Community Sector Banking

In response to the National Housing Finance and Investment Corporation Consultation Paper

September 2017

Introduction

Community Sector Banking (CSB) welcomes the opportunity to provide feedback to Government on the potential structure and governance of the National Housing Finance Investment Corporation (NHFIC), and the operation of the NHIFC and affordable housing bond aggregator (BA).

CSB is Australia's only banking service dedicated to the not-for-profit sector and Australia's first financial institution to be certified as a B Corporation. We are a joint venture between Bendigo and Adelaide Bank and 38 not-for-profits, including Community Housing Providers (CHPs), who form Community 21. By working in partnership with our shareholders and customers we intend to increase the supply of social and affordable housing to improve the lives of those who are currently experiencing the effects of the housing affordability and homelessness crisis in our country.

CSB has financed up to 1,700 social and affordable houses. Our unique partnership with the not for profit sector and relationships formed with institutional investors ensures CSB is well placed to take on a financial intermediary role connecting the public and private sector with funding and investment opportunities.

The affordable housing bond aggregator

CSB supports the Government's decision to take an active role in the development of a bond market for Affordable Housing. We understand that the proposed structure and governance arrangements of the Affordable Housing BA model have not yet been finalised. As such, we take this opportunity to put forward our recommended role for Government in the development of affordable housing bonds. We support the development of a bond aggregator to facilitate investment into affordable housing and we also encourage the Government to consider the value of a credit enhancement to further facilitate investment in new affordable housing supply.

There is significant market demand and investor appetite for social, responsible and impact investment options. Superannuation funds and large philanthropic groups have expressed a willingness to engage with CSB to participate in transactions that deliver a positive social return. When parties are appropriately compensated markets can efficiently facilitate the transfer of capital; however, the inability for CHPs to generate adequate return due to the below market rents attached to their assets is impeding investment.

Because of this, Government support is critical. A Government guarantee appropriately aligns the risk taken on by investors with the yield provided by CHPs. This is a low-cost and efficient way for Government to stimulate investment to facilitate new affordable housing supply.

The Australian social bond market is in its infancy compared to some more mature overseas markets. There are issues concerning liquidity, risk, bond terms and yield. In addition, funds have indicated that they are not prepared to take on construction risk and this can be mitigated by a multi-provider structure.

CSB recommends the following structure:

- New houses/units: Construction is funded by Banks, with these loans to be refinanced in the bond market.
- Loans are made to CHPs on a project by project basis. Certain financial covenants would be put in place upfront ensuring they are acceptable to the ratings agencies and investors in the longer term.
- Bank loans may be refinanced by a dedicated asset manager in a social housing fund, which acts as a warehouse facilitator until sufficient funds are aggregated to refinance into the bond market. This fund would be financed by a mixture of banks and institutional funds, with security over the properties provided by CHP's.
- When an appropriate level of loans is reached, an amount (e.g. $200M) is offered to a bond issuer (financial intermediary) to fund into the bond markets. A tenor of 10 years, zero amortisation and a variable interest rate seems to be acceptable in the market. The bond would be secured by real assets (charge over properties).
- In order to achieve this tenor and alleviate liquidity concerns, the Federal Government would provide a guarantee to the bond investors. This guarantee would only be called upon post liquidation of the security properties.
- The financial intermediary would use the bond funds to pay for fees and provide back-to-back loans to the aggregated CHP's based on their percentage of the property security in the bond (please refer to Appendix 1 for more details).
- This financial intermediary would be bankruptcy remote from the CHP's it lends to.
- The bonds need to be rated by an acceptable rating agency. We recommend that a dual rating exercise is undertaken from the outset – one with a Government guarantee and one without a Government guarantee. This will enable the market to grow, while at the same time, allowing the investors to recognise the financial strength of the sector without the need for a guarantee.

Successful implementation of either the above structures requires CHP ownership of affordable housing assets which can be achieved by stock transfers or construction of new housing. We believe that either of these options could be tested right now by refinancing a portion of existing bank debt (e.g. $200M). Obtaining the desired credit rating is crucial to success and determines investor price and tenor. If a Bond was underpinned by a Government guarantee it is likely that there will be high demand for the bond. It is the non-guaranteed rating that is key to unlocking private investment.

Summary

It is our firm view that the market, if provided with the appropriate incentives, can efficiently and effectively match investor capital seeking an investment grade return to CHPs creating new affordable housing supply. Tackling this social issue does not only require efficient use of capital, but efficient use of time and resource as well as the appropriate allocation of roles and tasks within the BA structure. Our recommended structure focuses Government support on the delivery of credit enhancement, enabling and encouraging the market to efficiently facilitate the transfer of capital.

Response to issues for consideration - affordable housing bond aggregator

Eligibility

We suggest the bond aggregator model will be best suited to meet the needs of Tier 1 CHPs only. In our opinion, Tier 2 and 3 CHPs have adequate access to capital from the market.

We believe there are further benefits to be gained from expanding the eligibility criteria to include other stakeholders, in particular to encourage the provision of infrastructure such as land for development. Potential stakeholders could include State Governments, Religious Organisations, etc.

Purpose of loans

CSB agrees BA loans should primarily be used for funding housing maintenance and turn-key purchases. The BA loans should not be used for construction finance. The BA should provide long term interest only debt that can be easily sold in the fixed income market.

Security for loans

CSB suggests that the BA does not duplicate what can already be delivered by Australia's banks. Demanding security to the extent of which is required to secure bank funding, reduces the efficiency of the BA model and places unnecessary additional administrative costs upon the CHP.

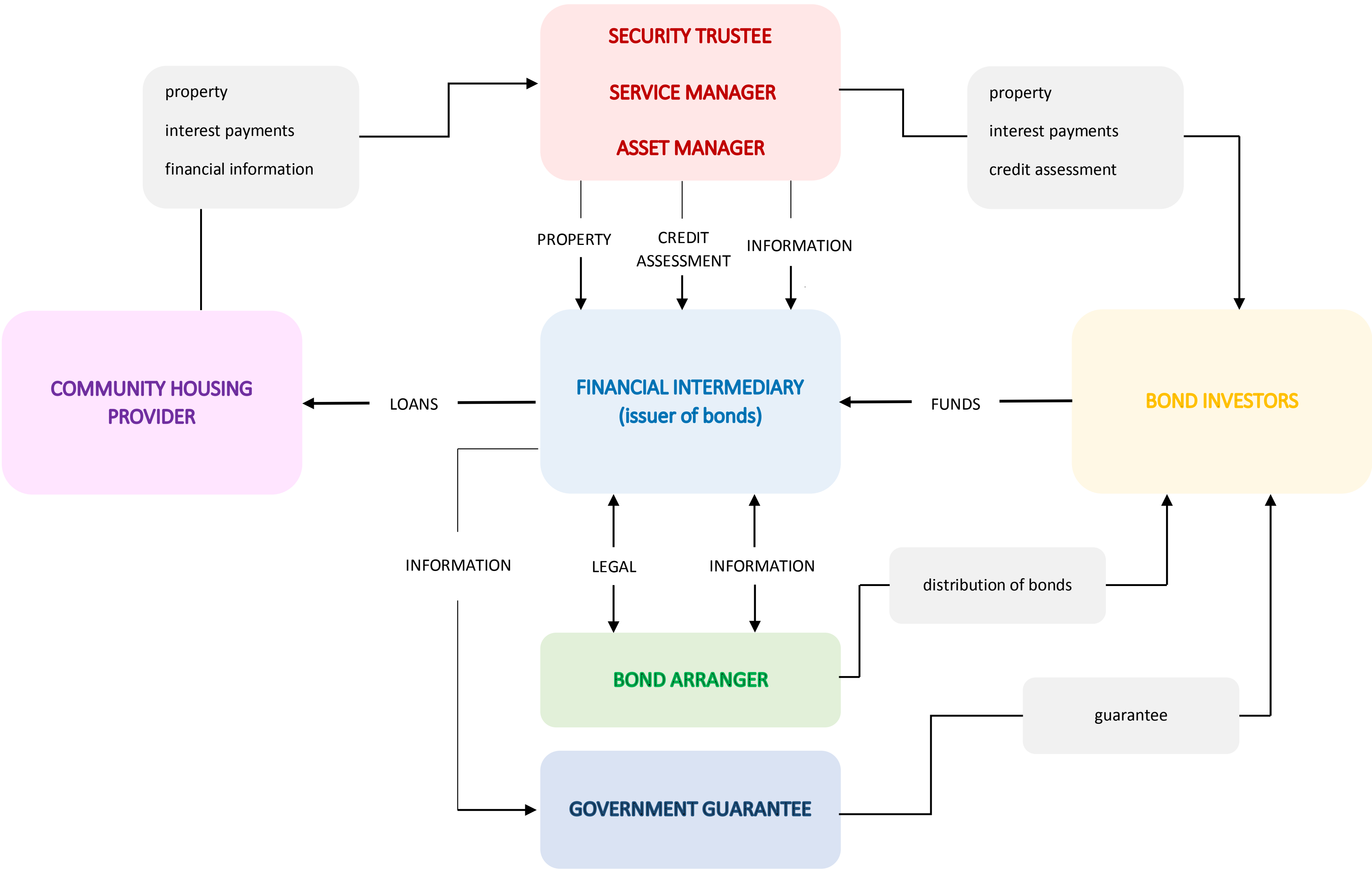
Complementarity

It is our opinion that government focus should be on delivery of credit enhancement rather than facilitation. Boosting the credit rating to investment grade is key to enabling the market to firstly match capital and secondly attract capital at scale. Providing a credit enhancement will also allow the Government to scale back its role as the market matures.

Government guarantee

Government support is critical. A Government guarantee appropriately aligns the risk taken on by investors with the yield provided by CHPs. This is a low-cost and efficient way for Government to stimulate investment to facilitate new affordable housing supply. The guarantee would only be called upon as a 'last resort' post liquidation of the security properties.

Appendix 1 – Diagram



Appendix 1 – Notes

Security Trustee

- Holds property security on behalf of bond investors.
- Manages any change to the security portfolio over the term of the Bond.

Service Manager

- Collects information (financial and otherwise) from the CHP's and passes on to the investors, financial intermediary and the guarantor.
- Collects interest payments (bond coupons) from the CHP's and passes on to the investors.
- Provides information to the financial intermediary and the guarantor.
- Handles any bond payments/prepayments.

Asset Manager

- Responsible for choosing appropriate CHP's and existing loans to build the bond.
- May provide warehousing facility for loans prior to transfer to bond.
- Aggregates loans in order to provide acceptable size and quality for bond investors.
- Works closely with financial intermediary to structure the bond and liaise with the Rating Agency and bond arranger(s).
- Over time may become part of the financial intermediary with rating agency agreement.

Standby Guarantee from Federal Government

- The bond is secured by a 1st Registered Mortgage over properties offered by CHP's to bond investors.
- This property security will be supported by a number of financial covenants (e.g. interest cover ratio) that further enhance the financial strength of the issue. Ratios will be dictated by credit rating agency.
- In the case of default, and assuming no other remedies are available, the secured properties will be liquidated to pay out the bond investors.
- Any shortfall post liquidation of the properties is covered by the Government guarantee.

Bond Arranger

- A Bank with experience in the Bond market.
- Primary role is to widely distribute the bond at the best possible price for the issuer.
- Coordinate documentation/legal advice/ and roadshows.

Financial Intermediary

- The issuer of the Bond.
- Must meet all regulatory requirements to carry out its role.
- Liaise with CHP's, lawyers and rating agency to properly document and aggregate each bond.
- Should be a properly constituted limited liability organisation (E.g. THFC in the UK).
- Ownership should reflect the stakeholders in the sector and include; peak housing bodies; peak social bodies and Government.
- Board of directors should have knowledge of the sector and relevant professional experience (e.g. banking, law, property development). Government should also appoint a Director.
- Key staff will be minimal at the beginning, with such tasks as Service Manager outsourced initially. Bringing these roles in-house may be considered as bond issuances increases.
- CEO to have relevant experience in the sector and finance.

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