**Response to the Consultation Paper 'National Housing and Finance Investment Corporation' September 2017**

RMIT Centre for Urban Research

AHURI Research Centre

Julie Lawson, Honorary Associate Professor, CUR, RMIT University

Mike Berry, Emeritus Professor, CUR, RMIT University

Carrie Hamilton, Housing Action Network

Contact details

Julie.lawson@rmit.edu.au

RMIT AHURI Research Centre,
Centre for Urban Studies, Australia
+47 4550 4629 (Norway)
+61 3 9925 2272 (Melbourne Office)

**October 2017**

**Response to the Consultation Paper**

October, 2017

We welcome the Treasurer's Consultation Paper and the accompanying consultant's report demonstrating the usefulness of a financial intermediary and recognising the vital role of public co-investment to address the funding – financing gap. We also strongly support the AHWGs recent advice to Heads of Treasuries (2017) that calls for greater policy efforts in closing the funding gap to fuel a pipeline of social housing investments and ensure housing produced addresses need.

As researchers we are committed to informing progress in Australian housing policy with independent evidence-based research and consultation with key industry stakeholders and policy makers.

We have been active in efforts to develop appropriate tools for Australian housing and urban conditions such as the design of a financial intermediary and guarantee, drawing on international best practice and a strong appreciation of national policy and market settings. This has involved rigorous research and industry consultation which has culminated in a body of work that is both peer reviewed and published online as Lawson, Berry, Hamilton, Pawson 2014, Lawson, 2013, Lawson, Lawson and Deutsch, 2013, Milligan and Yates, 2012, Lawson, Gilmour and Milligan 2010.

Recent AHURI research models the differing impact of various other policy levers on affordable rental housing development, such as the role of government equity, land policies, tax settings and other instruments which further reduce financing costs. Important lessons are emerging from a thorough evaluation of completed developments on the ground (Randolph, Milligan, Troy, et al 2017 in press). This work suggests that planning and land policy levers securing land acquisition are vital for well-located housing opportunities and government equity and recurrent funding can secure a continuum of social housing outcomes. As the AHWG rightly points out, there is a funding gap that must be filled and the financial intermediary is just one important piece of the puzzle. Land and equity are another and should form an integral part of a capital investment strategy.

**Influence of current investment pathways**

Under current funding and financing settings CHPs are more likely to deliver new *affordable* rental housing and dwellings for sale (reinvesting sale proceeds in their mission) than deeply social housing, given insufficient cash flows and lack of equity to do so (AHWG, 2017). Outsourcing public housing management and maintenance to CHPs has transferred these important responsibilities but allowed for only very limited surpluses to be generated to actually grow social stock (Pawson, et al, 2017). In some transfers, a percentage of sales is required to cover operating costs, offsetting any potential growth achieved (ibid, see note 11 page 25).

Accelerated renewal strategies in several states, some inspired by the 15% asset recycling incentive and driven by internal rates of return, have some potential to renew stock but are often at much higher densities (1:12 in Ivanhoe, under Communities Plus in NSW) than communities or indeed tenants may be willing to accept. These same strategies can also disperse established social housing communities from areas rich in opportunity to cheaper isolated areas, as observed in a mixed review of renewal efforts by the ACT Auditor General (2017).

To date most financing reforms focus on affordable housing provision via CHPs and do not address the fundamental structural problems facing public housing provision (VAGO. 2017). Financing proposals such as NHFIC are certainly useful to the CHP sector, but should not skirt the reality facing the largest providers of social housing in Australia of the inadequate funding and financing for deeply social rent geared to income housing, currently provided by state housing authorities and by contract community housing providers. We hope the revised NHHA will address this pervasive and pressing issue.

**Ongoing research**

Of direct relevance, AHURI is currently conducting an Inquiry into the rationale, business case and investment in social and affordable housing considered from the vantage point of **infrastructure** policy, project appraisal and investment. We have completed work on assessing the annual stock of social rental housing required for the next twenty years to meet both the backlog of unmet needs as well as future arising needs and developed comparative land and construction costs in 90 SLAs across Australia (Lawson, Pawson, et al, 2017). Research is currently drawing on an evaluation of the most effective policy levers (Randolph, Milligan, Troy et al, 2017), international best practice and Australian market settings. Early 2018 research will model the cost to government of a more effective investment pathway for social housing.

We hope this effort will inform the Treasurer's proposed approach (Commonwealth Budget, 2017) under the NHHA to setting social and affordable housing targets, prioritising planning reforms requiring or incentivising affordable housing and delivering appropriate levels of investment in the renewal of public housing stock, involving both state housing authorities and community housing providers.

In this submission we provide additional advice on the structure and governance of the 'bond aggregator' component of the National Housing Finance and Investment Corporation (NHFIC). We support the AHWG's advice to Treasury (boxed below) on the complementary measures that will be required to grow social and affordable housing addressing the funding gap and consider the establishment of a financial intermediary an important complementary step in the right direction.

**AHWG (2017)**

**Recommendation 1**

The Affordable Housing Working Group recommends that the Commonwealth and State and Territory governments progress initiatives aimed at closing the **funding gap**, including through examining the levels of direct subsidy needed for affordable low-income rental housing, along with the use of affordable housing targets, planning mechanisms, tax settings, value-adding contributions from affordable housing providers and innovative developments to create and retain stock.

**Recommendation 2**

The Affordable Housing Working Group recommends that the Commonwealth and State and Territory governments and the community housing sector work together to develop and implement a uniform and **nationally applied regulatory framework** that supports the implementation of a bond aggregator as well as the growth of the sector nationally.

**Recommendation 3**

The Affordable Housing Working Group recommends that the ***National Industry Development Framework for Community Housing*** **be revised** and updated to reflect findings and recommendations from the Review of the National Regulatory System for Community Housing

As recognized in the Treasury Consultation Report (Australian Government, 2017) and Advice to Heads of Treasury (AHWG, 2017) affordable rental housing assisted via CRA and the NHFIC financing will not be financially feasible in most metropolitan housing markets where land and construction costs are prohibitive and cash flows too low.

In order to grow housing supply where it is needed most (p.8) complementary measures are most definitely required and are well established in every other social housing financing systems in the world. For housing to be accessible and appropriate for very low income households and people with specific vulnerabilities and support needs, much deeper levels of subsidy will be required.

A large scale and long term capital investment program, akin to that which existed in Australia until the 1990s, is required to move forward and grow well allocated, located and decent quality supply.

Australian housing policy can learn from past practice as well as current approaches in comparable countries, where good supply and support outcomes addressing homelessness, improving housing allocation and quality of occupancy, accessing employment, reducing energy costs and providing a stepping stone for young households toward independence in either the private rental or home ownership markets in Australia.

Typically governments provide a package of **direct equity** support, **revenue support** (rent assistance) and **financing** support in the form of interest subsidies and guarantees as part of the overall funding and financing of social housing.

An example is the UK's combination of Housing Assistance Grants, Housing Benefit payments and ‘not-for-profit’ financial intermediation provided by The Housing Finance Corporation (THFC). This model contributed towards 39,000 social dwellings in 2014 alone, but has become considerably less productive as grants have declined (Williams and Whitehead 2015), reduced and inappropriate investment on maintenance (with tragic results in Grenfell) and necessitating sales of social housing stock. Unlike England, Scotland has maintained a balanced focus on capital investment and demand support and hence continues to expand well-targeted supply.

Finland provides a sliding scale of grants depending on the complexity of needs and cost of housing (Averio, 2015, ARA 2017). It also provides interest rate subsidies for approved loans with market competitive terms and tenor. Since the GFC, very long-term low-cost private investment has been sourced via its local government-owned financial intermediary, Munifin. The use of Munifin has reduced the cost of financing and hence interest subsidies considerably. This cost effective mechanism for financing relatively broad-based social housing contributes towards 22 per cent of all new housing produced in Finland, being 8,000 dwellings in 2016 and to reach 9,000 in 2017 (ARA, 2017).

A new private sector example is Austria's proposed Housing Construction Investment Bank which, coupled with grants and public loans from regional housing programs, will raise long-term fixed cost finance to invest in an additional 30,000 affordable rental dwellings over the next five years, above current social housing programs. This will be launched end of 2017.

Capital investment programs coupled with cost efficient private financing, as in Finland, Austria and Scotland, demonstrate how growth can be achieved in Australia.

These approaches provide both equity and recurrent subsides to sustain an ongoing pipeline of bond issues and ensure new development and the renovation of older social housing continues to serve population needs. In Australia, as in Europe, such investment must be coupled with an effective National Regulatory System for Community Housing *and* Public Housing.

Overall, Australian governments spend modestly on housing assistance being ($6.2 billion in 2015–2016), with the largest share dedicated to demand-side assistance in the private rental segment, a market characterised by low vacancy rates and weak tenancy regulation (Hulse, Milligan, Easthope. 2011). Combined Australian governments in 2015–2016 spent a little under 0.4 per cent of national GDP on both CRA and the National Affordable Housing Agreement (NAHA). While comparisons are a challenge, when compared to international counterparts this is extremely low. For example, Austria spent more than double this at 0.9 per cent of its GDP on housing assistance programs, France 2.2 per cent, the UK, 2.0 per cent, and the Netherlands 3.2 per cent (based on 2011 and 2012 figures in Wieser, Mundt and Amann 2013).

The Commonwealth Government's contribution to capital via the NAHA (formerly the CSHA) has been gradually declining over many years to $1.82 billion in 2015–16, while its expenditure on CRA to the private rental sector (PRS) has been increasing strongly (over 20% in four years), rising to $4.4 billion in 2015–2016. This is similar to many other European countries that have seen public funds shift towards demand support rather than affordable supply, with varying effects (Yates and Whitehead 2010). Rates of new supply have only kept pace in countries which have retained a capital investment strategy – as demand assistance alone cannot produce accessible demand quality dwellings. Unfortunately, Australian CRA has become less effective as an affordability instrument: while indexed to the Consumer Price Index (CPI), rental costs have increased at a faster rate over the past seven years (ROGS 2017).

Notably, capital contributions toward investment in social housing have not been specified under joint housing agreements since 1996 and as a consequence have been declining ever since. The important contribution of state and territory governments as partners in the NAHA has varied: with expenditure increasing in Victoria and NSW and decreasing in other jurisdictions.

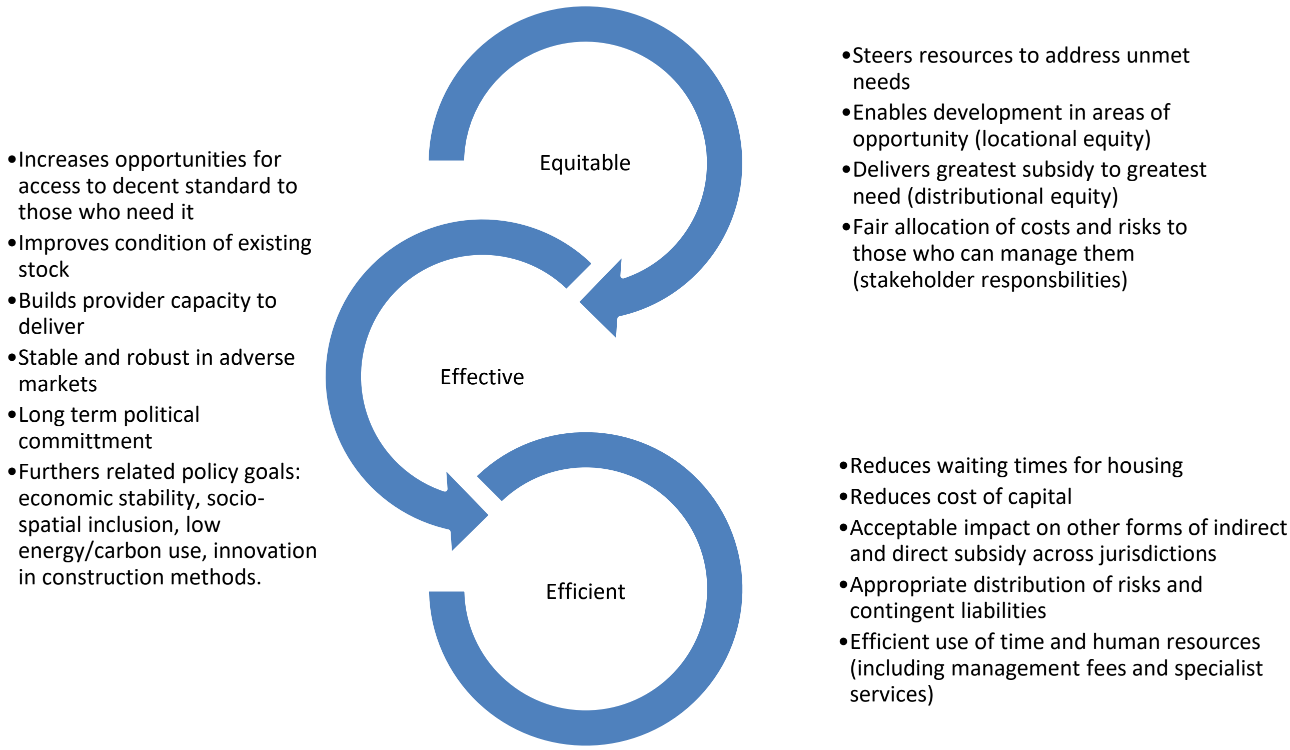
The National Housing and Homeless Agreement (NHHA) in particular is critical to the NHFIC's success in that it will define whether there are sufficient resources directed at additional new supply as well as supporting the policy settings to enable community housing sector expansion. The current NHHA negotiations provide an opportunity for state / territory governments to commit to targets and jointly invest in additional social and affordable housing delivering necessary reforms through supply side interventions.

As mentioned above, our AHURI research on Social Housing as Infrastructure is working hard to provide a detailed picture of the spatial distribution of housing need, differing procurement costs, and the most effective funding and financing levers to inform a reformed capital investment strategy and working papers are already bearing fruit (Social Housing as Infrastructure Inquiry Discussion Paper, 2017).

The Consultation Paper confirms in many respects the value of AHURI's extensive national and international research on the design of the intermediary and any potential guarantee (Lawson, Gilmour, Milligan, 2010, Lawson, Milligan, Yates, 2012, Lawson, 2013, Lawson, Berry, Pawson, Hamilton 2014). The findings of this AHURI research were based on deep international and national consultation and engagement with key stakeholders and experts, which both selected and brought appropriate evidence to the fore from the UK, Switzerland and Austria for this purpose.

This submission now focuses on issues pertaining to the bond aggregator component of the NHFIC.

Why do governments influence the flow and nature of investment towards affordable housing social housing? It is important to re-affirm the purpose of this effort and ensure that it meets equity, efficiency and effectiveness criteria, as illustrated below: (Lawson, Pawson, van den



Nouwelant et al, forthcoming drawing on Lawson, Gilmour and Milligan, 2010:14, ROGS, 2017).

**Comments on specific issues raised for consideration.**

While the NHFIC cannot conjure a robust pipeline of housing production on its own, it can play an important role in reducing the cost of finance for affordable housing by community housing providers, lengthening their loan terms and reducing refinancing risks. We now turn to specific issues raised for consideration in the consultation paper.

**1 Eligibility**

At this important stage in the consolidation and growth of a social and affordable housing industry, we consider that regulated not for profit providers serving the social and affordable segment of the housing market should be the target and recipient of bond aggregator NHFIC financing. These providers are most likely to be use conditional funding under specific social and affordable housing programs developed at the state and territory level and also funded under inter-governmental housing agreements. Lower-cost longer-term NHFIC financing would make subsidies provided under these agreements go further and enable preferred social housing delivery partners to grow. The National Regulatory System for Community Housing (NRSCH) reduces risks to investors due to the application of a regulatory framework that governs the risk taking of providers**.**

There are sufficient regulated and registered tier 1 and tier 2 not for profit providers who would be suitable candidates for NHFIC financing who are growing in management, project development capacity and should be supported with access to longer term lowest cost NHFIC financing. Potentially T3 providers with increasingly large management portfolios and who wish to grow and develop new housing could also have access.

Lower-cost longer term-financing is important to CHPs who face revenue constraints of allocating housing to low income households and who operate under efficient conditions that deliver little surplus; CHPs also have few lenders to turn to. Reduced financing costs, complemented by (cross) subsidies, are vital for CHPs to ensure they can deliver affordable housing outcomes, maintain and replace stock over time.

Given the stable long-term operating profile of a rental property, living under the average 5-year refinancing risk is akin to being hostage to the need to sell the dwellings at short notice should acceptable (financially viable) terms not be agreed at the pre-determined review or debt expiry points. For an industry whose mission is long-term stability of tenure for tenants, this is anathema. It is vital to the CHP sector that the NHFIC concentrates efforts on reducing refinancing risks in the first instance.

For-profit entities have alternative sources of financing not currently available to CHPs. Unregulated for-profit providers are not appropriate candidates for NHFIC financing. They undertake a range of commercial development activities under less regulated circumstances. NHFIC financing, with its low investor yield, is not intended for these higher risk activities, which may have other financing options at their disposal and of course primarily serve other housing segments of the housing market that are already well-served.

**2 Purpose**

There is no reason why the bond aggregator component of the NHFIC could not operate as a stand-alone corporation.

Independent standalone entities can operate transparently in the absence of any external influence that may arise from the project feasibility evaluation function that is an essential element of the NHIF. One option may be for these functions to be undertaken in separate entities.

A good international example of two independent entities working well together to achieve affordable housing funding and financing objectives can be found in Finland. A cost effective financial intermediary Munifin, which provides lower cost longer term loans, complements a capital investment program ARA, that provides grants, interest rates subsidies and guarantees. The Housing Finance and Development Centre of Finland (ARA) is a governmental agency of the Republic of Finland operating under the supervision of the Ministry of the Environment to implement social housing policy. ARA is an expert partner, developer and moderniser of housing and promotes ecologically sustainable, high-quality and reasonably priced housing. It offers capital investment subsidies with clear conditional requirements and targets. The dual efforts of ARA and Munifin generate more than 8,000 affordable dwellings a year addressing a continuum of housing needs (Averio, 2015, ARA, 2017). There are of course federalised versions on this approach, as exemplified by Austria with its nine regional housing programs tailored to local needs and policy preferences. Key to their success is the established national level of regulation for not for profit housing provision and operation at scale of national level financial intermediaries able to operate at scale (Lawson and Deutsch, 2013).

The proposed dual structure of the NHFIC could weaken or confuse the standalone credit quality of the aggregator through its “contamination” with issues arising from the NHIF.

Focusing on the NHFIC, CHPs raise commercial debt for three reasons: to finance construction, to fund turnkey acquisition, or to refinance existing loans.

In the first phase of establishing the NHFIC it is best to concentrate on longer term lower cost turn-key finance for completed projects. Once the NHFIC is up and running and a dedicated pipeline of construction is underpinned by a capital investment program, other additional types of financing instruments may be considered (see below).

**3. Security of loans**

The security, or collateral, taken by banks to underpin a loan is often the most contentious part of financing negotiations. The scale of security agreed is extremely important in terms of the extent to which a CHP’s future endeavours are accordingly constrained.

Management of the NHFIC would hold the title deeds to the properties purchased by the providers as collateral for the loans financed by the bond purchase. Alternatively, title deeds could be passed to and held by a commercial trustee.

Without exception, lenders require security well beyond the assets being financed by the debt. Some CHPs report that positive borrowing track record has led to the disappearance of the requirement for fixed and floating charges. CHPs also report that their security assets are under-valued, as a result of offering income-related rents (Lawson et al, 2014).

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

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

For these two reasons as well as the fact that Community Housing is a cashflow rather than a property enterprise, Debt Cover Ratio (DCR) rather than LVR has become the dominant measure in 'sizing' or calculating the size of a loan supportable by a new development or a combination of new and existing portfolio properties. Commercial banks describe this as a 'cash flow lend, not a security-based lend'.

Punitive DCRs of 2x (meaning CHPs would have to demonstrate free cash flow twice that required by debt repayments) were quoted in the early days of community housing lending, but ratios quoted by current borrowers are between 1.3x and 2x, most commonly at the mid-point.

Despite the fact these DCR calculations result in loan size that is very modest relative to asset value, commercial banks have often required security beyond the subject property due to the fact that Community Housing lending is still maturing, and because CHPs have preferred corporate-entity lines of credit rather than project-specific finance, which they believe gives them more flexibility. However, in the more mature market in the US, CHPs borrow only on a project basis, ring-fencing each development to its specific finance. This is also the case in Austria, Finland and Switzerland, where rents and subsidies are more clearly linked to project costs.

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

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

Although early aggregated bond issues will likely refinance existing broad CHP lines of credit, we propose that the NHFIC can support industry maturity (and likewise simplify security demands) by over time trending toward project-based financing, which is contained by the cash flows and likewise the security titles of specific affordable housing assets.

## 4. Complementarity with other sources of gap funding

The investment mandate provided by the Treasurer should define the purpose of NHFIC investment, specifying the affordable housing to be produced, via not-for-profit housing providers, to ensure the supply of housing to households not met by the private housing market in the appropriate locations. It would be informed by the level and nature of housing need and specify the type and level of community service obligations to be delivered. It should also relate to the policy ambitions of state and territory governments.

We assume that only projects that meet housing need will attract the 'gap funding' necessary to make a project stack up. In other words, they will already have gone through a process of obtaining conditional funding, under state and territory housing programs.

With regards to construction-phase finance, some countries establish a parallel Revolving Development Fund to provide project finance that can be replenished following project completion and tenancy and refinanced with lower cost longer term loans.

The parallel capital investment fund needs to complement housing policy objectives and be informed by evidence-based policy on needs and costs of housing procurement and firmly embedded in local housing planning goals as well as state housing strategies.

Most social housing systems have established capital investment agencies providing grants, interest rate subsidies and guarantees to complement efficient financing via revolving development funds and efficient long term finance.

Again it is worthwhile mentioning Finland's Housing Development Finance Centre (ARA) and local government owned financial intermediary Munifin together constitute one of the most effective social housing systems in Europe in terms of generating supply, preventing and reducing homelessness and providing a continuum of housing options for households neglected by the free market.

Finland uses a straight forward approach that balances conditional public investment of variable grants with lowest cost publicly raised and guaranteed bonds and well-targeted housing allowances plus regulation on providers to provide a continuum of housing services for Finnish households. There are four categories of grants which vary from 10% (student housing) to 50% (formerly homeless, people with disability) of procurement costs. Finland supports in some form 22% of all housing production and produced 8 000 affordable and social rental dwellings in 2016, with 9,000 budgeted for 2017 (more on this in the forthcoming report Lawson, Pawson et al, 2018).

In general, the Treasurer's investment mandate should address the need for social and affordable housing consistent with national and state / territory affordable housing strategies to be delivered by registered community housing providers.

The NHFIC board would report on delivery of these outcomes to the Treasurer and in turn the Parliament.

Were a guarantee to be applied to any bonds, agreement of the use of the guarantee should reinforce this mandate. A guarantee agreement would also set boundaries for its use, define an annual lending volume cap and support sustainable levels of financing for the mandated housing outcomes. It would also require reporting to Parliament on the status of guarantees provided, including levels of lending under the volume cap and results of monitored risks as well.

**5. Bond issuance**

This will evolve over time and in relation to a variety of contextual issues, including development completion pipelines. For a review of past bond issues by both THFC and the Swiss Bond Issuing Co-operative see Lawson 2013. For example, we find that the Treasury consultants' input that the NHFIC issue only ten-year bonds is an inadequate mismatch to the stable long-term cash flows and tenancy goals of the CHP industry. Hopefully, this short tenor compared to other countries' housing bonds will merely be an early condition that this new asset class quickly matures beyond.

In terms of bond size, the Treasury survey of CHPs established a capacity for refinancing existing debt that would allow for initially large bond issues of $100 million and smaller subsequent issues. The ongoing demand for finance will increase when there is a pipeline for investment which depends whether other complementary reforms are put in place, such as a capital investment program which co-funds new stock and complementary planning measures to deliver appropriately located land.

**6. Contracting out functions/Governance**

Credit assessment, monitoring and control need to be undertaken by a team which is in good communication with the sector and liaises with regulator. It must have constructive relations with CHPs. With in-house capacity, the NHFIC will build up a stable, professional and expert team which has credibility and respect of capital markets and is useful to CHPs. Investors are critically aware of the skills required: sound experience in risk management, regulation, accounting and reporting. It will also need to work closely with the CHP regulator, individual and consortia of CHPs.

As a public corporation the NHFIC has a strong complementary interest in making sure that risks are monitored and reduced and that defaults are avoided. Outsourcing undermines both capacity building and complementary governance relationships.

The board of the NHFIC needs to hold specific skills and have strong appreciation of the role and purpose of not-for-profit housing provision; detailed awareness of the cash flow limitations and commercial constraints affecting providers and commitment to regulatory compliance and financial continuity of CHPs.

This would imply ensuring the following are included in the Board's skill set:

1. Commitment to affordable housing policy implementation at the Commonwealth, state and territory level, strategies to develop CHP industry capacity in order to grow affordable and social housing supply equitably, effectively, efficiently
2. Strong awareness of regulatory standards and best practice, including complex provider structures, special purpose vehicles and joint venture partnerships
3. Experience in treasury management, risk management, accounting and management reporting
4. Experience in corporate bond issuance and the borrowings requirements of social housing providers
5. Appreciation of the different roles of social housing providers play such as tenant management and support, maintenance and renovation as well as new and mixed tenure developments.
6. Experienced in the legal complexities of project financing structures, including those relevant to mixed tenure developments and special purpose investments
7. Appreciation of the relationships of housing providers have to other support services which affect their role and financial capacity

With regards to the day-to-day skills set within the NHFIC, emphasis should be placed on building constructive relations with CHPs and building their critical financial capacity. Skills in corporate finance, credit risk assessment, financial monitoring, mentoring and reporting, project finance and long term strategic asset management are vital in building industry capacity for growth.

The Department of Industry Innovation and Science is mentioned as a source of skills in this area, but perhaps it is not the most obvious one, especially in terms of affordable and social housing policy and not for profit industry capacity building. Additional recruitment would most likely be required from the affordable housing sector and financial services sector, with experience in affordable housing development, regulatory compliance and project finance. The pathway of organisational development undertaken by the CEFC, which has a considerable set of relevant in-house skills, should be further investigated.

Given the specialist nature of these skills required and the importance of constructively building capacity in the sector, it is vital that both the expertise of the board and skill set of management is consciously and strategically developed *within* the NHFIC and as part of a revised and updated National Industry Development Framework, as recommended by the AHWG (2017 p.9). It is neither effective nor efficient to contract out the ongoing operational tasks of the NHFIC to a large, generic accounting firm which has no necessary or ongoing affinity with the investment mandate.

Finally, the Board and staff should maintain a constructive but independent relationship with the industry regulator – with strong lines of communication to promote good financial practice and strengthen compliance. The Board should include a representative from both the Registrar and community housing industry.

Given the specialist nature of these skills required and the importance of constructively building capacity in the sector, it is vital that both the expertise of the board and skill set of management is consciously and strategically developed *within* the NHFIC and as part of a revised and updated National Industry Development Framework, as recommended by the AHWG (2017 p.9). It is neither effective nor efficient to contract out the ongoing operational tasks of the NHFIC to a large, generic accounting firm which has no necessary or ongoing affinity with the investment mandate of the NHFIC.

**7. Government guarantee:**

The AHURI study found that a properly structured guarantee would substantially improve the financing conditions for CHPs (Lawson, 2013, Lawson et al, 2014). The absence of a guarantee will increase the costs of finance which in turn increases the size of the funding gap. Ultimately this reduces CHP capacity to deliver supply and affordability outcomes.

In the Consultation Paper and the consultant's report the arguments surrounding the guarantee are not fully presented. These need to be more fully considered and the issues resolved. Simple assertions of moral hazard are too simplistic. Since the GFC there has been growing use by governments of guarantees as an important policy tool to channel investment to where it is required (OECD, various Gibb et al, 2013). Today governments use guarantees to:

- Address market failure causing undersupply in segments of housing market (Elsinga et al, 2009, Buckley, 2006, 2003, Min, 2012, Chan et al, 2006)
- Increase investor comfort and familiarity with new assets (OECD, various, EPEC, 2011,2012) in the context of shrinking government investment and increased reliance on private resources, there is a need to
- Bolster credibility of investment to reduce cost, increase leverage and broaden access to finance (EPEC, 2011)
- Speed up provision of necessary infrastructure at minimal government cost (Irwin/World bank, 2007)
- Improve terms, amidst tighter borrowing conditions limiting long term debt (crises, Basel II and III), thereby maximizing the benefit of any government subsidy (Lawson et al, 2012).

The structure of any guarantee must be designed according to agreed principles, with a long-term mandate and boundaries set by a facility agreement. There should be strategies in place to lower the risk of investment, such as appropriate regulation and effective monitoring and enforcement, in order to allow early detection and cure of any cash flow risks and avoid any potential call on the guarantee. It is important to structure the guarantee to allocate risks amongst those best able to manage them. International experience of guarantees in social housing has shown that a well-designed and managed guarantee has little or no implications for government budgets (Lawson, 2013), who are often the very last line of call in a well-structured guarantee agreement.

This is important because the very existence of any guarantee will influence decision making by investors and influence required yields. Typically, investors and their agencies link the rating given to movements in the government's own rating (as in the UK and Switzerland).

A persuasive public good argument, based on enhanced productivity and economic stability, can be made to legitimate the considered use of guarantees in affordable housing by registered not for profit CHPs delivering a clear community outcome: well targeted affordable housing to address needs not met by the private housing market.

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

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

Having identified the key risks that it could bear, governments can supplement the qualitative assessment of the potential costs by estimating the quantitative impacts.

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

Then measure the government's possible exposure:

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

AHURI has conducted very extensive international and national research on the nature of guarantees used in social housing financing systems (Lawson, et al, 2014, Lawson, 2013), including many interviews with key Australian stakeholders, which should be more effectively drawn on by the Government and their current advisers.

Drawing on international experience and national policy guidance, a number of recommendations were made:

- Establish the risk to be assumed and a case for government to assume the risk; in cooperation with key stakeholders in the public, not-for-profit and private sectors.
- Impose timeline termination of the liability given the duration of the guarantee and associated obligations.
- Calculate the possible maximum loss to government and value-for-money in the event of loss.
- Ensure relevant legislative requirements are met.
- Ensure appropriate risk management procedures are in place; in the case of a suitable social housing guarantee, including further reforms to the evolving national regulatory system for social housing providers in Australia.

It was already noted in our 2014 report that the magnitude of exposure potentially to be guaranteed in the housing proposal was minute compared to government balance sheets and therefore was unlikely to impact on overall government ratings. Furthermore, the ongoing ability to service debt, rather than the level of debt itself, was the main factor influencing the rating of any government.

Rating of NHFIC bonds with a government guarantee would most likely to track the rating of the government, as it does in the UK and Switzerland, with movements in the overall rating of the government influencing the rating of bond issues, and thus interest on the loans they support, rather than the other way around.

Industry has further recommended that a guarantee can be adapted over time (Lawson et al, 2014).

As always, financial markets work most efficiently when simplicity, transparency and the free flow of information prevail. Rental providers, especially non-profits delivering affordable outcomes, must transparently demonstrate their financial, operational and governance strengths within a robust national regulatory system, in order to build the level of confidence in the financial sector necessary to attract their interest.

Appropriate government guarantees have a complementary role to play in achieving this outcome. Moreover, when robust complementary policies and regulations are in place, the impact of guarantee structures will be greater and the cost to government, lower. This suggests that guarantees should form part of an overall structure of government support aimed at expanding the supply of affordable rental housing (ibid. p.68)

Guarantees can be structured in a number of ways to be fit-for-purpose; there is no 'one size fits all' option.  The potential exposure of government does not, in general, create on-budget impacts until and unless the risk is crystallised. The Commonwealth Treasury will include the estimated cost to itself on budget if it judges the probability of crystallisation at greater than 0.5 or 50 per cent.; if below 50 per cent, the contingent liability is noted on the Statement of Risks.

In the case of guarantees that support the provision of affordable rental housing by non-profit providers, the credit standing of the latter become relevant to the structuring of the guarantee and the rating of its guarantor. The ratings agency Standard and Poor's (2012) has a well-developed methodology for rating non-profit social housing bond issuers and has applied it in a number of countries, as does Moody's.

Ideally for a government providing a guarantee in this field, the providers (whose performance will largely determine the probability of the government's risk crystallising) will score a 'stand alone credit profile' (SCAP) of at least 2, the second strongest score, based on a rating of single a/a- (adequate) to aa/aa+ (very strong) on the two key factors, financial profile and enterprise profile. Each sector receives an 'enterprise profile' assessing the background strength/risk/growth potential of its core enterprise and this risk weighting modifies each issuer rating. The IP report (Milligan et al. 2013, p.48) notes that Standard and Poor's have, in fact, assigned the social and affordable housing sector's enterprise profile a '2' (on a scale of 1 [lowest risk] to 6 [highest risk]) in countries like Australia. This should give governments a level of comfort in providing guarantees on, for example, debt raised by 'tier 1' Australian CHPs.

A number of key principles for intermediaries and guarantees have been identified by AHURI research on structure of guarantee, lending volume and volume cap, drawing on international experience. This research informs the development of an appropriate Australian social housing guarantee. These principles and their related practices (Section 5, Lawson 2013 are summarised in the following Table 1. For ease of reference, relevant sections of the reports are also listed in Annex 1.

*Table 1: Principles and practice*

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

*Lawson, Berry, Hamilton, Pawson (2014:6) and detailed in report The use of guarantees in affordable housing investment—a selective international review (Lawson 2013)*

**Annex 1**

In summary, a guarantee requires:

- Clear eligibility and supply targets.
- A capped lending volume, enforceable limit.
- National regulatory system and guarantee agency work together to ensure ongoing compliance.
- Government defines overall volume of obligations, defines target and eligibility and receives reports on potential contingent liability.
- Borrowers can contribute to contingency fund, collected by intermediary as a fee on top of loan interest.
- Borrowing remains off government budget, only contingent liability need be noted on public accounts.
- Financial intermediary accumulates separate fund, partial guarantee reserve.
- Backed by unencumbered assets of the borrower.
- Potential to sell dwellings if required for return, before recourse to government guarantee. From Table Key design elements – stakeholder views (Lawson, Berry, Hamilton and Pawson, 2014 pp. 66-67)

**Relevant sections of Research Reports on Intermediary and Guarantee:**

| **Report/Section** | Lawson 2013 The Use of Guarantees in Affordable Housing Investment – a selective international review, AHURI, RMIT |
|---|---|
| **2.3** | Design elements of the guarantee |
| **2.5** | Accounting norms and practices when using guarantees |
| **3** | Different types of guarantees used for social and affordable housing |
| **4** | Discussion and comparison |
| **5** | Principles |
| **Report/section** | **Lawson, Berry, Hamilton, Pawson, 2014 Enhancing investment in affordable housing via a financial intermediary and guarantee, AHURI, RMIT** |
| **5** | Building on Australian Policy and Practice in the use of Guarantees |
| **5.5** | Key issues in developing a Social Housing Guarantee for Australia |
| **6.3.1** | Model – Affordable Housing Finance Corporation, specifically p.86-88 |
| **7.1** | Building on research evidence |
| **7.2** | Applying key principles |

**Ongoing research**

We aim to continue to inform Australian social and affordable housing policy providing evidence via the Social Housing as Infrastructure Inquiry to inform Treasury's efforts towards addressing the funding gap providing needs prognosis, procurement benchmarks and modelling of the cost to government of an effective investment pathway. More information on this research effort can be obtained from the leader of this Inquiry Julie Lawson.

Julie Lawson, Honorary Associate Professor, CUR, RMIT University

Mike Berry, Emeritus Professor, CUR, RMIT University

Carrie Hamilton, Housing Action Network

**Key references**

Averio, P. (2015) 'The Finnish housing finance system and the role of Munifin', *Housing Finance International*, Autumn: 37–8

Commonwealth Budget (2017) 'A comprehensive plan to address housing affordability', *Budget 2017*, Australian Government, Canberra, http://www.budget.gov.au/2017-18/content/glossies/factsheets/html/HA_11.htm

CEDA (2017) *Housing Australia*, Committee for Economic Development of Australia, CEDA, Canberra http://adminpanel.ceda.com.au/FOLDERS/Service/Files/Documents/36002~HousingAustraliaFinal_Flipsnack.pdf

Groenhart, L. and Burke, T. (2014) *Thirty years of public housing supply and consumption: 1981–2011*, Final Report no. 231, Australian Housing and Urban Research Institute Limited, Melbourne.

Hall, J., Berry, M. (2007) *Public housing: shifting client profiles and public housing revenues*, AHURI Final Report no. 108, Australian Housing and Urban Research Institute Limited, Melbourne, https://www.ahuri.edu.au/research/final-reports/108

Lawson, J., Gilmour, T. and Milligan, V. (2010) *International measures to channel investment towards affordable rental housing*, RMIT, Australian Housing and Urban Research Institute, Melbourne.

Lawson, J., Milligan, V. and Yates, J. (2012) *Housing supply bonds—a suitable instrument to channel investment towards affordable housing in Australia?* Final Report no. 188; Melbourne: AHURI, http://www.ahuri.edu.au/publications/projects/p30652

Lawson, J. (2013) *The use of guarantees in affordable housing investment—a selective international review*, AHURI Positioning Paper no.156, Australian Housing and Urban Research Institute, Melbourne, https://www.ahuri.edu.au/__data/assets/pdf_file/0025/2887/AHURI_Positioning_Paper_No156_The-use-of-guarantees-in-affordable-housing-investment-a-selective-international-review.pdf

Lawson, J., Berry, M., Hamilton, C. and Pawson, H. (2014) *Enhancing affordable rental housing investment via an intermediary and guarantee*, AHURI Final Report no. 220, Australian Housing and Urban Research Institute Limited, Melbourne, https://www.ahuri.edu.au/research/final-reports/220.

Lawson, J Denham, T. Dodson, J, Flanagan, K, Jacobs, K, van den Nouwelant, R. and Pawson, H (2017) Discussion Paper as part of *Inquiry into Social housing as Infrastructure*, produced for the Inquiry Panel meeting, AHURI, Mercure Hotel Sydney 18 October 2017, Australian Housing and Urban Research Institute

Lawson, J., Pawson, H., van den Nouwelant, R. Troy, L and Hamilton, C (forthcoming) Building and Investment Pathway, SRPC Report as part of *Inquiry into Social Housing as Infrastructure*, Australian Housing and Urban Research Institute Limited, Melbourne.

Randolph, B., Milligan, V., Troy, J., van den Nouwelant, R. and James, A. (forthcoming), 'Affordable housing prospects in different market contexts', SRPC Research Report as part of Inquiry *Increasing affordable housing supply: evidence-based principles and strategies for Australian policy and practice*, Australian Housing and Urban Research Institute Limited, Melbourne.

ROGS (2017) *Report on Government Services, Housing*, Australian Government http://www.pc.gov.au/research/ongoing/report-on-government-services/2017/housing-and-homelessness/housing

Wieser, R., Mundt, A. and Amann, W. (2013) *Staatsausgaben für Wohnen und ihre Wirkung im internationalen Vergleich* (International Comparison of state expenditure on housing and its impact), IIBW, Vienna.

Williams, P. and Whitehead, C. (2015) 'Financing affordable social housing in the UK; building on success?, *Housing Finance International*: 14–19, https://eprints.lse.ac.uk/63399/1/__lse.ac.uk_storage_LIBRARY_Secondary_libfile_shared_repository_Content_Whitehead,%20C_Financing%20affrodable%20housing_Whitehead_Financing%20affordable%20housing_2015.pdf