it to prevent default on their loans only after they have exhausted all other income and assets to cover their loan repayments). Besides providing a direct guarantee for investors, in conjunction with the specialist intermediary, the way in which the guarantee fund operates could contribute to the building of the financial capacity of the affordable housing sector through auditing of cash flow and business strategy. The structure outlined above is designed to reduce most of the risks that are likely to affect investors in affordable housing.

Credit risk is affected by the CHP capacity to manage rent incomes and costs and is covered by the guarantee fund, by a regulatory framework that monitors CHP performance and by rent setting and demand subsidy policies. Collateral risk is affected by the value of the property and is reduced for AAA bond holders by the cover provided by the mezzanine and equity contributions. Counter-party risk, whereby the investor is reliant on CHP managers doing their job, is reduced by the regulatory framework.

Affordable housing providers, however, are also affected by a number of risks that arise when debt rather than equity finance is employed. At the end of each 10-year term, loans to affordable housing providers will need to be refinanced. Over this period, tenant income, rents and dwelling values can be expected to increase at least in line with inflation and possibly faster.<sup>53</sup> This results in a considerable growth in capacity to pay. Thus over the period, housing providers can begin to build up reserves that can reduce the extent of refinancing necessary and any refinancing that is needed can be undertaken from a considerably improved asset base. While the guarantee fund and government equity component can protect investors from capital losses at the end of the 10-year period, refinancing risks do remain for borrowers.

There are two additional risks that arise but are not addressed by the structure proposed above, because they are under government control. These are policy and reputational risk. Policy risk arises because changes to levels and eligibility rules for CRA can affect the capacity of CHPs to generate the income required to make bond repayments. Government also faces its own reputation or political risk with collaborative funding if a program it sets up does not deliver the outputs intended, whether because of inadequate resourcing, inappropriate governance or poorly defined goals. Chapter 5 suggests how a number of these key policy issues can be addressed as part of an overall implementation strategy.

#### **4.4 Indicative Housing Supply Bond costing**

This section provides an indicative approach to costing the proposal outlined in the earlier sections in this chapter and approximate estimates of the level of government assistance required. Chapter 5 recommends that the assumptions made here be assessed and more formal costing be undertaken.

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<sup>52</sup> Guarantee funds for affordable rental and social housing are typically financed by a combination of government contributions and provider fees, calculated on a per unit basis, as in the Netherlands and Switzerland.

<sup>53</sup> Following the shift to a private financing regime in the Netherlands, nominated rents for social housing were indexed 1 per cent above inflation to give comfort to investors.

The estimates of the cost to government of the three tiered Housing Supply Bond proposal presented here are based on a \$7 billion per year program.

This is sufficient to finance an additional 20 000 dwellings each year at an average cost of \$350 000 per dwelling (including all land and associated costs). The 20 000 estimate is based on the data presented in Chapter 1 and the \$350 000 average dwelling cost (which represents less than 70% of the Australian median dwelling price) has been chosen to ensure that increases in dwelling supply can be provided in relatively high cost rather than only in lower cost locations. To the extent that average dwelling costs can be kept below \$350 000, the amount needing to be raised will be commensurately lower.

#### *4.4.1 The NAHA Growth Bond*

NAHA growth bonds can be funded either from government revenue and costed as a once off capital grant or from government borrowing, in which case they would be costed on an annual basis at an appropriate government bond rate for the period for which the funding mechanism outlined above is assumed to operate (assumed here to be 10 years). Although there are limits on government spending, NAHA growth bonds clearly address a widely accepted housing market failure and the loans that they facilitate would be an investment with many positive economic and social spinoffs. In recent years, states have used CSHA and NAHA capital funds intended for new supply to cover the operating deficits for, and upgrading costs of, existing public housing. The proposal outlined above presumes that NAHA growth funds will be dedicated to additional supply and used to grow a third sector providing affordable rental housing.

Under this scheme growth funds become zero interest NAHA growth bonds which would raise funds that could be recycled in a revolving fund for future projects as CHP capacity to repay these emerges. It is proposed that they provide 10 per cent of the cost of project finance at a critical early stage of the project in the form of a subordinated 'equity' component. Consultations with the Australian and Austrian finance experts who collaborated on this project suggested that 10 per cent is a minimum requirement for this first-in/last-out funding that gives relative security to the two remaining tranches and takes the pressure off the return required by investors in these tranches. The greater is the proportion of this lowest cost form of finance, the greater will be the reduction in overall financing costs.

The cost to the government of this transformation from grants to equity, therefore, is either a once off cost of 10 per cent of funds to be raised, or an annual amount equal to foregone interest on the government bond issues to fund this contribution. This cost would be shared between the federal government and all states and territories.

#### *4.4.2 Tax Smart Housing Bond*

The Tax Smart Housing Bond is targeted to retail investors and is designed to reduce the before tax yield required by these investors. In the proposal outlined in this chapter, it is assumed that the interest received on this bond is tax free. However, as proposed by the Benevolent Society (2011, p.4) for social bonds, the beneficial tax treatment could be provided as a franking credit to ensure neutrality across all retail investors (including superannuation and corporate as well as individual) regardless of their tax rates. Alternatively, a tax benefit could be rationed to income eligible groups of investors or capped at an upper limit, or a tax free earnings threshold could apply, as in Austria.

The annual cost to the government of providing the specific tax incentive proposed here is the tax foregone on all interest received from Tax Smart Housing Bonds.

Estimates are based on the assumption that the average tax rate (or franking credit) for retail investors is 40 per cent. In the example below, only 20 per cent of project costs are assumed to be funded by Tax Smart Housing Bonds as these are the most expensive of the three bonds proposed. Again, this is based on advice provided by the project's financial collaborators. It is a residual estimate derived from the 10 per cent NAHA contribution and an assessment of the optimum proportion of the total HSB package institutional investors would be prepared to hold while keeping the cost of the AAA bonds to a satisfactorily low level.

#### *4.4.3 The AAA Housing Supply Bond*

The AAA Housing Supply Bond, matched to the institutional investment sector's appetite for fixed-interest debt, is similar to a corporate bond issue. It is raised by a SPV and backed in the first instance by the obligation of subscribing CHPs to pay interest and principal from their own businesses. The government guarantee backs this obligation on private debt. In the example below, AAA HSBs are assumed to fund no more than 70 per cent of the finance required because of the potential cost of providing the government wrap beyond this proportion.<sup>54</sup> First round protection for these bonds is provided by the NAHA growth bonds and the Tax Smart bonds.

This guarantee can be costed on the basis of an assumed default rate on bonds issued on behalf of CHPs. Over time, an empirically determined rate can be used but, in the absence of any experience with such loans, some assumption about this default rate must be made. Based on experience with the UK RSL sector, a rate of 0.5 per cent of loans is employed in the estimates below. This could be regarded as being relatively optimistic, since it is marginally below the current level of mortgage loans that are 90+ days in arrears (RBA 2011). However, arrears rates on housing loans in Australia are driven by increases in interest rates (as a result of the dominance of variable rate loans) and losses of income (associated primarily with household dissolution). AAA Housing Supply Bonds are fixed interest securities with no interest rate risk in the first 10 years (or whatever term is employed) and a high proportion of lower income tenants is likely to consist of a single income household, often reliant on (indexed) social security payments, which suggests that income risk might also be lower. Also, default rates, while they signal problems, are generally lower than arrears rates.

This cost would be a contingent liability and would appear in public accounts as a fund set aside to back the guarantee.

#### *4.4.4 Summary costings*

As indicated above, the indicative costs summarised here relate to the first \$7 billion raised through the issue of HSBs. It is assumed that the bonds will be redeemed after 10 years. Costs will be repeated for each subsequent issue of bonds. However, there is the potential for cost savings, for example, if the value of the guarantee fund accumulates because there are no calls made upon it.

The yields included in Table 5 are based on the project's financial collaborators' best estimates of what the market would bear at the time the costs were estimated (late 2011).

1. The AAA Housing Supply Bonds' cost to government is predicated upon an assumed 0.5 per cent default rate based on experience in the UK of senior term debt for community-managed affordable housing. If these bonds are to provide 70 per cent of the \$7 billion required, then \$4.9 billion is to be financed with AAA

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<sup>54</sup> In this case, the government wrap is provided by the proposed guarantee on AAA bonds.

HSBs. The cost of a 0.5 per cent default rate equals \$24.5 million each year for 10 years.

2. The Tax Smart bond costs are based on the assumption of a tax free 6 per cent coupon rate. This provides individual investors on a marginal tax rate of 46.5 per cent with the equivalent of a before tax yield of 11.2 per cent and corporate investors on a 30 per cent tax rate with the equivalent of a before tax yield of just under 8.6 per cent, seen as being approximately that needed to attract retail investors to such bonds. The cost to government, therefore, is the amount of tax foregone by making the coupon tax free (or by offering a franking credit). Assuming 20 per cent of funds are raised through Tax Smart bonds, and a 40 per cent tax rate as a hybrid of corporate and personal tax rates, this cost equals \$7 billion x 20% x 6% x 40% = \$33.6 million per year.
3. The third instrument is the revolving NAHA Growth Fund bond that funds the first 10 per cent of project costs. The annual cost to government each year for 10 years can be assessed as the interest foregone on the \$700 million. Assuming the borrowing cost for government is 5 per cent, then the annual cost to government for the NAHA growth bonds equals \$700 million x 10% x 5% = \$35 million.

Table 5 summarises these estimates and the assumptions made in generating them. It indicates some characteristics of the bonds, such as their relative shares and potential yields, the basis for calculating costs to government, and the estimates of these costs as an annual cost for a 10-year life for each \$7 billion bond issue.

**Table 5: Summary of Housing Supply Bond measures**

<i>Bond scheme (20 000 units.)</i>	<i>Share</i>	<i>Yield</i>	<i>Basis for calculation</i>	<i>Annual cost to govt. for each \$7 billion tranche<sup>1</sup></i>
AAA Housing Supply Bond	70%	5.0%	0.5 per cent default rate, Contingent liability	\$24.5m
Tax Smart Housing Supply Bond	20%	6.0%	Tax foregone at average 40 per cent income tax rate	\$33.6m
NAHA Growth Bond	10%	0.0%	Interest foregone at 5 per cent pa	\$35.0m
Total cost to Government				~\$90m per year for 10 years

<sup>1</sup> Estimates of costings for September 2011

These costs are indicative only. They do not take into account repayments that CHPs might make buy back high cost Tax Smart bonds, or to the revolving loan fund supported by the NAHA growth funds. They also do not take into account the possibility that the cost of raising funds might decrease as investors become familiar with HSBs and with their risk and return characteristics. Finally, they do not allow for the possibility that contingency funds may not be needed.

On the basis of the assumptions made about the yields required by retail and institutional investors, and on the 70-20-10 allocation into AAA, Tax Smart and NAHA growth bonds respectively, the average cost of funds available for on-lending to CHPs is estimated to be 4.7 per cent, considerably lower than the 200–300 basis points above the bank swap rate reported in 2010 (KPMG 2010, p.9). An additional allowance would need to be made for costs incurred by the financial intermediary in raising and distributing these funds.

## 4.5 Indicative outcomes

The primary purpose of the HSB proposal outlined above is to make funds available for registered CHPs and to do this at a lower cost than is currently on offer in the private market. Having such a mechanism in place ensures that CHPs with the capacity to utilise various incentives (e.g. provided by NRAS) or opportunities (e.g. provided by the transfer of dwellings funded under the SHI) are not constrained from doing so by their inability to raise funds or by the cost of funds that are available.

The question of how much additional assistance will be required to ensure that CHPs will be able to provide affordable housing (defined here as that which provides rents at less than 75% of market) is not the focus of this report. However, indicative modelling undertaken by the AHS team suggests that, with current support provided by NRAS and CRA, the Housing Supply Bonds structure outlined above will generate an overall cost of funds for affordable housing that is low enough to enable revenues to cover all interest costs as well as all other outgoings. At the end of the 10-year NRAS period, the level of gearing should be low enough (courtesy of growth in asset values) for bonds to be restructured and serviced from rental revenues without NRAS subsidies. Thus, this HSB proposal will prevent the need for all NRAS properties to be sold after 10 years to pay off outstanding debts. After 10 years, CHPs may still require access to loans funded by (subsidised) HSBs in order to retain financial viability without selling off some stock. Alternatively, they may choose to on-sell some stock (possibly at a discount to tenants) to render the remaining debt financed stock debt free.

In the first instance, AHS modelling assumed that rents for affordable housing are set at 74.9 per cent of market value (of a \$350 000 dwelling), that NRAS incentives are available for each dwelling funded with HSBs and that dwellings are obtained at a lower cost by virtue of a GST exemption. An additional volume discount of 5 per cent on market value was assumed to be sufficient to cover transaction costs associated with purchase. Gross rents were assumed to provide a 5 per cent yield on market value. Net rents were set at around 50 per cent of gross rents with operating costs assumed to cover management costs, maintenance, vacancies etc.. Gross and net rents, National Rental Incentives (from NRAS) and household income were all assumed to increase at an average of 4 per cent per year, 1 per cent above CPI. In this illustrative modelling undertaken by AHS, gross rents were initially set at around \$350 week with an affordable rent being around \$250 per week. These assumptions affect the capacity of the CHP to meet loan repayments. House prices were assumed to increase at 2 per cent above CPI. This assumption affects the rate at which collateral is built up. Under these assumptions, operating surpluses are generated in the first 10 years with HSB-funded loans. These surpluses, plus revenue from property sales, can be used to repay outstanding debt or assist with interest repayments on a refinanced loan after 10 years.

Different outcomes can be obtained with different assumptions. CHPs can supplement the net income received from debt financed acquisitions with operating surpluses from existing stock or they can use operating surpluses from existing stock to pay down outstanding debt after 10 years. If rents are charged at 80 per cent of market rent (as is permissible for private providers under NRAS) then repayment capacity can be increased and larger surpluses generated. If acquisition costs can be reduced by more than the 10–15 per cent assumed in the AHS modelling, then surpluses will be generated more quickly, and so on.

In the Austrian model, which provided the inspiration for the bonds proposal outlined in this report, bonds are generally required to finance only 40–60 per cent of the market value of affordable rental housing in Austria. The remaining costs are met

through reinvestment of housing association surpluses, up-front payments by tenants and provision of land at a discounted value from municipal governments. Housing bonds as exist in Austria, or as proposed in Australia, make an important contribution to facilitating the supply of affordable housing.

In the first place, they provide a vehicle for delivering finance to CHPs able to pay but unable to secure finance in the private sector. In the second place, they increase the chance that affordable housing projects that are not financially available when private finance is available only at a cost of 8 per cent or more are financially viable when finance is available at a cost of around 5 per cent. However, without additional forms of assistance, it is not a foregone conclusion that such projects will meet affordability criteria for all types of households in all circumstances. Demand side assistance (e.g. provided by CRA) is also needed. Housing Supply Bonds fill a missing piece of the affordable housing solution, but they are not the only answer.

The following chapter proposes a strategy for action on the HSB proposal.

## **5 TOWARDS IMPLEMENTATION**

As outlined in Chapter 1, the 5-yearly renegotiation of the national housing policy framework, the NAHA, represents a critical window of opportunity to establish an enhanced, more comprehensive and long-term national policy framework for achieving public and private investment in affordable housing supply at sufficient scale to address current and predicted housing needs. To achieve a new framework agreement will require integration of all current housing subsidy provisions (including NRAS and CRA) within an overarching national strategic policy direction.

Renegotiation of affordable housing financing and delivery models comes at a time when broader policy strategies to build a stronger third sector, promote investment in social infrastructure and deepen Australia's bond market are also on the national agenda. In this context, it is highly pertinent that both the Productivity Commission and the Australian Senate Economics Reference Committee's recent inquiries concerned with the not-for-profit sector and social investment respectively have called for specialist financial intermediaries and instruments to channel investment towards socially useful forms of investment. At the same time in the housing arena, most, if not all, Australian jurisdictions are actively re-examining ways to promote the supply of additional affordable housing. Traditional approaches (e.g. public investment in public housing) are on the decline and openness to new mechanisms to fund and deliver affordable housing is being demonstrated across the political spectrum.

The Housing Supply Bond concept designed for Australian conditions offers the most developed response so far to multiple calls for reform and innovation in the field of affordable housing investment. After the research process followed in this study, this proposal is now ready for more detailed refinement and development. This chapter proposes an implementation strategy that is designed to guide more focused work on the bonds proposal and its associated financial architecture, especially by involving government and industry players working in close collaboration.

### **5.1 A development process and strategy**

The next section outlines priority work that will be required to achieve an operational model. First, however, it is important to discuss how work towards implementation should proceed.

Both the nature of intergovernmental responsibilities for housing policy and the primacy of private financial market interests to this proposal mean that a variety of both government and industry interest groups must be formally engaged in its further development. Furthermore, experience in the rapidly developing third sector (both among housing providers and more broadly) will bring well-grounded knowledge to the process. Therefore what is proposed is an intensive phase of government—industry—third sector engagement focussed on a number of key tasks that are identified below.

Recent experience with the implementation of NRAS (discussed in Milligan & Tiernan 2011) reveals significant problems with housing policy capacity in the existing public service and provides a number of lessons about how to achieve effective design and implementation of a path breaking financing instrument of this kind. To overcome issues that have been highlighted by difficulties implementing NRAS, there is a critical need to promote stronger understanding and technical knowledge of how publicly driven and privately financed affordable housing models operate at both senior and middle management levels within governments (rather than relying too much on external policy advice) and a necessity for policy-makers to engage in intensive and

close interaction with the Australian investment industry to leverage industry knowledge and financial expertise.

This indicates that a viable proposal cannot be developed in isolation by either the public or the private sectors, as it must take account of finance industry expertise as well as public prudence and policy goals. All parties must be focused on achieving the outcome of a low cost, well targeted stable investment mechanism for affordable housing supply as an alternative to diminishing public grant funding, which has stymied growth of the Australian public housing sector, and costly commercial funding which is impeding expansion of the community housing sector.

To meet these requirements, a cross sectoral high level industry, government and third sector Housing Supply Bonds Task Force (HSBTF) is proposed. Ideally such a task force would be led by a distinguished independent chair. The HSBTF would provide overall advice to governments on the HSB and steer five working groups each of which will be required to produce specific outputs either towards the refinement of the bond concept and design or the operation of a financial intermediary. Details of working group tasks, their core membership and required outputs are provided in the next section and summarised in Table 6.

Building on the research so far, the approach to the next stage of development of a housing bonds instrument is intended to: harness both the good will and expertise demonstrated by informants throughout this study; to promote an ongoing constructive exchange between stakeholders; and to produce achievable outcomes. Such an approach offers a way to promote organisational learning within governments and to develop greater financial capacity amongst housing policy-makers at the same time as helping to build industry and political consensus about the best use of government subsidies to leverage private investment and encourage long-term, sustainable growth in affordable housing supply.

A key outstanding issue is how this work might relate to the proposal arising from the Senate Economics References Committee's inquiry into social investment (discussed in Chapter 1) to establish a Social Finance Taskforce to take forward development of a capital market for social investment in Australia. There would be obvious benefits if the Australian Government were to act on that proposal and those in this report simultaneously. In that event, the HSBTF could benefit from and feed directly into the wider ambit of the proposed Social Finance Taskforce. This would position the housing sector as an initial case study for testing the rules, mechanisms and infrastructure that will be required to promote large scale social investment in Australia and help to establish housing as priority domain for such investment. While the proposal below is designed to stand alone, it could be revised to sit within this broader program of work.

## **5.2 Structures and key tasks**

As described above, the proposed implementation strategy employs a collaborative government—industry—third sector task force to steer and coordinate five expert groups with the overall goal of developing and refining the housing supply bond concept, based on the broad proposal in this report. These expert groups have been named, provisionally, as: the Yield Gap Working Group; the Legal Infrastructure Working Group; the Risk Reduction Working Group; the Business Model Working Group and the Development Certainty Working Group. It is anticipated that the work of the task force could be completed within a six month time frame over 2012. While this timeframe may be seen by some as ambitious, an intensive period of effort will build on the goodwill that has been established, give further momentum to the proposal and tap into relevant opportunities and directions that have been outlined



above. The task force's core focus should be to develop a tradable housing bond<sup>55</sup> and contribute directly to the plan for the enhanced NAHA with advice on consequential strategic policy settings funding, legislative requirements and necessary intergovernmental agreements.

An initial task is to complete a formal assessment of the cost effectiveness of various combinations of public bond issues (NAHA Growth Bonds), revolving public loans, tax incentive for social private bonds (Tax Smart Housing Supply Bonds) and the cost of guarantees (AAA Housing Supply Bonds), as outlined in Chapter 4, with a view to determining the optimal share of these in any funding model. It is proposed that this task would be undertaken by an expert working group, the Yield Gap Working Group, whose membership would include Commonwealth, state and territory financial analysts and representatives of potential investors from the superannuation, insurance and retail markets. This group would be charged with consulting with ratings agencies, major financial institutions and other key stakeholders who are not represented on the group. It will also be important that this work links with growing efforts in the third sector to establish a market for social bonds in Australia<sup>56</sup> and the findings of the inquiry into funding of the not-for-profit sector. This group would report first to the HSBTF, which in turn would give direction to other appropriate working groups, as detailed below.

Building on the conclusions of the Yield Gap Working Group, a specialist Legal Infrastructure Working Group would prepare key documentation to cover bond prospectuses, SPV provisions and trust deeds for the financial intermediary that would be responsible for issuing bonds and allocating funds. Reviewing regulatory requirements applying to a financial intermediary and cost estimates for establishing and operating the entity (whether stand alone or located with an existing institution) will also be required. Accordingly, membership of this working group should include appropriate regulatory stakeholders, ASIC and APRA, in addition to housing experts. A key linkage for this group would be to existing efforts to establish financial intermediaries for the social housing sector, such as (but not exclusive to) the National Housing Company.

In order to reduce perceived and real risks in delivery of affordable housing, the next task is to review proposed regulatory requirements for not-for-profit housing providers (most probably under the emerging national regulatory model rather than current state based schemes—see Section 1.2.3) especially as they relate to solvency, risk management, use and reinvestment of profits and business planning to ensure these requirements are appropriate and sufficient and that investor expectations can be met. This group might also consider the most appropriate authority for monitoring financial and other regulatory requirements that govern non-for-profit providers. This discrete task could be addressed by a Risk Reduction Working Group and report to the HSBTF which, in turn, would give direction to a Business Model Working Group. Membership of the working group would include the housing registrars and the new Office for the Not-for-profit Sector.

As expressed by numerous stakeholders, clarifying and strengthening the business framework for the operations of a housing third sector founded in a clear social purpose and a robust co-financing model is imperative to attracting lower cost investment to the sector. The specialist housing regulatory system operating in several Australian states has been significantly developed in recent years, but work

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<sup>55</sup> As called for in the West Australian Government's Affordable Housing Strategy (Government of Western Australia 2010).

<sup>56</sup> See for example, Mission Australia (2011).

still needs to be done on what business models and service standards will be appropriate for providing government's desired range of affordable housing services. Considerable tensions remain in current practice—for example, between the narrow definition of housing target groups applying to charitable entities that is enforced by the ATO, the broader ambitions of community housing providers to house a mix of low and moderate income groups and the market realities of the finance sector. The focus of the group will be on determining policy settings that balance government affordability objectives, public subsidy levels and financial yield requirements. This is an area for additional modelling, possibly utilising expertise in the AHURI research network working alongside housing sector peak bodies and international experts in limited profit housing systems. The desirability of a legislative basis for the operations of the sector, similar to those applying in several European jurisdictions, would also be considered by this group.

In the broadest sense, risk can be considerably mitigated by increasing certainty for affordable housing development. One of the ongoing and unresolved issues in Australia, which has been better addressed in many other countries from the US to France and, most ably, the City of Vienna, is the role of land use planning policies oriented to delivering housing policy objectives. To address this gap, a Development Certainty Working Group would be charged with proposing a consistent set of reforms to state land use planning systems to promote the use of planning instruments, such as inclusionary zoning and density bonuses, and to propose explicit affordability goals for urban renewal strategies and government land banking activities. This aspect of reform aims to align actions by state and territory governments (and consequentially local government) with national housing policies and priorities and to ensure that target levels of affordable housing development can actually be delivered in appropriate locations. The work of this group should be coordinated with and informed by inter-government work that is proceeding on planning system reform.<sup>57</sup> The link to the Australian Treasury's engagement with housing affordability issues would be recognised through their membership of this group.

### **5.3 Strategy management and next steps**

There are several ways that the implementation strategy could be taken forward by government. One option is for the Housing and Homelessness Policy Research Working Group of officials (HHPRWG), who have been fully briefed on the proposal in this report, to advise the Housing Ministers Advisory Committee (HMAC) (to whom they report) and through them the Standing Council on Community, Housing and Disability Services—comprising Housing, Community and Disability Services Ministers—on a process for setting up and guiding the HSBTF. However, consideration will also need to be given to involvement of other government agencies beyond human services portfolios, especially treasuries and finance departments and linkages to any concurrent government action on social investment that emerges (see above). Another option would be for one or more jurisdictions to initiate the next stage of work towards implementation. The role of the Council of Australian Governments (during and beyond the further development phase) should also be considered further now in the light of their ongoing steering of housing policy reforms and their responsibilities for the NAHA.

There will be modest resource requirements for the next phase. These include secretarial support to the HSBTF and expert sub groups, dedicated capacity within

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<sup>57</sup> In April 2012, the COAG Reform Council released a report of its review of capital city strategic planning systems across Australia. The report highlighted the need for more attention by governments to housing affordability and social inclusion in capital cities (COAG Reform Council 2012).

government (possibly via a small, dedicated off-line team of officials from different sphere and agencies of government hand-picked for their relevant expertise) and funding for travel and out-of-pocket expenses of participants in meetings of working groups. It is envisaged that up to four meetings of each sub group would be required and four to six meetings of the task force. While the proposed approach makes strategic use of industry expertise, it will also be necessary (given time lines and specialist aspects of the work) to engage appropriate consultants for some detailed tasks that are the responsibility of specific working groups. Therefore, a consultant's budget needs to be determined and funded. However, as discussed above, it will be important to ensure that long-term capacity and specialist knowledge is developed in the public service, initially through officials having intensive cross sector involvement and interaction.

Table 6 summarises the proposed implementation strategy for discussion.

## **5.4 Final comments**

There is a well-demonstrated need for an effective means of channelling much larger volumes of private investment into the supply of rental housing in Australia to meet expanding requirements for affordable housing. Current policies and incentives, while welcome, have not been sufficient and do not measure up to international best practice.

Key factors undermining efforts in Australia to address this issue have been the high cost, limited availability and conditionality of private finance. In response to this problem, this research has focused on the design of a special purpose fund raising instrument and associated institutional settings that would be suited to Australian conditions. The proposal presented has been developed through a highly consultative and collaborative approach that has involved international experts in similar instruments and local investment industry leaders, housing providers and government officials.

The results are a well-grounded concept for an Australian Housing Supply Bond that would be issued by a specialised financial intermediary, and regulatory measures that are designed to ensure that the funds raised through bond issues are channelled towards affordable rental housing and meet outcomes required by governments. The report also offers a practical strategy to move from concept to implementation, by drawing further on industry expertise and harnessing and developing capacity within the public sector.

This work is timely in many respects. It comes at a critical juncture in the growth of not-for-profit housing organisations that have been building their capacity to play a larger role in the provision of affordable housing and require greater certainty. It falls amidst various strategic reviews of national housing and planning policies that recognise the need for greater effort to be directed towards increasing the supply of affordable housing. The findings complement those of recent parliamentary and government-commissioned enquiries that have been concerned with securing the future of Australia's third (social enterprise) sector and enhancing capital investment in that sector. Finally, the proposal comes at a time when the Australian Government is actively encouraging a diversity of funding sources through a deeper and more liquid corporate bond market in Australia and when an Infrastructure Finance Working Group has been asked to work on a long-term tradable bond market.

The Housing Supply Bond proposal, therefore, can be seen to be ideally positioned: it can overcome a key missing ingredient in affordable housing policy; it can lead the

way for a new approach to third-sector financing; and it can assist bond market development in Australia.

**Table 6: An implementation strategy for Australian Housing Supply Bonds**

<i>Responsibility and mission</i>	<i>Representation</i> <sup>58</sup>	<i>Completion</i>	<i>Output</i>
<p><b>Housing Supply Bonds Task Force</b> —to ensure low cost, well targeted investment in affordable housing supply building on the advice provided in this report.</p>	<ul style="list-style-type: none"> <li>→ Treasury</li> <li>→ FaHCSIA</li> <li>→ State HHPRWG representatives</li> <li>→ State treasury representatives</li> <li>→ Affordable Housing Summit Group members<sup>59</sup></li> <li>→ Finance industry representatives</li> <li>→ Community housing peak bodies</li> </ul>	December 2012	Defined suite of bond instruments and specifications for financial intermediary, risk mitigating reforms, legal basis for business model and strategy to ensure targets can be met.
<p><b>Yield Gap Working Group</b> —to define the most cost effective combination of bonds, investors and enhancements refining the concept provided in this report.</p>	<ul style="list-style-type: none"> <li>→ Representatives of departments of treasury and finance</li> <li>→ Australian Superannuation Fund Association</li> <li>→ Financial Services Council</li> <li>→ Representatives of bond investors</li> <li>→ Third sector organisations (e.g. Mission Australia; Benevolent Society)</li> </ul>	August 2012	Cost assessment of alternative combinations of public bond issues as outlined in this report.
<p><b>Legal Infrastructure Working Group</b> —to prepare the legal documents required to issue such bonds and inform investors appropriately, based on the outcomes of the YGWG.</p>	<ul style="list-style-type: none"> <li>→ ASIC</li> <li>→ APRA</li> <li>→ HHPRWG</li> <li>→ Directors of community housing providers/intermediaries with strong legal expertise</li> </ul>	September 2012	Prospectuses. Trust Deed for SPV. Licensing for financial intermediary.
<p><b>Risk Reduction Working Group</b> —to ensure sector financial management and regulation reduces risks across the community housing sector.</p>	<ul style="list-style-type: none"> <li>→ Social housing registrars group</li> <li>→ HHPRWG</li> <li>→ Community housing peak bodies</li> <li>→ Office for the Not-for-profit Sector</li> </ul>	November 2012	Recommended reforms meeting regulatory requirements and industry demands.

<sup>58</sup> Proposed representation for each working group is indicative of key members but not definitive.

<sup>59</sup> This covers National Shelter, the Australian Council of Social Service, the Housing Industry Association and the Australian Council of Trade Unions.

<i>Responsibility and mission</i>	<i>Representation</i> <sup>58</sup>	<i>Completion</i>	<i>Output</i>
<p><b>Business Model Working Group</b> —to define a sustainable business model, which performs a social mission and is financially sound informing the work of other working groups.</p>	<ul style="list-style-type: none"> <li>→ Community and affordable housing specialists from FaHCSIA and SHAs</li> <li>→ Community housing peak bodies</li> <li>→ Department of Finance</li> <li>→ ATO</li> <li>→ International input</li> </ul>	October 2012	<p>Defined business model and tax requirements.</p> <p>Draft specifications for legislation.</p>
<p><b>Development Certainty Working Group</b> —to ensure the supply and appropriate location of decent quality rental housing choices for Australian households.</p>	<ul style="list-style-type: none"> <li>→ Commonwealth Treasury (Cities, Housing and Planning Unit and/or the Housing Supply and Affordability Reform Working Group)</li> <li>→ State/ territory planning, land and housing agency officials</li> <li>→ Local Government</li> </ul>	October 2012	<p>Planning strategy to deliver affordable housing development opportunities.</p>

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# APPENDICES

## Appendix 1: List of organisations consulted

<i>Field</i>	<i>Stakeholder</i>	<i>Interviewee</i>	<i>Workshop Invitation*</i>
Bond investors	ME Bank	√	√
	MECU Bank		
	Commonwealth Bank	**	
	Australian Super	√	√
	Construction and Building Industry Super (Cbus)	√	√
	Australian Ethical	√	
Bond market specialists	Australian Financial Markets Association	√	√
	FIIG securities	√	√
	Financial Services Council	√	√
	Frontier Asset Consultants	√	√
Financial regulator	Australian Prudential Regulation Authority (APRA)	√	
	Australian Securities Investments Commission (ASIC)	√	
Housing policy-makers and administrators	Centre for Affordable Housing NSW		√
	Deputy Secretary, FaHCSIA	√	√
	Housing NSW		√
	National Housing Supply Council		√
	Office of Housing, Human Services, Victoria	√	√
	Housing Supply and Affordability Division, SEWPAC	√	√
Housing providers	Community Housing Federation Australia (CHFA)	√	√
	Community Housing Federation Victoria (CHFV)	√	√
	Housing Choices Australia	√	√
	PowerHousing		√
Housing sector regulator	NSW Registrar of Community Housing	√	
Industry and policy advisors	Affordable Housing Solutions	√	√
	Arrow Financial Services		
	Centre for Social Impact, UNSW	√	
	Community Sector Solutions		√
	Corrs Chambers Westgarth	√	√
	Grattan Institute	√	√
	Affordable Housing Summit Group (Industry coalition for affordable housing supply)	√	
Industry and policy researchers	RMIT, Melbourne	√	√
	University of Glasgow		√
Public finance managers	Federal Treasury	√	√
	Reserve Bank of Australia	√	

\* Some invitees were prevented from attending by adverse flying conditions on the day of the workshop.

\*\* Did not reply to requests for interview.

## **Appendix 2: Interview topics by stakeholder group**

### *Bond investors*

- The market for different types of bonds, their characteristics, investors and taxation treatment.
- Market conditions, demands, norms and expectations.
- Potential for housing supply bonds.
- Current experience and perception of social bonds.
- Potential market for HSB, retail arrangements and marketing.
- Necessary features to attract investors to HSB, Investors expectations, typical terms and level of returns.
- Volume of issues for required liquidity.
- Timing of issues.
- Disclosure requirements.
- Initial price and coupon rate determination fixed, floating indexed and conditions governing convertibility, equity shares.
- Marketing capacity and advice for dealers and other investors.
- Requirements of potential purchasers of HSB.
- Current role bonds play in different investor segments and their portfolios.
- Rationale for the current scale and scope of this investment.
- Familiarity with social bonds and infrastructure bonds.
- Perception of HSB, as applies in Austria, and adaption to Australian conditions.
- Necessary characteristics and yield of HSB to attract investor interest.
- The potential of a tax incentive, depreciation allowance or guarantee to make low yield bonds more attractive.
- Potential market size.
- Prospectus expectations.
- Marketing.

### *Bond market specialists*

- Potential for special purpose housing supply bonds.
- Necessity for a SPV as financial intermediary.
- Most acceptable structure of this intermediary (licensed banks, co-operative, corporation, not-for-profit, public etc.)
- What role should this financial intermediary have (monitoring, creditworthiness, pooling demands, allocation of funds, project assessment, etc.)
- How would the financial intermediary be funded, managed and guaranteed?
- Appropriate investor market retail, SMSF, wholesale, banks, fund managers etc.
- Necessary government enhancements.
- Launching and marketing the bonds.

- Regulatory mechanism to ensure that the funds raised are used for desired purpose.
- Pooling funding demands.
- Adequate provider business model and financial management capacity required.
- Assessing applications and allocating funds.
- Issuing and lending conditions (covenants, loan to value, interest cover ratio).
- Link with conditional public subsidies.
- Subordination of public loans.
- Links with other regulatory and funding agencies, such as subsidy providers, sector regulator, town planning authorities, financial regulators.

### *Financial regulator*

- Current status of Australian bond market.
- Role in regulating this market.
- Current policy issues and initiatives.
- Risk assessment, disclosure standards the income on bonds.
- Treatment of special purpose bonds.
- Concept of social bonds.
- View of central agencies towards social bonds or a housing supply bond.
- Anticipated and required reforms affecting bond market and the design of any housing supply bond.
- Requirements of financial intermediary issuing housing supply bonds for affordable housing.
- Preferred model and rationale for different financial intermediaries.
- Role regulatory agencies can play to ensure appropriate use of funds raised from the bonds issued.

### *Public finance managers*

- Reflect on the role of Austrian housing expenditure in economic policy.
- Role of national agreements in Austria's Federal system with nine provinces and comparison with the NAHA.
- Role of national legislation outlining limited profit cost rent legislation and linking efforts to environmental policies (including active commitment to Kyoto protocol), as well as provincial programmatic innovation and variation.
- Outline different instruments used and the costs to the state of HCCB tax incentive to the Austrian state.
- Australian vision for the development of the housing market, given persistent affordability problems and the advice of the National Housing Supply Council.
- Views on current mechanisms to achieve policy goals (NAHA, Housing Fund, NRAS negative gearing, rent assistance).
- After the economic stimulus package, what next for the long term?
- View of additional measures such as financial intermediary, special purpose bond and necessary enhancements.



- Role in regulation and marketing

### *Housing providers*

- Access to finance, current lending to conditions.
- Measures that could improve these terms and conditions.
- Risk management and allocation.
- Role of financial intermediary.
- Perception of housing supply bonds.
- Role in the Austrian limited profit system.
- Potential for adaptation to Australian conditions.
- View of a variety of intermediation models.
- View of enhancements tax incentive, guarantee, co-financing.
- Role of a guarantee fund, active or passive.
- Rent policy, allocation criteria, revenue management and borrowing capacity.

### *Housing policy-makers and administrators*

- Vision of key government stakeholders with regards to the expansion of affordable rental supply and the actual mechanisms, especially financial support and institution building.
- Vision for the role of private investment in the sector and potential or incentives and intermediation to support this, such as the Housing Supply Bond.
- Funding supply—intentions with regards to grants and loans.
- Selecting needs—intentions with regards to eligibility and long-term access.
- Assisting demand—Intentions with regards to rent policy and rent assistance.
- Channelling investment—co-financing, leveraging, financial intermediary, incentives, requirements.
- NRAS lessons.
- Views on HCCB in relation to current system.
- Regulatory and administrative constraints.
- Required reforms.
- Policy and political constraints to these reforms.
- A feasible strategy.

### *Housing regulators*

- Relationship between regulation of registered providers and their access to finance.
- Role in financial capacity as well as longer term planning.
- Reporting and disclosure, readership.
- Implications of shift from state to national model.
- Current relationship between registration, auditing and access to public subsidies, urban planning, commercial financing?
- Role of the regulatory authority in relations to NRAS properties and after 10 years

- Learning from NRAS.
- Knowledge of Austrian housing supply bonds and potential for Australian adaptation.
- Role of public collateral (public loans and grants) in relations to commercial loans (subordination).
- Role of regulator in financial monitoring and assessment of covenants.
- Role in promoting cost efficiency.
- Cost caps for land, construction, finance and operations, indexing system.
- Generation of revenue, build up and use of surplus—are there profit limitations, requirements for re-investment?

*Other stakeholders (researchers, advisors, industry associations)*

- Additional views on the design of a housing supply bond and appropriate financial intermediary, drawing on different realms of expertise.

### **Appendix 3: Housing and limited profit sector housing finance in Austria<sup>60</sup>**

#### *Background information on Austria and its affordable housing system*

In 2010, Austria had approximately 3.6 million households and 4.1 million dwellings and, over the coming decade, has a projected population growth rate of around 4 per cent due mainly to migration. It is the third wealthiest country in the European Union in terms of GDP per capita being lower only than Luxembourg and the Netherlands. Austria has overcome the economic crisis of 2007/08 better than most European countries. The decline in real GDP in 2009 (of 3.9%) was one of the lowest downturns of all EU countries and its real growth in GDP (of around 10%) since the crisis has been one of the highest of the 'high GDP' countries within the EU.

Housing policy in Austria is under the authority of the Federal State and the provincial governments (Länder). The 'subsidized housing' sector has considerable influence on the price level of the private market and made a significant contribution to Austria having no house price boom before 2008 and no house price crash thereafter. However, contrary to most European countries, Austrian house prices have increased substantially since 2009.

The Limited Profit Housing Associations (LPHA) in Austria, or subsidised housing sector, comprise altogether 190 housing co-operatives, private-limited and public-limited companies with a housing stock (rental dwellings and owner-occupied apartments) that represents 23 per cent of the total dwelling stock. The LPHA are responsible for one third of new residential construction and more than half of all multi-apartment housing construction.

In 2010, the Länder subsidized 28 000 dwellings (representing roughly 60% of all new construction). The extent of this involvement means investment in subsidized housing moderates and reduces volatility in housing costs and explains why subsidized new housing can have such a strong influence on the private market.

Demand side allowances complement the supply side subsidies but total expenditure on demand side assistance is less than 25 per cent of that on supply side assistance. Prior to 2000, housing allowances generally were available only for dwellings in receipt of supply side but, over the past decade, most Länder have extended such allowances to the private rental sector as well because of declines in the proportion of affordable dwellings (due to substantial refurbishment activities).

Austria's older rental stock is highly regulated, post war subsidised stock more liberally regulated and single family homes are now unregulated. Almost 40 per cent of households rent either privately (17%) or in the social housing sector (23%). Social rental housing construction still forms a very high proportion (35%) of total new construction (which, unlike construction in most EU countries, experienced no downturn as a result of the 2008–09 financial crisis and is projected to be sustained through the 2010–12 debt crisis).<sup>61</sup>

A rent-to-buy scheme, introduced in the early 1990s, now covers some two thirds of all new construction. This is attractive for LPHAs as, under this scheme, they may

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<sup>60</sup> Based on material provided by Dr Astrid Kratschmann, Erste Bank, Austria and Dr Wolfgang Amann, IIBW, Vienna. More detailed information can be found in Amann & Mundt (2009), Amann et al. (2009) and Deutsch & Lawson (2010).

<sup>61</sup> Much of this new construction has been at the forefront of environmentally sustainable development with obligatory 'passive house' standards being applied in some Länder. Generous subsidy schemes also apply for refurbishment of existing stock in some Länder.

request significant (refundable) upfront payments from their tenants. After 10 years dwellings are offered to the sitting tenants for sale at below market prices with upfront payments (but not the rents paid) being used to offset the purchase price. Significant own equity investment is required to make LPHA make financing feasible.

Household expenditure on housing (including energy) accounts for just over 17 per cent of household disposable income in Austria and is significantly below EU average of 23 per cent. Few low-income groups spend more than 25 per cent of their incomes on housing and only 5 per cent of the population pays more than 40 per cent (compared with an EU average of more than 12%). In the past decade, private market rents have decreased in real terms.

### *Establishment and refinement of the Austrian housing bond*

The Austrian banking sector is well integrated into the international financing sector. Austria has a high density of bank branches, with strong competition in particular in housing finance.

- 'Bausparen' (contract saving) is important for the financing single family homes in rural areas, but increasingly is being used for multi-apartment construction and refurbishment.
- Special housing banks 'Wohnbaubanken', introduced in the 1990s, issue tax advantaged housing supply bonds to finance construction of subsidized (and regulated) housing. These HCCBs were designed to encourage individuals to invest in a simple, secure and long-term financial product. The bonds must have a minimum duration of 10 years with longer terms being offered if there is a demand for them.<sup>62</sup> Repayment is assured at 100 per cent at the end of the term. Sale prior to maturity on the secondary market is possible at the respective market price but there is a limited secondary market because more than 95 per cent of investors hold their bonds until maturity.

These intermediaries and instruments were introduced at a time where there was a high demand for dwellings, when interest rates were high and unpredictable, when there was a shortage of long-term capital and when public loans for limited profit housing associations had been capped. They represented an attempt to broaden the private capital base for funding affordable housing.

The incentives required for private individuals to invest in long-term assets and the means of providing these were identified as:

- Attractive yield return (achieved through tax concessions).
- Security of capital (achieved by earmarking funds for investment in non-speculative housing and by restricting issuance of housing bonds to publicly supervised banks and registered housing developers).
- Security and stability of interest rates (achieved by issuing fixed rate bonds; variable rate bonds tied to specific indices; or bonds with both nominal and index linked floors and caps on the rates paid).
- Transparency (achieved by explicit legislation defining the characteristics of the bonds and identifying the fiscal measures to support them; and by consumer protection measures for issuing securities).
- Liquidity (achieved by having bonds issued by finance or construction companies listed on the stock exchange).

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<sup>62</sup> The longest maturity of a Wohnbaubank bond to date has been 25 years; the average is 13.5 years.

As a result of the tax concessions provided, the capital raised is cheaper than alternative long-term capital and refinanced housing loans can be granted at lower interest rates than currently on offer in the market. The cost of raising funds was kept low by use of existing banks infrastructure to support the housing banks set up as refinancing vehicles within each bank.

The bonds must be used for housing construction, renovation or refurbishment for dwellings with a floor space that does not exceed 150 square metres. If used for rented dwellings, these must be allocated to households with incomes below a defined level and rents must not exceed a specified amount.

Annual issues averaged out at around €300–400 million during first 7 years of operation in the 1990s but grew to an average of more €1500 million during the 2000s. When established, target investors were private individuals, but discussion is currently underway to extend the HCCB system to pension funds.

## Appendix 4: Social bonds financing options

The Benevolent Society (2011) submission to the Senate Economics References Committee's Inquiry into finance for the not-for-profit sector recommended that franking credits be made available to bond issues for funding of capital infrastructure for social purposes (e.g. for buildings and equipment for health services, aged care, services for people with disabilities and accommodation for homeless people), but not for funding of recurrent operations. The submission argues that the advantage of the franking credit is that it is an established form of tax relief, which applies to equities, and would be seen to have the ATO stamp of approval. It claims that franking credits would work for different categories of investors including:

- Those who pay no tax such as retirees using their self-managed super funds (SMFS) and private ancillary funds—in the example given after tax return improves from 6 to 9 per cent.
- SMFS in the pre-retirement phase (subject to 15% tax)—after tax return increases from 5.1 to 7.7 per cent.
- Corporations (30% tax rate)—after tax return improves from 4.2 to 6.3 per cent.
- Individuals on a high marginal tax rate (46.5%)—after tax return improves from 3.2 to 4.8 per cent.

### *Estimated impact of offering a franking credit*

The Benevolent Society considers that SMSF are the most logical investors. If one per cent of SMSF (\$400 billion) were invested in bonds attracting franking credits, \$4 billion in social investment could be raised. Of this, one third would be sourced from retiree accounts and two thirds from non-retiree accounts.

In relation to private ancillary funds, The Benevolent Society assumes that if 5 per cent of the \$1.5 billion currently invested in those funds is invested in social bonds, this would raise a further \$75 million.

In total this would mean that almost \$4.1 billion could be made available for the development of much-needed social infrastructure, bringing in addition a large multiplier impact on the economy from such projects and from on-going employment. The cost to government is estimated to be \$122 million per annum for five years.

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