NATIONAL AUSTRALIA BANK SUBMISSION

National Housing Finance and Investment Corporation Consultation Paper

30 October 2017

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NATIONAL HOUSING FINANCE AND INVESTMENT CORPORATION CONSULTATION PAPER

Dear Mr Crawford

National Australia Bank ("NAB") welcomes consultation on the National Housing Finance and Investment Corporation ("NHFIC"), National Housing Infrastructure Fund ("NHIF") and the Bond Aggregator ("BA") and the opportunity to respond to the Department of Treasury's *National Housing Finance and Investment Corporation Consultation Paper*. NAB's response is broken into two sections; Appendix 1 contains our detailed commentary about the BA and Appendix 2 responds directly to the questions in the consultation paper. We have chosen to respond to those questions that are particularly relevant from a financier's perspective.

NAB's contribution to adequate, safe and affordable housing for all Australians

As a bank, NAB believes we have a responsibility to deliver innovative financial solutions that help our customers, community partners and government to address the growing social problem of affordable housing. Housing is a key input into building strong and healthy Australian communities.

NAB's leadership in the developing impact investment market has allowed us to identify a growing trend that investors, in particular institutional investors, are seeking investments that align with their core values[1]. An opportunity exists to meet the demand for scalable investment that drives social outcomes in the area of affordable housing.

NAB is in a unique position to contribute to this discussion. We have a deep understanding of the institutional debt capital markets and in the 2017 Peter Lee Australian Debt Securities Origination survey NAB was rated first for overall market penetration and first for overall relationship strength. We were actively involved in developing three proofs of concept examples referenced by the Ernst & Young (EY) report[2]:

- Local Government Funding Vehicle (LGFV) bond aggregator in Victoria;
- Local Government Funding Association (LGFA) bond aggregator in New Zealand; and
- Brisbane Housing Corporation (BHC) to help them become the first Australian Community Housing Provider (CHP) to receive an individual credit rating.

[1] Responsible Investment Association Australasia, 'Responsible Investment Benchmark Report 2017 Australia', 25 July 2017
[2] Ernst & Young, 'Establishment of an affordable housing bond aggregator', 21 September 2017

NAB's key recommendations from the NHFIC Consultation Paper are outlined below.

NHFIC:

- We welcome the Government's objective for the NHFIC to prioritise more affordable housing dwellings entering the market each year and suggest this is explicit in the objectives of the NHFIC.
- The objectives, structure and governance frameworks for the NHFIC outlined in this consultation paper are sound. We recommend they are sufficiently flexible to allow the NHFIC to add additional functions or carve out activities as and when required.

NHIF:

- The mandate of the NHIF should complement the BA as much as possible. A principle about addressing affordable housing is welcomed.

Bond Aggregator:

- As identified in the EY report, "Government assistance is a necessary part of the BA in order to address the market gap in the current operating environment"[3]. The EY report identifies the methods as:
    1. Initial Australian Government ownership and seed funding.
    2. Guarantee: The Australian Government could elect to explicitly guarantee the BA's obligations to bond holders.
    3. Grants: The Australian Government could fund the BA to make grants to eligible borrowers to reduce on-going debt refinance requirements and hence de-leverage borrowers.
    4. Subsidies: The Australian Government could provide funding to the BA to meet borrower's coupon payments thereby reducing borrowing costs on funds raised through the BA.
- The EY report analysis suggests that the BA could deliver "savings in the order of 1.4% p.a. for 10 year debt, depending on the final structure and a government guarantee".[4] This goes some way to closing the yield gap and modestly increasing the supply of housing but, as identified by EY, "the BA will not solve the sector's primary concern – the funding gap and level of Government intervention required to make projects commercially viable".[5]
- Although it would require Budget funding, NAB's preference would be a subsidy model, and we encourage the Government to continue to explore subsidy options (combined with education and other market building activities) to grow the CHP sector and to close the 'yield' gap to attract institutional investors.

Supporting the affordable housing sector in Australia is very important to NAB. We commend the consultation taking place with a broad group of stakeholders and look forward to continuing the dialogue with the Government.

Should you wish to discuss this submission further, please contact Vanessa Curtain, Manager, Government Affairs and Public Policy at Vanessa.L.Curtain@nab.com.au or 0400 697 625.

Yours sincerely

Steve Lambert
Executive General Manager, Corporate Finance

[3] Ernst & Young, 'Establishment of an affordable housing bond aggregator', 21 September 2017, pg. 36
[4] Ibid, pg. 8
[5] Ibid, pg. 8

APPENDIX 1: NAB's recommendation about the affordable housing BA

Supply of new affordable housing is urgently needed and would be welcomed across the sector. There is a misconception by the wider public that housing affordability and affordable housing are one and the same.

- **Housing affordability** refers to the relationship between expenditures on housing (prices, mortgage payments or rents) and household incomes.
- **Affordable housing** refers to low-income housing that is appropriate for the needs of a range of very low to moderate income households and priced so that these households are also able to meet other basic living costs such as food, clothing, transport, medical care and education.

Housing affordability can affect the affordable housing sector however they are separate issues which exist on a spectrum. NAB believes that it is important to consider the issues separately.

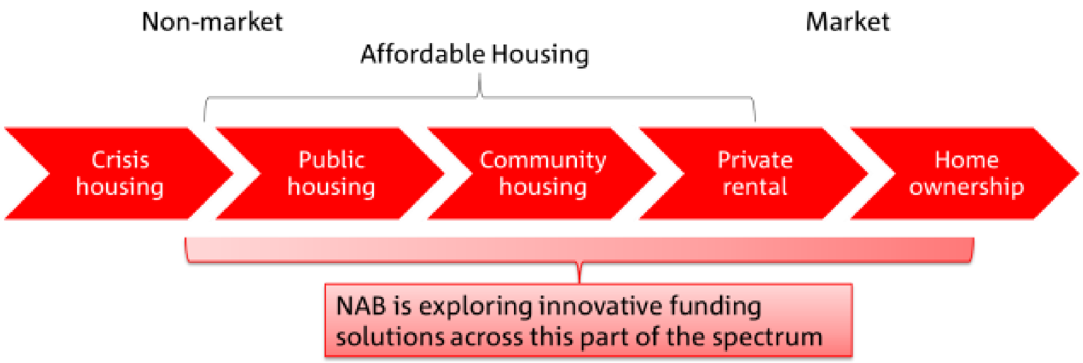


Fig. 1 The housing continuum (Australian Government, 2016)

In June 2017, NAB commissioned a report, "Stakeholder Perspectives on Affordable Housing", which identified ten areas that would improve access to affordable housing, which included, but was not limited to, 'accessing institutional capital'; an area where NAB has core expertise.

NAB outlined the use of the BA as our preferred method to attract institutional investment in our submission to the Australian Government's Affordable Housing Working Group in March 2016. We summarise our interest in sustainably improving the supply of affordable housing through:

- Supporting the CHP sector to grow, as this will ensure any new housing will remain for the purpose of addressing housing equity in perpetuity;
- Creating socially responsible financial solutions with appropriate scale and structure to provide choice of risk/return and impact to the institutional market; and
- Collaborating with the sector to contribute a financial perspective to addressing a complex social issue.

These three objectives have significant overlap with EY's suggested objectives for the BA.

The yield gap

One of the significant challenges of creating and sustaining supply of affordable housing is the ability to attract capital. The yields for affordable housing are insufficient for institutional investors, despite their demand for socially responsible investments.

To close the yield gap, the EY report identified four options to consider:

1. A BA initially owned and seeded by the Australian Government;
2. A BA with a government guarantee;
3. A BA that provides grants to eligible borrowers; or
4. A BA with a government subsidy.

NAB's supports a BA with a subsidy

We have seen domestically and internationally that improving the credit rating (options 1 and 2 above) will go some way to reducing borrowing costs. However it will not fully close the yield gap and therefore will not create a sustainable outcome for the sector or for the government.

The BA is a tool that can help to achieve a significant increase in the supply of affordable housing. The BA is a proven way of allowing the private sector investment to supplement government expenditure on housing. It creates a pathway for capital to reach the CHPs at scale. NAB believes CHPs are the right organisations to lead this as they are mission driven and not-for-profit so the houses remain in the system as affordable housing in perpetuity.

By closing the yield gap using a subsidy, the Government can accelerate the growth of the CHP sector because it can attract significant investment from the private sector in the form of debt and provide the CHP's with no or low interest debt to finance new housing stock.

This additional housing stock will lead to larger, more sophisticated CHPs, which at a point in time will be able to access the institutional markets directly. A government subsidy in the BA would act as an enabler to dramatically increase construction of new affordable housing**.** But unlike other housing schemes such as the National Rental Affordability Scheme (NRAS), the subsidy can be time-bound but still create an increase in the quantity of affordable housing in perpetuity.

The concerns about the subsidy option, raised in the EY report, are discussed below:

EY's concern	Mitigating factor
Requires long term budget funding	If applied correctly it can be time-bound (e.g. 10 years) and can have long-term benefits which reduce pressure on the future budgets such as through reduced health and mental health costs[6].
Sunk costs and subject to competing sectoral and State claims	This area is complicated and will require careful consideration to reduce perverse impacts of the subsidy. The benefits of creating a subsidised BA are that it will immediately stimulate the sector and will create an opportunity to engage all interested parties to come together to deliver the best outcome for the sector.
Does not achieve debt aggregation nor induce greater commercial rigour into the CHP sector	If no or low interest loans are offered, NAB believes that a significant change will occur in the CHP sector. We have seen increasing commercial acumen in the CHP sector and given the opportunity, we believe the sector will take advantage of the subsidy to strengthen and grow their balance sheets so they directly enter the institutional markets as a take-out from the BA.
CHP sector reinvestment of additional leverage (and creation of increased capacity) is not a causal outcome	CHP are mission-driven organisations and so any cost savings will remain dedicated to the provision of affordable housing for Australians.

[6] Australian Housing and Urban Research Institute, (2002). Do housing conditions make a difference to our health? (AHURI Research and Policy Bulletin No.6). Melbourne <www.ahuri.edu.au/publications/projects/P30002>

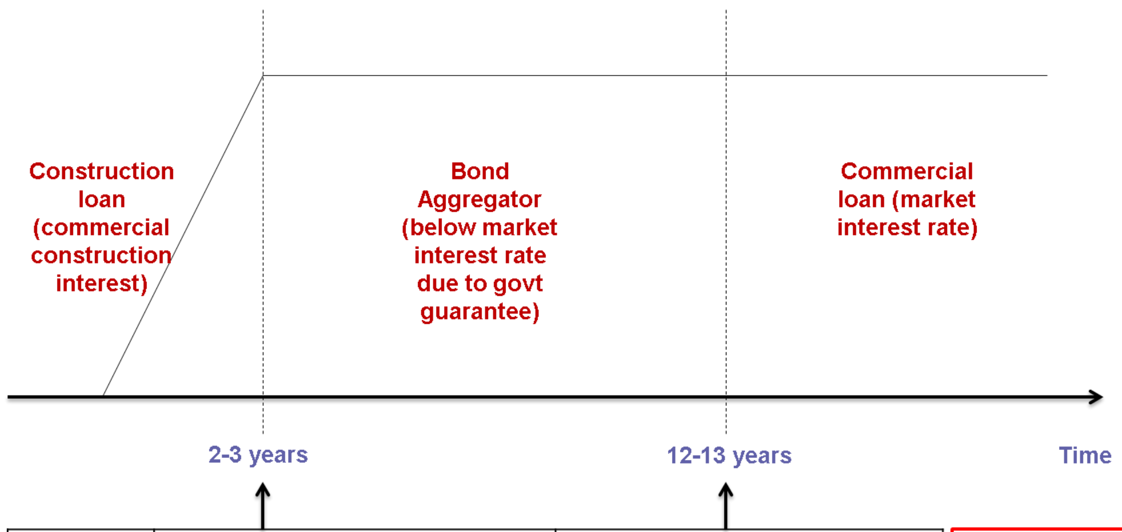
NAB's support for a subsidy model reflects analysis of the two options for the BA that we believe will deliver the most impactful affordable housing outcomes. The analysis is summarised below:

Analysis A: BA with Government guarantee

The EY report analysis suggests that BA could deliver "savings in the order of 1.4% p.a. for 10 year debt, depending on the final structure and a government guarantee".[7] This goes some way to closing the yield gap and modestly increasing the supply of housing but, as identified by EY, "the BA will not solve the sector's primary concern – the funding gap and level of Government intervention required to make projects commercially viable".[8]

We agree with this analysis and this diagram illustrates the fundamental problem facing providers of affordable housing, which is the yield gap. Over a 10 year time frame the rental cash flow is insufficient to service the initial investment (in this diagram characterised as debt) causing the "loan" to increase in value.

The key concern NAB sees by not applying a subsidy is that after the 10 year finance provided by the BA, there are limited options to refinance the debt through mainstream banking or institutional channels as the yields are below market returns (as demonstrated below).



Period	Loan enters Bond Aggregator	Loan exits Bond Aggregator
Valuation	$558,000	$750,000
Loan value	$558,000	$599,000
Rent	$340 pw	$400 pw
% Yield	c. 3.1%	c. 3.4%

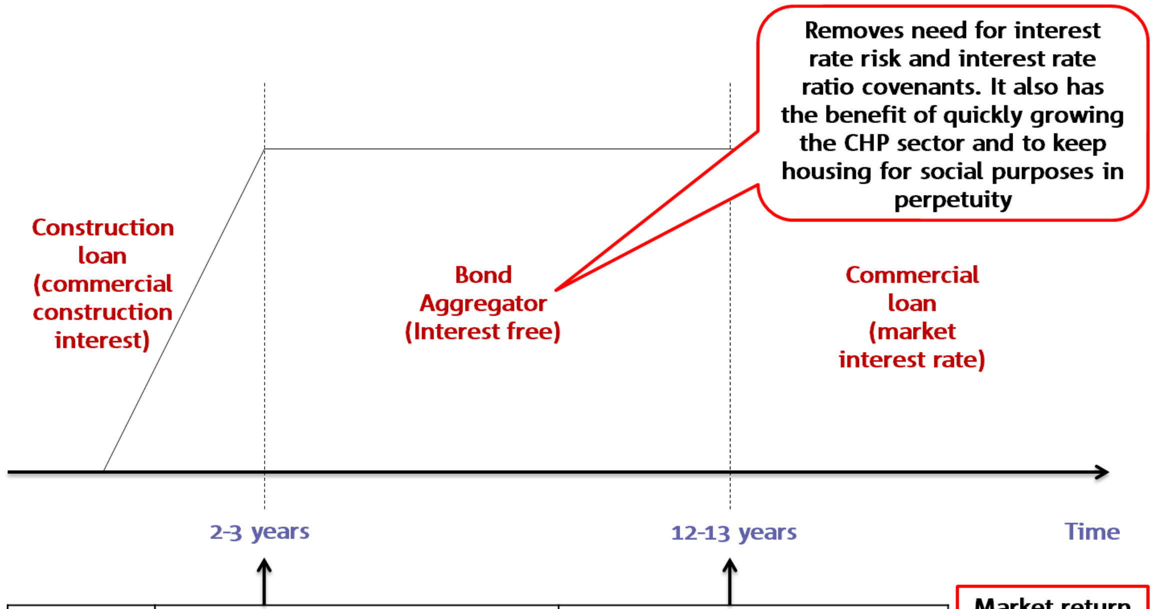
Below market yield so no ability to bridge to the institutional investors

Assumptions
Home price growth: 3% pa
Interest rate: 4.00% pa
Initial gross rent: $485pw (affordable rental at 70% market: $340pw)
Rental growth: 1.65% pa

[7] Ibid pg. 8
[8] Ibid, pg. 8

Analysis B: BA with Government subsidy

The introduction of an interest subsidy enables the affordable housing provider to use the net rent to reduce the value of the "loan". In this scenario with modest rental growth assumptions, rent is sufficient to cover interest and continue to amortise debt at year 10.



Period	Loan enters Bond Aggregator	Loan exits Bond Aggregator
Valuation	$558,000	$750,000
Loan value	$558,000	$368,000
Rent	$340 pw	$400 pw
% Yield	c. 3.1%	c. 5.6%

Market return so institutional investors can now invest in affordable housing

The assumptions are the same as the previous example of BA with government guarantee.

A subsidy that covers the interest coupons of the BA would need to be supported by government.

Our estimates suggest a subsidy of $100m pa would attract c$2.5 Bn (compared to c. $1Bn of current CHP sector debt[9]) of private sector investment into Australian housing infrastructure, significantly increasing the borrowing capacity of CHPs to construct new affordable housing stock (c.5,000 units).

By comparison, this represents less than a third of the NRAS expenditure currently incurred to support affordable housing outcomes in the 2017-2018 Budget.

The amount of government subsidy can vary by considering the following levers:

1. Reduce the size of the BA (reducing from $2.5Bn to $2Bn would reduce the subsidy by $20m);
2. Change the interest rate from no-interest to low interest (increasing interest rate to 1.5% would reduce subsidy by $30m);
3. Consider different tranches of debt finance that have longer tenors;
4. Consider finding other philanthropic sources of capital to reduce the government commitment, recognising that housing outcomes deliver other social benefits (e.g. health and mental health); or
5. Consider changes to other Government housing subsidies.

[9] Ernst & Young, 'Establishment of an affordable housing bond aggregator', 21 September 2017 p. 3

Each lever would have an impact on the speed and scale of building new supply of affordable housing. It may also impact the attractiveness of the BA to institutional investors. We would be happy to canvas the options to find a workable balance between the main stakeholders.

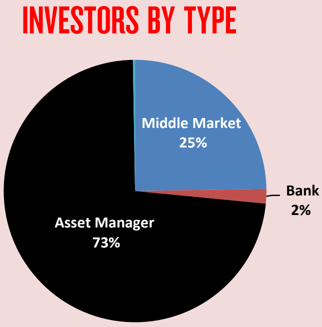
Case Study: Places for People - A$150M 5YR Senior Unsecured Medium Term Notes

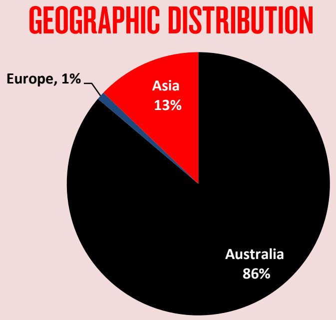
Places for People Group Limited is one of the UK's largest social housing infrastructure players, owning or managing over 182,000 housing properties. The Group consists of four regulated social housing providers that provide affordable rented homes in the UK, with a particular focus on England and Scotland.

Places for People (A3/A) were interested in exploring an A$ transaction aimed at creating an initial funding foothold in Asia Pacific to further diversify its funding base. NAB acted as sole arranger and book runner for the capital raise.

The majority were Australian investors who were attracted by the socially responsible connection to funding social housing assets. Strong oversubscription saw it upsize the transaction to $150m and close same day with strong high quality investor participation which resulted in pricing of +190bps.

This was Australia's first social housing bond and demonstrates the appetite for this type of financial product, even where those assets are not domestic.





APPENDIX 2: Response to the National Housing Finance and Investment Corporation Consultation Paper Questions

Section 2: The National Housing Finance and Investment Corporation

Issue 1

Structure - The proposed 'one entity, two functions' structure for the National Housing Finance and Investment Corporation (NHFIC), including how the National Housing Infrastructure Fund (NHIF) and BA functions can be designed to ensure that they are delivered effectively?

The proposed 'one entity, two functions' structure of the NHFIC is sound as the objectives of the organisation support both the NHIF and BA.

The benefit of the proposed structure is that the NHFIC can oversee the impact both organisations have on the housing sector and also attract and stimulate the market. We recommend a strategic long-term view is taken for the NHFIC and that the structure is sufficiently flexible to allow the NHFIC to add additional functions or carve-out activities as and when required.

Issue 2

Governance – The proposed NHFIC governance structure, including: the role of the independent board; what issues may be reflected in the investment mandate; and the potential role of the Government in decision making?

From a financier's point of view, certainty about the NHFIC approach will reduce risk and uncertainty. NAB supports the proposal that the NHFIC will operate at arm's length from the Government and has a consistent investment mandate.

Issue 3

Resourcing – Whether 30 staff members split across the NHIF and BA is likely to be sufficient; the potential outsourcing of some NHFIC functions; and whether the self-funding objective for the NHFIC is attainable and if so, over what timeframe?

In the context of the BAs that are currently operational, NAB is aware of three operational BAs and understands the resourcing allocated to these aggregators is as follows:

- The Local Government Funding Vehicle (LGFV) in Victoria manages a c. $300m lending book and is operated by two staff from the Municipal Association of Victoria (MAV) and four external consultants.
- The Local Government Finance Authority (LGFA) in South Australia manages a c. $600m lending book with four staff members and two support staff. They also manage a deposit book.
- The Local Government Finance Association (LGFA) in New Zealand manages lending book in excess of NZD$5Bn with seven staff members.

Based on these examples, we would recommend that outsourcing some of the functions in the initial period until the NHIF and BA are established would be sensible. Once sufficient scale is reached, this approach can be revisited.

It is possible that the NHFIC could become self-funding, depending on the structure and costs charged for the services it will provide. This will need to be balanced with the scale of the impact it intends to make to improve housing affordability and how quickly it wants to make the impact.

Issue 4

Engagement – How can the NHFIC effectively engage with stakeholders across Australia to ensure that viable projects are identified?

NAB has been involved in developing the impact investment market in Australia and sees the NHFIC acting as a market builder to stimulate and facilitate the housing ecosystem. Once the eco-system is mapped and developed we believe it will easier to find viable projects.

Section 3: The National Housing Infrastructure Facility

Issue 1

Infrastructure – Noting the examples identified in Table 4, what types of infrastructure do LGs fund, deliver and own? What types of infrastructure could be prioritised to address infrastructure bottlenecks?

In assessing the delays to the development of new housing stock, it is important to take a holistic view encompassing not just the hard infrastructure, but also issues such as State and local planning rules, and larger scale transport requirements.

The involvement of all three levels of Government to create a unified development plan is critical to the timely development of new housing stock.

Issue 3

Financing options – Are the types of tailoring potentially available under the NHIF's three types of finance sufficiently flexible?

The mix of concessional loans, equity and grants appears to be an appropriate spread of capital structure, although the fixed allocation across these may result in the criteria to access them being too restrictive.

There are currently a number of State sponsored concessional loan programmes. Given that the NHIF is proposing to provide funding through State and Territory governments, the complementarity of the funding should be considered to maximise the impact of the NHIF.

Issue 5

Financing arrangements – Could the NHIF expand 'eligible applicants' to include a consortium of investors, such as institutional investors, social impact investors, CHPs and other stakeholders (for example, state and territory governments)? In addition, what could a partnership with LGs involving the NHIF equity injection look like? Are there further opportunities for aligning the interests of investors and other stakeholders to create incentives for co-investment to accelerate housing developments? Given the long lead times associated with the infrastructure construction, what are the appropriate repayment timeframes (on the loans and equity)?

NAB sponsors the John Grill Centre's Better Infrastructure Initiative (BII) and in June 2017 the BII released the report "Customer-led DIY Infrastructure".[10] This report considers a model for local communities to nominate projects, with funding arranged through a new market that would access different sources of finance.

Although this paper specifically examines the need for infrastructure that is not government-led, the findings are still relevant to the NHIF, including the need for a viable ecosystem for community-led infrastructure.

The BII outlines the basic elements of what this ecosystem could look like. This includes:

- The formation of a community infrastructure hub that allows for the development of ideas and where individuals can accelerate their thinking;
- A community capital enterprise that takes the form of a new investment market to provide capital to community-led projects; and
- Capability in project management and delivery.

The second recommendation in particular outlines the clear role for investors to creatively initiate infrastructure projects which benefit the community and may be worth considering in the design of the NHIF financing arrangements.

[10] Bowditch, G., Why wait for Government? Customer-led DIY infrastructure, Australia's No. 1 priority, The University of Sydney, John Grill Centre for Project Leadership, June 2017

Issue 6

Complementarity – Given existing state and territory lending facilities, how can the NHIF position itself so that it complements the state and territory financing schemes and private sector finance options?

Engagement with different stakeholders and collaboration around the common objective of addressing housing affordability are critical to ensuring the NHIF role delivers the greatest impact.

The NHIF could position itself to fill the gaps in the blanket of commercial and state government funding as that would provide additional capacity, rather than displacing existing sources of capital.

Issue 7

Affordable housing – Should the NHIF also focus on facilitating the supply of affordable housing, including for key workers? If so, what is the most effective way to achieve the objective?

The mandate of the NHIF should complement the BA as much as possible and so including a principle about addressing affordable housing is welcomed.

The principles could include preferencing:

- affordable housing outcomes in perpetuity, rather than for a period of time;
- the location of housing e.g. is public transport easily accessible; and
- inclusionary zoning rules for new developments.

The NHIF should consider the role of the CHP sector to support these principles.

Section 4: The affordable housing BA

Issue 1

Eligibility – It is currently envisaged that the BA will only provide loans to Tier 1 and Tier 2 CHPs. Could there be benefits to expanding the eligibility criteria to include other stakeholders involved in the provision of affordable housing?

As per the EY report, the BA could be extended to finance Tier 3 CHPs.

We agree with the CHP characteristics raised in the EY report that would be likely to affect the credit rating of the BA, which is largely a function of:

- Scale;
- Financial ratios (which are impacted by debt levels); and
- Status of CHPs as Tier 1 and 2 (due to higher regulatory oversight as well as greater scale and sophistication).

The inclusion of Tier 3 CHPs in the first instance is likely to impact the pricing of the finance available through the BA without the likelihood of a significant increase in housing supply.

Issue 2

Purpose of loans – The bond aggregator's loans are expected to be primarily used for funding housing and maintenance and turn-key purchases. Do stakeholders agree with this focus? Is there scope for the bond aggregator to provide construction finance or should the bond aggregator be prevented from providing such finance?

The focus of the BA should be:

1) increasing the supply of affordable housing in perpetuity
2) catalysing the sector's growth thereby reducing the reliance on government intervention over time; and

The policy objective to increase affordable housing supply should be on new supply, therefore the refinancing of newly commissioned property or turn-key purchases should be the priority. Expenditure on maintenance should be limited to long term maintenance/renovations that either:

- extend the life of property; or
- repurpose the property for a particular demand (typically changed demand).

The BA should not be used to finance minor capital expenditure/maintenance. Instead, its focus should be "to do that which the private sector cannot do". In the current market this could be enabling the CHP sector to access term funding longer than 5 years.

Banks can efficiently finance construction activity. Excluding construction finance from the mandate of the BA will reduce the costs born and risk taken by the NHFIC. By excluding construction risk the number of staff (cost) needed to manage the loan portfolio is reduced.

Limiting the mandate to long term funding delivers a clear and simple focus to the BA and certainty to CHPs in regards to availability of funding and its cost.

Issue 3

Security of loans – What forms of security should CHPs be asked to provide to access bond aggregator loans? Are there any circumstances where such loans could be unsecured? If security is provided, to what extent should it be collateralised against the other assets owned and operated by the CHP? What form of financial covenants from CHPs should exist alongside any security? If a CHP has multiple secured creditors, how should the security in favour of the bond aggregator rank?

The issue of security, collateral and covenants should be dealt with by the BA as an operational matter. The complexity of lending/security arrangements will vary from CHP to CHP.

These matters should be dealt with on a case-by-case basis in a commercial context with each CHP with a view to 1) catalyse the sector for delivering more affordable housing 2) enable the creation of scale CHPs (>20,000 dwellings per CHP) that can finance on attractive terms in the capital markets in their own right.

Issue 4

Complementarity – How could the Government ensure that the bond aggregator complements and partners with existing private and public sector investments into CHPs

The role the BA could play to create additive impact to the sector would be to focus on activities that the existing public and private sector will not do.

For example:

- Banks lend for 3-5 years, the bond aggregator should lend for longer than 5 years; and
- Catalyse the creation of new affordable supply by closing the yield gap – through the use of government subsidies.

Issue 5

Bond issuance – Could affordable housing bond issuance be expanded to the offshore market or the retail bonds market? What are the potential benefits and costs?

The BA should have flexibility to access any market that makes sense given the demand for finance from the CHP sector. The BA should be allowed to issue retail bonds if it makes sense to do so. The BA should not be restricted to specific sources of capital.

Across a business cycle, various forms of funding will be more or less competitive. The most appropriate and competitive form of capital should be used to finance the BA. In general the upfront costs of accessing a particular form of capital may be more or less than other alternatives however any decision to access particular markets should be based on the total costs, noting the terms and tenor of the funding required.

Market	Pros	Cons
Retail	Available in all market conditions Ready source Can be cheaper when considering total costs Source of AUD	Higher upfront costs (could be reduced if the bond aggregator could use simple corporate bond legislation; this would require a legislative amendment)
Offshore	Long tenor Amortising of debt is allowed in some markets Can be cheaper when considering total costs	Higher upfront costs Generally not AUD – swaps would be required

Issue 6

Bond issuance size – what is the likely preferred issuance size for large-scale institutional investors?

While the minimum index amount of $100 million allows a borrower to access the domestic market, the growth of the market now means borrowings should target larger size.

Based on our debt capital market experience, we believe the preferred size for the bond issuance should be a minimum of A$250m.

This ensures that upfront costs are covered and there is sufficient scale for large-scale institutional investors to invest, as this size addresses key risks such as liquidity in a secondary market and also keeps fixed operational costs to a reasonable level for end borrowers.

Issue 7

Contracting out functions – Are there potential benefits from contracting out bond issuances and back-office functions? What are the potential costs?

In our response to Section 1 Issue 3, NAB supports outsourcing of certain activity until sufficient scale is generated. When the BA gets to scale, it may then be more cost effective to bring the back-office functions in-house.

For a pass through vehicle issuing up to $1 billion dollars (approx. 4 tranches of bond issuances), servicing would involve issuing the bonds, collecting interest from up to 40 loan participants on a semi-annual basis, paying interest to investors, collecting principal repayments from loan participants, preparing accounts, managing tax (including GST) and auditing.

Issue 8

Government Guarantee – How would a potential government guarantee on NHFIC bond issuances impact the NHFIC's ability to raise and price funds? What are the risks associated with applying a guarantee and how could those risks be mitigated?

In Appendix 1, NAB has outlined the case for a subsidy to allow the BA to create greater housing supply, keep the affordable housing in perpetuity and limit government intervention.