SUBMISSION TO THE INQUIRY BY THE **COUNCIL ON FEDERAL FINANCIAL RELATIONS** AFFORDABLE HOUSING WORKING GROUP

Innovative Financing Models for the Affordable Housing Sector

Submitted by:

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Introduction

As Australian cities, in particular Sydney, Melbourne and Perth, are frequently cited as amongst the most expensive in the world, housing affordability is a social issue that needs to be addressed with urgency. Given the enormity of the affordable housing crisis in Australia, it is going to take a coordinated effort by all sectors, including institutional investors, to come up with workable solutions.

The issue of affordable housing is one that lends itself to participation from institutional investors, including superannuation funds. Many funds have already invested in unlisted property through unit trusts and direct investments. Moreover, the scale of affordable housing required is of a level that is able to be funded only by large pools of capital.

Despite what are viewed by many as unsustainable levels of housing prices, residential property continues to make up a significant portion of many Australians' investment strategies. Within this asset class, affordable housing offers some attractive characteristics.

Christian Super categorises the sector into two distinct areas: Low Income Social Housing and Middle Income Affordable Housing. Our view is that Low Income Social Housing requires ongoing government support and, at this stage, should continue to be funded and managed largely by government. The Middle Income Affordable Housing space seems to present opportunities for private institutional investors to participate alongside the government and this submission outlines some of our views on how that can be achieved efficiently.

Key considerations

Potential solutions to the problem are many. But it is important first to understand the cause of the problem.

If the problem is caused by a supply/demand imbalance that provides the ability for owners of capital (in this case, owners of residential property) to extract returns from those who require the use of this capital (in this case, renters), then this problem can either be cyclical or structural.

- If the problem is cyclical, what is required are solutions to help those who are struggling to find affordable housing until the cycle returns to normal. Rent subsidies, first home-owners' grants and other similar tools can be effective over shorter periods of time in addressing cyclical problems.
- However if the problem is structural, then these short-term tools will prove ineffective and ultimately drain government spending over the long-term. What is needed are structural solutions that shift the dynamic of the market into supply/demand balance.

In the case of the majority of affordable housing difficulties in Australia, we believe that the problem is primarily structural. Large, coastal cities with limited supply of land and steadily increasing population through immigration require a constantly increasing supply of housing. The centralisation of these major cities (particularly in Melbourne and Sydney) creates a situation in which house prices radiate out from the centre, leaving few affordable options for those in essential services who work near the centres of these cities.

There may be exceptions to this. It could be argued that affordability problems in Perth, for example, are caused more by cyclical issues relating to the mining boom than by structural problems. Perth still has a substantial supply of land with relative proximity to the centre, relative to Sydney and Melbourne. Additionally, the fact that interest rates are at historically low levels has arguably lifts house prices at a faster rate than expected – a cyclical factor that could easily revert if interest rates change.

In our view, since the problem is primarily structural, there are three main areas that are crucial to determining the most appropriate solutions. Successful initiatives must:

- Be sustainable, with an ability to solve the affordability problem over the long-term
- Create paths for home ownership by long-term users of affordable housing
- Alter the supply/demand dynamic by increasing the supply of affordable housing

Sustainable & Long-Term

Attempts in the past to involve institutional investors in the affordable housing space have rightly focussed on appropriate risk-adjusted returns, as a necessary precursor to institutional involvement. However in doing so, most approaches that we have seen require a substantial portion (usually the majority) of the return to investors to come from continued capital growth. In our view, this is misaligned, in that the continued capital growth at the rates seen over the last 20 years simply serves to exacerbate the ongoing affordability crisis by pricing even more people out of the market. This has created a vicious cycle in which those trying to save a deposit find that house prices are increasing more rapidly than their ability to save.

In our view, the market would be better served by seeking to create opportunities at the lower end of the risk/return spectrum, focussing on attracting institutional investors by de-risking affordable housing (relative to other unlisted property) instead of subsidising the returns aspect or creating solutions which require the capital value of properties to increase at such high levels.

Any successful affordable housing strategy requires appropriate risk sharing by all stakeholders including the government, investors, occupant/tenant and others such as community housing providers.

Paths to Home Ownership

Options that increase the availability of affordable housing for rent are likely to remain ineffective unless there is path to broader home ownership. Simply increasing cheap rental supply may perpetuate subsidy-dependency by the renters, reduce supply in the owner occupied market (by making it attractive for investors to buy existing housing) and create a long-term cost to government.

While the demand side incentive programs, such as the First Home Buyers Bonus, increase the ability of new entrants to gain access to the market, it increases market distortion. It provides young families who may not otherwise be able to afford to buy with additional means to borrow, artificially increasing the demand and prices and reducing their ability to service the mortgage in the long term. This is likely to have similar effect as the "teaser rates" on adjustable-rate mortgages in the US prior to the Global Financial Crisis (GFC): short term affordability followed by widespread defaults in the medium to long term.

Market distortions are desirable over the long term only if they actively work towards public policy objectives. Marginal renters need to be provided with a sustainable solution that ensures they can afford home ownership in the long term, which means that solutions which allow them the benefits of capital growth are likely to be more effective.

Beyond just creating more avenues for market entry by the middle class, it is important that any affordable housing strategy aims to sustainably improve the creditworthiness at entry and beyond without compromising on the lending standards.

Increase Supply

Ultimately, if the drivers behind affordability are ultimately linked to the supply of, and demand for, accommodation, then any long-term solution must adjust this supply/demand curve so that more supply is available. Programs that simply increase short-term borrowing power or encourage unsustainable borrowing are unlikely to be successful in creating structural change, since they distort the market. Solutions must either:

- Increase density in existing areas of housing (recognising that this can create strains on infrastructure); or
- Convert existing non-residential stock into residential housing; or
- Release new land for construction; or
- Create jobs in non-central areas of major cities

Our recommended approaches seek to address these issues by opening new ways to allow the middle class to enter into the housing market in a sustainable way without creating imbalances that perpetuate the problem. Our recommendations below would work with increased release of land for development and provision of the supporting infrastructure by the government.

Recommendations

Based on the principles set out above we suggest two models that seek to grow Affordable Housing markets for both renters and buyers. The recommendations address the structure of the underlying investment and social program but do not address the conduit of the investments. Both these models can be financed through speciality financial institution that is focused Affordable Housing market. Such an institution can be something akin to The Housing Bank, as proposed by Grace Mutual in a separate submission. Such an institution can be seeded by government and can replace the role of the government in recommendation below.

Path to Ownership Model

The Path to Ownership Model requires that every stakeholder carry some level of risk in the long term while also sharing on the upside. The various stakeholders participate as follows:

1. **Government:** Government would establish a Path to Ownership Program. Under such a program, investors of eligible dwellings would receive a tax offset of 3-5% p.a. of the purchase price of the dwelling. Additionally, the government may provide protection against occupancy or capital risk. The level of government support can be on sliding scale depending on how well the investor helped the occupier to transition to ownership.

2. **Occupier/Renter:** Under the Path to Ownership Program, the occupier will pay up to 20% discount on current market rent provided that they meet strict criteria for people eligible for affordable housing. The ultimate objective is for the occupier to build equity in the property over a period of up to 10 years by sharing the capital gain with the government. How much the capital gains the government shares with the occupier will be on sliding scale depending on progress the occupier is making towards saving for a deposit on house, with the help of the investor. The equity would help the occupier to comfortably afford a mortgage after the 10 years. The usual tenancy rights and obligations apply during the 10 years (for example, if the occupier is vandalising the property, the investor has the option to evict the tenant without compensation). After 10 years, the occupier has the option to either:
    a. buy the property at market price less equity earned (if the market price is higher than original price); OR
    b. buy the property at market price (if the market price is lower than original price); OR
    c. Vacate the property and forfeit equity earned.
3. **Investor:** The investor (institutional investor only) commits to providing the initial capital required to purchase the dwellings. There should be minimum on the number dwellings an investor can buy to ensure these assets remain institutional grade and the supply is significantly boosted. The Investor has various sources of risk adjusted returns on their investment:
    a. 3-5% p.a. Tax offset on the purchase price of the property
    b. Rental income from the occupier (80% of the prevailing rents)
    c. Transition to ownership incentive payments from the government.
    d. Availability payments from the government to mitigate occupancy risk
    e. Capital loss protection from the government.

    The investor has a number of exit options including:
    a. Selling the property at market price to the occupier (less equity earned by occupier and government); OR
    b. If the occupier cannot purchase dwelling, selling the property to another institutional investor (less equity earned by the government). The new investor will be required to continue with the Path to Ownership program with a new occupier. .

Various pro-rata compensation and forfeiture provisions would be needed for various scenarios in the intervening years to ensure that fair risk and reward sharing among all stakeholders.

Path to Full Rent Model (Affordable Rent Model)

The Path to Full Rent Model recognises that not everyone will be able to afford to buy a house even after being given time to build equity by the Path to Ownership Model outlined above. Under this model, a portion of any new residential housing project is allocated to affordable rental with discounted rents similar to the Path to Ownership Model but with no sharing of the equity uplift. The various stakeholders participate as follows:

1. **Government:** Government will provide tax offsets and/or “availability payments” to investors to supplement the investor’s rental income to ensure the investors achieve a predetermined Weighted Average Cost of Capital (WACC) over a 5 year period, for example.

The level of government support can be on sliding scale depending on how quickly the investor helped the occupier to transition to full rent.

2. **Occupier:** The occupier will pay discounted rent. In addition, the investor (working with a Community Housing Provider or similar entity) will work on an exit plan with the occupier. The exit plan will help the occupier to boost their income and manage their expenses to be able to exit out of the affordable housing program after a set period of 5 years, for example and pay full rent thereafter.
3. **Investor:** The investor (institutional investor only) commits to providing the initial capital required to purchase the dwellings. There should be minimum on the number dwellings an investor can buy to ensure these assets remain institutional grade and the supply is boosted. The Path to Full Rent Model is best suited for long term institutional investors who need stable income and do not necessarily need regular liquidity and who are not competing with individual buyers in the market on a regular basis. The Investor has three sources of risk adjusted returns on their investment:
    a. Tax offset on the purchase price of the property
    b. Availability payments from the government to mitigate occupancy risk
    c. Rental income from the occupier (80% of the prevailing rents)
    d. Transition to full rent incentive payments from the government.

    At any time, the investor has the option to sell the property to another investor at market price based on the current predetermined WACC. The pricing of the affordable housing is determined by the target WACC is not significantly influenced by fluctuations in the market.

Additional Recommendations

Our recommendations above focus on what can potentially work for institutional investors and draw on our experience in Impact Investing globally. However, in line with the above recommendations, there are other legislative levers that can considered as part of the solution. Although they are beyond our area of direct expertise, we recommend the following be considered as well, subject to deeper review by the relevant experts:

- Removing the ability of Self-Managed Superannuation Funds (SMSFs) to leverage in order to purchase residential property. There is a restriction on superannuation funds directly using leverage and a restriction on leverage by SMSFs in other asset classes; we believe these equivalent restrictions should be similarly applied to SMSFs making future investments in residential housing.
- Significantly increasing supply of land for Affordable Housing. This can be achieved through a range of legislative levers including rezoning key target areas, tax incentives for lending to Community Housing Providers (similar to tax exemption on municipal bonds in the US) and increased land releases in areas and providing incentive for inner city landowners to use their land for Affordable Housing.