National Housing Finance and Investment Corporation

NSW Federation of Housing Associations – Response to Consultation Paper September 2017

Introduction

The NSW Federation of Housing Associations (the Federation) fully supports the Australian Government's intention to establish the National Housing Finance Corporation (NHFIC) and welcomes the opportunity to provide feedback on the proposals in the consultation paper.

The Federation has 98 members including all registered Tier 1 and 2 community housing providers in NSW and over 50 Aboriginal Community Housing Providers (CHPs[1]). Together these providers manage well over 35,000 homes. With the transfer of an additional 14,000 homes from the public to community housing management over the next three years, the sector will manage approaching 35% of the total social housing portfolio in NSW.

Many Federation members have used the opportunity offered by previous Australian and State government programs to develop new social and affordable housing. Recent initiatives in NSW including Communities Plus, the Social and Affordable Housing Fund (SAHF), reprovisioning of residential homes and social impact investments have attracted strong interest and successful bids from NSW CHPs.

Through the Federation, CHPs have supported, both financially and through their knowledge and expertise, joint projects to build the sector's capacity. Consistent with the recent AHURI Inquiry into Australia's affordable housing industry capacity[2] these projects have focused on all five of the capacity dimensions the AHURI authors have identified. As published in mid-2016, our proposal for the design of a government-backed Affordable Housing Financial Intermediary[3] (AHFI) is one recent

[1] In our response a reference to CHP includes Aboriginal housing providers. In NSW the government has agreed to transition ACHPs to the NRSCH over the next four years.
[2] Pawson, Milligan, Lawson, MacLennan (2017) Ready for Growth? Inquiry into Australia's affordable housing industry capacity, AHURI, Melbourne
[3] Frost and Hamilton (2016) The Affordable Housing Intermediary Proposition Paper, NSW Federation of Housing Associations, Sydney

example of the Federation's work to influence the sector's resource capacity. That paper built on extensive research to advocate for a new initiative for financing social and affordable housing in Australia. We are pleased that the Government's proposal for the NHFIC reflects much of that vision.

In this submission we have chosen to focus on a few key themes important to the community housing sector and critical to the success of this initiative, rather than attempting to address every single question in the consultation paper. We also have referenced other Government consultation processes. The NHFIC is inextricably linked to these other initiatives. 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.

This last point is well put in the Affordable Housing Working Group's September 2017 paper on 'Supporting the implementation of an affordable housing bond Aggregator'[4]. The Federation wholeheartedly endorses its recommendations on the need for a program of robust, recurrent subsidy and a reformed National Regulatory System for Community Housing.

The Federation works closely with other state and territory community housing representative organisations. We have also applied to become an associate member of the national community housing peak body, the Community Housing Industry Association (CHIA). With these other organisations the Federation has also collaborated on a more comprehensive response which is additional to this submission.

The Government's Plan to address housing affordability

The Australian Government identifies the NHFIC as 'central to the Government's plan for housing affordability' and acknowledges the impact unaffordability is having on households across Australia. In Australia, the absence of robust housing needs assessments[5] means estimating the scale and breakdown of additional social and affordable housing required to address shortfalls and meet future demand is difficult. Judy Yates in a recent CEDA report[6] estimates that there is a national shortfall of affordable rental housing for households in the lowest income quintile of circa 250,000 in 2016. In some places such as the greater Sydney area and large parts of regional NSW, many households in the second bottom quintile are also occupying housing that consumes more than 30% of their gross income. Applying ABS household projections, Dr Yates estimates that an additional 20,000 affordable

[4] Australian Government 2017, Supplementing the Implementation of an affordable housing bond Aggregator
[5] Akin to those conducted for example in the UK where Governments have issued methodological guidance. https://www.gov.uk/guidance/housing-and-economic-development-needs-assessments and http://www.gov.scot/Topics/Built-Environment/Housing/supply-demand/chma/hnda
[6] CEDA (2017) Housing Australia, CEDA, Melbourne

homes per annum are needed just to 'tread water' i.e. to ensure the current shortfall for the lowest quintile does not increase.

Without factoring in the needs of the second bottom quintile, a twenty-year program to address the shortfall and meet projected needs suggests a requirement for a **national annual program of upwards of 30,000 new homes.**

Beyond the traditional arguments for expanded affordable[7] housing provision (e.g. benefits to health and wellbeing), it is increasingly recognised that affordable housing shortages may be economically damaging. The Federation is collaborating with the Greater Sydney Commission on research to better understand these linkages[8]. Among the questions to be addressed are the effects of rising housing costs on household consumption patterns, and economic productivity impacts of growing dislocation between employment growth hubs and the location of cheaper homes towards the urban fringe.

The NHFIC could contribute to delivering a large affordable housing program. Relevant here is experience from other jurisdictions, notably the UK, where The Housing Finance Corporation (THFC) has demonstrated that large scale institutional investors (either directly or through fund managers) can be attracted to affordable housing, enabling it to become a normalised, recognised asset class.

However, as argued in the Federation's 2016 AHFI paper[9] (also attached) 'an essential prerequisite for the intermediary is a Commonwealth government announcement of a long term affordable housing expansion program'. Thus, as acknowledged in the aforementioned Affordable Housing Working Group report[10], irrespective of efforts to channel low cost private finance through the proposed bond Aggregator, decent quality housing affordable to lower income groups remains dependent on significant government financial support.

As part of its work underpinning the bond Aggregator proposals, the Australian Government has estimated that CHPs will need to access $1.4billion of debt over the next five years. This justifies setting up the Aggregator in 2018 but the viability of the Aggregator in the longer term needs to be addressed to ensure that large investors are attracted. Market soundings[11] conducted with superannuation funds and other institutional investors have repeatedly reinforced this point. The NHFIC will be unable to create a new asset class of affordable rental housing unless its bond issues

[7] In this submission we have used affordable housing (when it appears without social) to encompass all sub market rental housing
[8] Work in progress due for publication Q2/Q3 2017/18
[9] Ibid Hamilton et al
[10] Ibid Australian Government 2017,
[11] Most recently for the Federation's AHFI project, by PwC for a project commissioned by Power Housing in 2016, for the Wester Australian Government in 2014 and AHURI in 2013

are understood by these investors to be recurrent and on-going and thus enable the development of market liquidity.

The NHHA provides an opportunity for state / territory governments to commit to increasing their joint investment in additional social and affordable housing. In separate submissions on the NHHA the Federation has argued that the agreement should be implemented in two stages both with clear additional affordable housing supply outcomes. In the first stage additional funding should be committed to provide assurance to investors that the Government intends to support a long term affordable housing program.

Both the Australian and State Governments should commit to contributing resources to new social and affordable housing via (any combination of) government land and property asset titles with opportunity to redevelop, operating subsidy, concessional (rolling/repaid) construction loans, or capital grants/ equity investment. Equivalent support that can be measured and valued as supporting social and affordable new supply such as inclusionary zoning (IZ) could be included. States where most additional supply is needed will have greater capacity to contribute from IZ potential and stamp duty revenues.

The NHHA's second stage (from FY 2019/20) should strengthen the multilateral and bilateral agreements by incorporating elements from comprehensive national and state / territory housing strategies that are underpinned by robust on-going housing needs assessments.

Community Housing Provider Capacity

During the roundtables for the NHFIC, NHHA and in other forums, questions have been raised about the community housing sector's capacity to deliver a large scale affordable housing program. Although in recent years, Australian governments have not invested substantially in growing social and affordable housing provision, there is still plentiful evidence to support the sector's readiness to expand. The AHURI Inquiry noted earlier concluded 'provider organisations have considerable capacity for expansion - existing capacity of many larger players is underutilised.'

The sector has however utilised funding from past programs to demonstrate that it has the capacity to respond to future opportunities. Since 2008 when government programs such as the National Rental Affordability Scheme (NRAS) and the Social Housing Initiative (SHI) were initiated, the sector has built over 22,000 new affordable homes (including 2,300 leveraged from the SHI).[12]

[12] Ibid Pawson et al (2017)

In NSW, the Federation has recently surveyed[13] Tier 1 and Tier 2 members about their new housing development activity. The period covered by the data is the past five years 2012-2017, and includes projects under development or with an approved development agreement (DA). The aggregated data for 20 organisations is set out in the table below.

New Housing Provision by CHPs in NSW	
Social and community housing	550
Affordable rental housing (NRAS and vesting obligation agreement)	1,776
Other - Market rental, for sale (discount and market rate), and new generation boarding house	335
Total number of dwellings in NSW (since 2012 and with a DA)	**2,661**

Of the **2,661**, the number of dwellings already delivered is **1,232** and **1,429** have an approved DA. These dwellings are being delivered across **153** separate projects. Of these projects, over half (80) are being delivered solely by CHPs with the remainder split between acquisitions (turnkey) and where the CHP is part of a consortium.

In total the investment committed to NSW CHPs' recently completed and planned projects will amount to $698m - **$266m** of CHPs' own equity and **$432m** in CHP-held debt. Other contributions to development costs total **$265m.** This includes Government land, grants, subsidies, special payments, planning gain and cross subsidisation from sales. The average all-inclusive development cost per unit is **$362k** (this includes boarding house units and reflects the overwhelming numbers of smaller units in the projects). **80%** of all units are studio, one and two bedroom. **82** projects are in suburban areas, and **66** in town centres. **Five** developments are specifically for specialist disability accommodation (SDA) properties.

In order to deliver these projects, CHPs have recruited specialist development staff, strengthened their finance teams and sought new non-executive Directors with skills and expertise relevant to these newer areas of business. This is part of a long term trend; in the past ten years, the sector has invested in significant capacity development in the areas of financial and risk management and on building strong governance and probity infrastructure. The Federation, through the NSW Industry Development Strategy has also supported sector capacity building through projects such as managing strategic risk, effective leadership and self-regulation tools such as in-depth assessments modelled on the UK Housing and Community Agency regulatory approach.

[13] To be published in full by the Federation in late 2017

It is sometimes suggested that the existing structure of the community housing sector is problematic because of an absence of entities with sufficient organisational mass for cost-effective housing development at scale. On this argument, construction of social and affordable dwellings in significant numbers would require organisational mergers. Leaving aside that the bond Aggregator is to some extent an antidote to limited organisational scale, the evidence of past and present development activity should be sufficient to address this concern.

CHPs have responded to development opportunities in ways that address scale and capacity issues. Where major opportunities have presented themselves, individual providers have collaborated with finance and property development companies; for example the Aspire Consortium comprising Mission Australia Housing, Frasers Property Australia, Citta Property Group recently awarded the tender for redevelopment of Sydney's Ivanhoe Estate, the biggest estate renewal project so far seen in Australia.

CHPs have also combined resources, one example being Centacare Evolve Housing which is a partnership between Centacare Tasmania, and Evolve Housing NSW. The new entity manages properties transferred from Housing Tasmania under the Better Housing *Futures* Program. The 2017 Stock Leverage Program will support Centacare Evolve to construct and/or refurbish 150 dwellings by leveraging security provided by existing social housing stock.

Mergers between organisations may occur in future; where the opportunities on offer make this a sound business decision. Currently the scale and nature of government investment in new social and affordable housing (in NSW the additional units predicted from the Communities Plus program and SAHF are circa 10,000 with the vast majority to be retained in government ownership) does not prompt CHPs to consider mergers. The bond Aggregator and government investment in affordable housing programs will support organisational growth and at the same time maintain the sector's diversity and its ability to meet both the needs of local communities and different population cohorts.

A critical function for the NHFIC is the bond Aggregator's intermediary role. It needs to develop specialist expertise not just in the debt capital markets but in the community housing business model. We come back to this point later under governance and structure.

Consultation Paper Section 2: Structure and Governance

The Federation has assumed that the primary reason for combining the National Housing Infrastructure Facility (NHIF) with the Aggregator is to reduce operational costs. Since these are quite separate functions with separate counterparties (local Councils, in the NHIF's case) this raises a concern that the proposed structure could weaken or confuse the standalone credit quality of the Aggregator through its "contamination" with issues arising from the NHIF.

The Aggregator model as proposed by the Federation was an industry-led, non-profit, credit-rated and independent finance company modelled very much on the UK's THFC, a company with a long term track record of successfully raising low cost finance for the UK's CHP-equivalent sector. That remains our preferred model, although with sufficient independence and the right level of expertise the NHFIC should be successful. In the short term there may well be an advantage to the NHIFC having some relationship with government, since this could help to signal a long-term commitment to affordable housing development.

The Aggregator is essentially simple in function. It aggregates debt from CHPs and issues bonds to the institutional market to fund that debt. It operates in the market and passes fund through to the CHPs at a minimal margin to cover its operating costs. Those costs cover the management of its loan and bond portfolios and the cost of providing credit review of its portfolio. The Federation recommends that those functions should be conducted in separate standalone entities, where all the functions and management of the Aggregator can operate transparently in the absence of any external influence that may arise from the project selection function that is an essential element of the NHIF. One option may be for these functions to be undertaken in separate subsidiaries of the NHFIC.

Investment Mandate and independence of action

An important consideration for the Federation is the degree of independence the NHFIC retains. This will be in part articulated by the proposed investment mandate. In respect of the Aggregator the scope set out in Table 2 on page 10 of the consultation paper seems very broad.

In our view the mandate should be framed to set out high level principles such as:

- a definition of affordable rental housing
- lending for purposes that are consistent with national and state / territory affordable housing strategies[14]
- the organisations that it can lend to – registered community housing providers.

Restrictions on projects, limits on financing mechanisms, bond length and total lending, and other practical matters seem excessive. These will evolve iteratively with market development and maturity. Government should expect the NHIFC to develop operational policy and practice and, if necessary, require intensive oversight in the short term until its performance is proven to be sound. Given the NHFIC seems likely to start slowly and be issuing relatively small bond tranches the risk will be minimised.

[14] Noting that a proxy for these is needed in the short term

There have been some concerns raised about government directing lending to those projects that meet housing needs or where needs are greatest. Such views are understandable. However, restricting the Aggregator to certain projects would change it from an intermediary between a sector wanting finance and investors wanting to lend, to a government investment vehicle, supporting its chosen projects. It also presupposes that CHPs will choose to apply for loans for specific projects rather than as a general facility to be used across a program (which may well be the way the market matures, as it has in other jurisdictions).

A preferred approach is that an application assessment demonstrates that the purposes for which the loan is required are consistent with the relevant affordable housing strategy. We have also assumed that only projects that meet housing need will attract the 'gap funding' necessary to make a project stack up.

We are more sympathetic to additional guidelines around the use of any government guarantee. We appreciate that this might be restricted in the total amount covered and might be best targeted at projects requiring deeper subsidy or which are otherwise complex.

The Aggregator must also be able to issue bonds that meet CHPs' loan requirements – that are competitively priced, minimise risk, and can be matched with other sources of funding. The Aggregator should not be constrained by instructions to offer only one type of bond. Again, what is contemplated by this policy is the making of a new market – there must be room for it to evolve as track record is developed.

Governance and staffing

We believe the NHFIC board must include community housing sector experts. It will be critical that there is sufficient (and contestable - i.e. not all wisdom residing in one person) knowledge of the sector on the Board at least until all its members' expertise develops. The Federation proposes there should be one nominee from the national industry organisation, CHIA and another independent industry expert for at least an initial period. Alongside finance, legal and governance experts, they will bring the necessary sector knowledge in the core business of the NHFIC outcomes.

A Registrar from the National Registration System for Community Housing (NRSCH) should have an advisory relationship informing and liaising over financial monitoring and adherence that can be carried through to good practice via NHFIC relationship managers and CHPs. We do not support their having a Board position because of the conflicts inherent in having a dual position. An independent advisory role would be beneficial though.

The finance industry frequently states that reputational risk is a significant concern to them (i.e. being 'tainted' by failings of a social housing provider facing insolvency or otherwise judged non-compliant with required standards). Though this has never occurred, including sector representatives will ensure the Aggregator places appropriate priority on these aspects during its risk assessments.

Some stakeholders have expressed concern that industry 'representatives' including a Registrar may have a conflict of interest. We have assumed that operational matters will not be brought to the Board in line with standard professional governance practice. THFC has operated without conflict issues arising with both a Registrar representative and a CHP on its board for over 25 years.

We strongly support the NHFIC recruiting its own staff and developing in house expertise in the community housing sector (including the Aboriginal sector) and affordable housing delivery as well as finance, rather than outsourcing. Our experience is that the community housing business model, its functions and services are poorly appreciated by many in government and the private sector. The Aggregator needs to be an advocate of the CHP sector to the investor market, as well as of the lender to the CHPs.

Another strength of THFC is the in-house expertise it has built up that enables it to act as a real intermediary. The Aggregator in Australia needs to create a profile in the capital markets that has credibility and substance. It is crucial that financial sophistication in risk assessment, underwriting, and issuance is developed and concentrated in the NHFIC and not outsourced. Institutional investment advisors will look closely at these aspects.

Consultation Paper Section 3: National Housing Infrastructure Facility

While welcome, the NHIF is a relatively small scale fund similar to the 2008-13 Housing Affordability Fund (HAF) and we believe best targeted at a small range of strategic projects where investment will make a measurable difference in affordable housing outcomes by for example reducing development costs. In NSW this might, for example, complement Section 94 waivers for CHPs.

Investments sought from NHIF should be supported by strategic plans and policies that demonstrate clearly the need for affordable housing and the additional units (or the greater proportion of more deeply subsidised housing – arguably a form of additionality) that securing the loan / grant would make to the outcomes. Evidence could include (at the local level) a Council's affordable housing plan and at the regional scale the level of affordable housing assessed as necessary as part of City Deal, such as that being developed for Western Sydney. We support the NHIF being used in conjunction with other planning instruments to support affordable housing delivery such as inclusionary zoning.

There is also scope to examine how managed investment trusts (MITs), which may form with registered community housing providers as partners, could directly apply to the NHIF.

We would also support the Infrastructure Facility being targeted at a proof-of-concept or similar (with the demonstrable capacity to be scaled up) to actually develop new models for disadvantaged groups such as the Aboriginal community (possibly exploring options for replacing old worn out housing in remote and regional NSW using modern methods of construction) and older women at risk of homelessness. The Older Women's Studio project developed by a consortium facilitated by the Sydney Women's Homelessness Alliance is another example.

Feedback question 5 on the NHIC queries whether consortia of applicants could be acceptable. Indeed this may eventuate, as evidenced by several redevelopments of social housing estates as cited in the consultation paper, but we would advise consortia always incorporate a registered CHP in order to ensure the housing affordability and tenanting targeting goals of the Infrastructure Facility are assured.

Question 7 queries whether NHIC should focus on the supply of affordable housing for key workers, which we would certainly support, given the repeatedly documented barriers to its construction or incorporation within conventional development. Despite the modest size of the National Housing Infrastructure Fund, its impact in unlocking housing momentum and opportunity would be greatly magnified if it were targeted specifically toward facilitating an under-represented tenure in the Australian market, which seeks to span the divide between social and private rental.

Consultation Paper Section 4: The Affordable Housing Bond Aggregator

Overview

In our 2016 AHFI report we outlined the requirements for an Aggregator. To be a credible actor in the capital markets, maximise investor interest and ensure the keenest pricing there needs to be government commitment to the sector (bi-partisan support implied) and a stable policy and funding environment. We noted a number of requirements to meet the credibility threshold:

- inclusion in the bond index (minimum issuance size of $100m conforms with the discussion paper)
- investment grade rating (both the Aggregator and the CHPs it lends to need to meet at least BBB rating, even if in the latter case CHPs will not need to be individually rated
- regular issuance which adds to familiarity and means fund managers and chief investment officers start to pro-actively factor in the new asset class into their investment strategies
- commitment of government – recent history of programs being terminated reinforces scepticism. Apart from a formal guarantee – see below – long term national and state / territory housing strategies with strong explicit affordable housing components are a form of proxy guarantee from governments
- Strong regulation (see below).

The Aggregator's operation should be reviewed regularly starting from two years after its first issue until it has established presence in the financial markets.

Question 1: Eligibility

The Federation believes that all registered community housing providers should be able to apply for finance from the Aggregator. In reality this will mainly be T1 and T2s but there have been examples of T3 organisations successfully winning investment. Indeed, the UK's THFC Chief Executive has spoken of the value of his bond Aggregator in enabling sophisticated, efficient finance to be accessed by smaller housing organisations that often are of modest size due to specific-cohort targeting.[15] In reality a T3 that does development will probably be required to seek a change to its registration category, and participation in a bond issue of the NHFIC would go far toward skills development in a smaller organisation.

We do not support non-registered providers accessing loans from the Aggregator. Registration in the NRSCH (or the state equivalents) must be a condition of a loan in order to ensure the creditworthiness of the NHFIC bond issues. The risk analysis underwriting burden on potential investors would become unrealistic if there were not this baseline risk mitigation standard of unitary regulatory oversight on what is otherwise an appealingly risk-diversified borrowing group. It is the NHFIC's 'credit story' as understood by sophisticated institutional investors. The regulatory system is often cited by the investment community as a strength of the sector, given it provides assurance about the overall governance standards and operational performance of providers.

Question 2: Purpose of loans

The Federation sees no present need for the Aggregator to fund the development construction phase. Its role should be to focus on long term finance of tenanted dwellings. In the Federation's AHFI report we argued that commercial banks were well placed to offer construction phase debt. These banks understand property risk well and already lend to the sector for this purpose. Indeed, the inclusion of construction risk will undermine the credit quality that would otherwise apply to the term debt, and may lead to the market demanding a higher risk margin on the funds invested.

Question 3: Security

The nature of security sought needs to be explored further, and interacts strongly with NHFIC design questions around financing 'general corporate' or 'project-specific' debt. Most CHPs have relatively thin balance sheets and if the security that is required is against all property assets (akin to current 'Fixed and Floating Charge' arrangements), this will constrain borrowing capacity in the short to medium term until an unsecured property portfolio is built up by individual CHPs. The CHP industry believes that entity-level security over all corporate assets evidences the immaturity of early bank lending practice to the sector. The past ten years of robust commercial lending track record, plus the very important introduction of the NHFIC should represent an evolution of security arrangements past this early-days underwriting conservatism of Fixed-and-Floating charges.

Indeed, lending to the CHP industry has evolved from the early bank misapprehensions that this was *property* lending based on loan-to-asset value metrics, to the current banking industry understanding that they are lending against rental *cash flows*. This is why Interest Cover Ratio (ICR) is now the

[15] Piers Williamson address to NSW Federation of Housing Association conference, July 2016 "Fostering Growth in Small Organisations"

universally-accepted metric for sizing CHP debt capacity. In our AHFI report we noted that security against future operational phase cash flows (rental income), rather than property title, could be acceptable to the finance market, providing that the contracts under which assets were managed were of sufficient duration - twenty years plus was recommended. This brings into question the three year leases that (in NSW) apply to all historic social housing management transfers which provide little long term security.

In general, because lending to CHPs is based on the rental cash flows of specific dwellings, it follows that lending practice as innovated by the NHFIC may mature toward project-specific lending, where a discrete project or pool or assets are ring-fenced, rather than the more porous general corporate debt. This allows for careful project-based accounting practices and clean reporting, and in security terms does not risk the constraints of more onerous corporate-level security. We understand that much of the existing commercial bank debt in the market is general corporate debt facilities and their refinance through the NHFIC may need to match this. However, going forward, there may be scope to evolve toward project-based finance. This will likewise have security implications – and opportunities – with offering security against specific title.

The Federation has argued for title transfer in its property transfer position paper[16] for many reasons including to provide security against which CHPs can borrow. Title also brings other advantages, including the ability to manage assets strategically. Contracts that place the decision on structural repair, regeneration and replacement with the owner and allow for a percentage of properties to be clawed back, fetter CHPs ability to manage assets strategically and are one reason a government guarantee may be required.

We appreciate the issue of title transfer may not be resolved in the short term. However, we believe it should be tackled during the NHHA negotiations and that states should commit to more ambitious property transfer targets. The design of transfers should also maximize the potential for additional supply to be generated via either redevelopment and regeneration / or leveraging potential. As a minimum all existing three-year management leases in NSW should be converted to 20 year leases during 2018/19.

There are precedents for resolving the security interests of multiple lenders and interests (in NSW the state government retains an interest in properties transferred) which can be drawn upon. The NSW tripartite agreement[17] has operated successfully for many years, with parallel documents in other states.

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16 http://www.communityhousing.org.au/HousingMatters/May16/NSW%20Federation%20Large%20scale%20property%20transfers.pdf

17 http://www.housing.nsw.gov.au/__data/assets/pdf_file/0003/333084/AgreementTripartiteDeedNationalRegulationChanges.pdf

Question 4: **Complementarity**

CHPs, either solely or in partnership with others, are experienced in assembling (layering) different sources of funding to finance projects. Typically projects will combine varying proportions of equity, debt – private finance sometimes from multiple sources, land, grant, cross subsidisation (say from market for sale) and tax incentives to make the project viable. CHPs must be able to apply for loans from the bond Aggregator and combine this with other funding elements because the well-documented financial feasibility gap will require this layering of finance. Any attempt to place conditions that restrict applications on the grounds that other subsidies and private finance (e.g. from the Clean Energy Finance Corporation) are being used, will be counter-productive.

Layering several sources of finance to achieve affordable rental housing feasibility is not as some argue 'double-dipping;' it is standardised practice internationally where the need for low-rent housing drives innovation in customising and targeting development through multiple financing partnerships. (Often, the most 'senior' finance will require 'readiness' or securing of all other layers of finance before it is allocated – such as several American states' Low Income Housing Tax Credit allocation priorities.)

NHFIC should be working pro-actively with other states and territories where there are initiatives such as the Victorian government's guarantee mechanism and low cost loan facility, to promote complementarity.

Question 7: Contracting Out Functions

As noted in the Resourcing consultation question in Section 2, our industry's deep, Commonwealth-funded analysis into the case study of the UK's THFC presents a very strong argument for not out-sourcing any of the functions of the NHFIC. It is crucial for the confidence and perception of the institutional investment sector (which *directly* translates to interest-rate margin savings for the NHFIC's issues) that the financial sophistication, and strict Treasury processes be concentrated within the deep institutional knowledge of the NHFIC. Saving a modicum of administrative expense will have the false economy of increasing the cost of borrowing, because the buyers of the NHFIC's bonds will scrutinise this.

Question 8: Government Guarantees

We have already highlighted that commitment from government is essential to the Aggregator's success both for the community housing industry and in the eyes of the potential institutional investors. There are barriers that any new bond issuer faces particularly when the asset class is also new. To warrant new investors taking the time to analyse the sector and its underlying credit worthiness they will not only need assurance that there will be regular issuances of sufficient size, but credit support that will 'bridge' the time between a new asset class being introduced and the emergence of a sound history of transaction performance to analyse .

We identified that a national housing strategy or policy might suffice as a proxy guarantee for government commitment, but as the CHP sector is relatively unknown and its regulation not yet reformed, a guarantee will reduce borrowing margins that would otherwise be assigned to these unknowns. Beyond establishment-phase credit support, affordable rental housing's dependence on government to bridge the funding gap indicates that some form of guarantee will be required perhaps on the government's own forward obligations.

Guarantees can be formulated in many degrees with varying triggers such that they can be finely calibrated to offer comfort while remaining remote possibility of call for government balance-sheet purposes.[18] For example, a guarantee could be generally for the Aggregator or for each issue. Directly guaranteeing individual bonds is probably not the best long term approach as it is unlikely to promote investor acceptance of the CHP sector. An indirect guarantee of the Aggregator is more justified as it will be by design thinly capitalised – working on the 'pass through' model assumption. As we noted in the Federation's AHFI report, the latter approach is akin to the guarantee that is provided to Australian banks in support of their bond issuance programs.

That said, there may be an ongoing role for a government guarantee perhaps associated with specific programs where risks are higher. This might include new programs, new providers (newly registered Aboriginal community housing providers) or those targeted at solving more complex problems in difficult locations. In general, however, an appropriately reformed and strengthened Regulatory framework will provide much of this credit enhancement (see following section). If UK experience is a guide the THFC record of no defaults in its 30-year history ought to provide confidence that the guarantee is unlikely to be triggered.

National Regulation

A single strong national regulatory system is essential in providing confidence to government and investors. Over time the regulatory system should obviate the need for guarantee except in isolated cases.

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[18] 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. Melbourne: Australian Housing and Urban Research Institute. Available from: <http://www.ahuri.edu.au/publications/projects/p53019>.

Together with the other community housing peaks, the Federation has produced its proposals[19] for strengthening the regulatory system as an input into the NRSCH review planned for 2018. In the paper we have identified interim measures to strengthen the regime in the short term.

The NRSCH adds value by providing assurance to investors and government about CHPs' overall governance and business that supplement the credit analyses carried out by financial institutions. Critically they provide assurance around reputational risk. Another important role regulation plays is early detection and control of risks. Where performance issues cannot be addressed, a strong regulator can also manage an orderly wind up and transfer of business process.

Lastly the regulatory system should involve publication of sector information that will enable investors to gain a deeper understanding of the sector and of provider performance.

Next Steps

The October 2017 NHFIC consultation roundtables were useful in allowing an open discussion and enabling a variety of stakeholder views to be heard. Not all issues could be raised or worked through both because of the format and also the time. We recommend a further series of structured and facilitated sessions with separate stakeholder groups to progress these matters. For the CHP sector in NSW we welcome further discussion around the governance and independence of the NHFIC, eligibility, security, regulation, concerns raised about sector capacity and the need for a long term affordable housing program.

[19] To be released in November 2017

Appendix 1

The Affordable Housing Financial Intermediary

THE AFFORDABLE HOUSING FINANCIAL INTERMEDIARY

JULY 2016

nsw Federation of
Housing Associations inc

www.communityhousing.org.au

CONTENTS

EXECUTIVE SUMMARY

This Proposition Paper draws on extensive research and submissions to advocate a new initiative for financing affordable housing in Australia. For the purposes of this paper, affordable housing refers to housing that eliminates housing stress for low-income individuals whilst balancing the need for housing to be of a minimum appropriate standard and accessible to employment and services. Affordable housing in this paper includes both social and affordable housing as generally understood.

A long term programme for affordable housing expansion is critical to tackle the visible and deepening housing inequities in Australia. Should a plan to address affordable housing be established, it would be critical to enable and expand the community housing sector. The financial intermediary proposed creates new avenues for the sector to access efficient, stable funding and improve the scope, delivery and credibility of the services provided. It is the vehicle that provides a bridge between the community housing sector and the institutional financial markets and removes the barriers that hamper development.

This proposition paper is a practical proposal that identifies the economic and organisational benefits associated with a financial intermediary. In addition, this Paper maps the way forward for introducing an Intermediary to the affordable housing sector, its necessary size and operation and how it fits into the current regulatory and economic landscape.

The key benefits are summarised below.

I. An affordable housing finance intermediary provides transparent efficiency and value-for-money through **aggregation**.

II. Developing this intermediary is a **'market-building'** exercise in two senses:

   a. Building the community housing industry's capacity to interface with the capital markets, and
   b. Building a new asset class for institutional investment through the debt capital markets.

III. The intermediary encourages **diversity** in the community housing industry.

IV. The financing intermediary works in tandem with **government co-investment**, which it can leverage to address housing shortfall and generate economic benefit.

V. Over time, the non-profit intermediary will grow to become an institution in its own right that **normalises private investment in affordable housing**, and can smooth fluctuations in production through the property market cycle.

This Proposition Paper is split into nine sections:

1. The Intermediary: the way forward for affordable housing finance
2. Credibility and scale: why we need an Intermediary
3. Why the capital markets?
4. Requirements of the Intermediary
5. Fitting into the regulatory landscape: proposed legal and regulatory structure
6. What scale of programme would attract the Institutions?
7. Operation and benefits
8. Situating the Intermediary within the Australian economy
9. Next steps

1

THE INTERMEDIARY: THE WAY FORWARD FOR AFFORDABLE HOUSING FINANCE

Community Housing Providers (CHPs) are government-regulated non-profit organisations designed to efficiently manage affordable housing. Dwellings are rented to tenants who pay below-market rents affordable to their income levels, and enter into conventional Rental Tenancy Act leases which are professionally managed by the CHPs. These households may also receive the Commonwealth Rental Assistance (CRA) which supplements the cash flow associated with these rental operations.

The concept of an intermediary enables CHPs to expand and improve their services by providing access to more efficient sources of funding. The Intermediary will issue bonds into the institutional capital markets, raising funds to lend to the CHPs to finance the acquisition of affordable dwellings. Net revenue from managing these portfolios will service the loans from the Intermediary and fund the coupon payments of bonds it has issued based on this projected cash flow. These fixed-interest, long-term bonds will carry investment grade ratings from credit ratings agencies reflecting their stable, low-demand risk and operating fundamentals. Amortization over the term to de-risk refinancing may be managed by issuing bonds with a range of tenors.

The Intermediary is a specialist non-profit financing company that aggregates debt demand from CHPs, undertakes bond issuance, credit management and CHP lending functions. It intermediates between the institutional capital markets and the CHP sector. It is financially sophisticated and equipped with debt capital markets expertise in order to translate the ‘credit story’ of the CHP sector into an investment grade bond issue. The Intermediary will have experienced executives to assess management and systems quality, financial reporting and governance of the CHP borrowers. This will ensure that creditworthiness and ratings are maintained in order to sustain investor confidence.

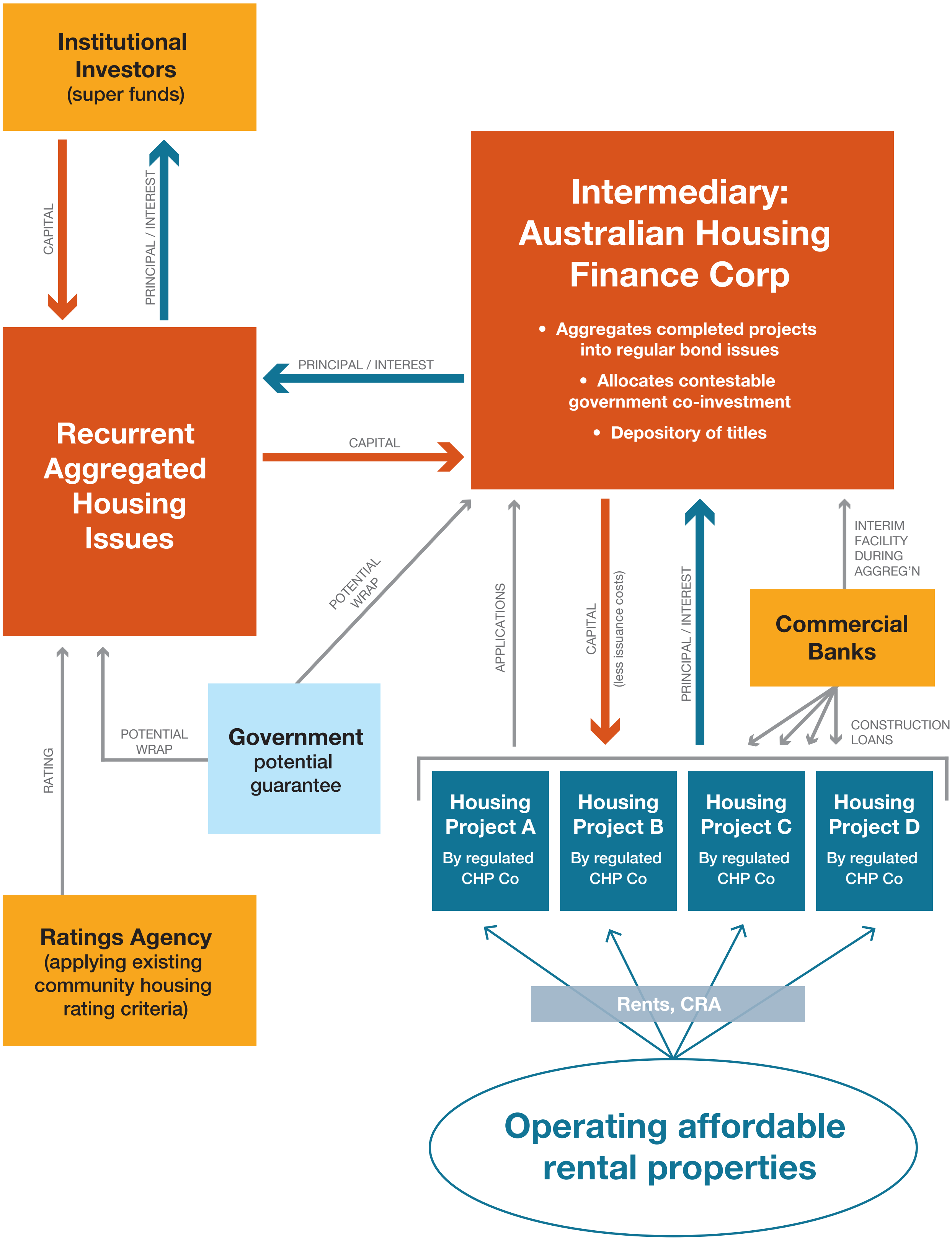
The functions the intermediary performs include:

- Credit assessment of both CHPs and affordable housing projects;
- Bond issuance to the institutional capital markets;
- Back-to-back lending to CHPs via loan agreements;
- Management of security over dwelling assets;
- Credit and compliance monitoring on CHPs over time;
- Treasury management of cash flows from CHPs to investor coupon payments.

The affordable housing financial intermediary is:

- *Industry*-led
- Non-profit
- Aggregates *debt*
- Aimed at *wholesale* investors
- Credit-rated
- Independent
- A *finance* company, not a housing company

The Affordable Housing Financial Intermediary model



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CREDIBILITY AND SCALE: WHY WE NEED AN INTERMEDIARY

In a word: scale. An Intermediary will aggregate the individual finance requirements for CHPs in order to package them to an institutional market scale. This will provide access to the capital markets with a myriad of potential benefits such as longer tenor and finer interest margins, compared to traditional bank funding. In addition, the Intermediary will act as a credible, financially sophisticated, single representative face for the sector to engage with the institutional markets and advocate on its behalf. (See appendix B: barriers to institutional investment, for a discussion of the importance of scale.)

The CHP sector is diverse and fragmented, which makes it difficult for institutional markets to engage with. The sector is characterised by a large number of small not-for-profit organisations operating successfully in their local communities, but individually lacking the scale and financial credibility to operate at an institutional level. Balance sheets are strong, but relatively small, and apart from the benefits of property transfers, capital creation is slow due to thin operating margins. However, CHPs manage stable operating businesses with high quality cashflows predominantly derived from tenant rental that is sourced from government benefits. There is excess demand for the properties being managed and this is unlikely to change given long waiting lists. The largest credit risk with these businesses is managing maintenance, vacancy and tenant turnover to minimise disruption to rental flow.

The CHP sector needs to be credibly represented to the institutional markets. Senior representatives of institutional investors have highlighted the need for a financially sophisticated conduit between institutional investors and CHPs to provide reciprocal education and communication. The Intermediary will provide investors with a better understanding of the CHP operating business and allow the sector to meet the management and financial governance standards demanded by the institutional markets.

The Intermediary will establish standardised credit terms and conditions and ensure these are harmonised with the investor's requirements. As the interface between the CHPs and the investors, the Intermediary will free individual CHPs of the cost and inefficiency of negotiating finance separately. The result will be to ensure all CHPs receive consistent terms in their financial dealing.

There are many documented precedents for affordable housing finance aggregation intermediaries. In a government-sponsored survey of comparable economies featuring stable private investment in affordable housing, every example featured an intermediary entity plus stable government co-investment. One in particular, The Housing Finance Corporation in the UK, has been extensively studied for its applicability to Australian conditions. Founded in 1987 by the UK's non-profit housing industry, the THFC has £4.2 billion in bonds on issue, aggregating the debt requirements of thousands of affordable rental dwellings in Britain. The Intermediary principle has also been recently deployed in Australia in the Local Government Funding Vehicle in Victoria. In 2015, 33 local councils aggregated to borrow collectively and efficiently in the capital markets with an Aa2 rating from Moody's.

The Housing Finance Corporation Limited:
A UK precedent appropriate to Australian conditions

Founded in 1987 by the UK's government and affordable housing association sector, The Housing Finance Corporation has aggregated finance requirements and issued bonds on behalf of these UK non-profits for nearly 30 years. It cites four pillars underpinning its success: robust regulation of the UK housing associations, housing benefit paid to tenants to supplement rent, consistent government co-investment to stimulate construction, and the ability to secure bond finance against the underlying property assets.

THFC aggregates debt demand from small-to mid-size UK Housing Associations (commensurate to Australia's mid- to large-scale CHPs) and issues tranches of bonds around £100m at margins between 0 – 200 basis points above gilts, or UK government bonds. This is typically half the spreads that are able to be offered by the commercial banking sector, and represents fixed-rate, 30-year debt.

- In 2015, the THFC's group loan book grew to £4.2 billion from £3.4 billion a year prior
- The group's total income that year was £8.3 million and pre-tax surplus £5.1m
- THFC has maintained an A+ credit rating since 2003
- Customer (Housing Association) repayments have been 100%, 28 years running.

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WHY THE CAPITAL MARKETS?

The capital markets are the deepest and most transparent sources of funding. They provide a wholesale market in which investors and borrowers can transact at the finest interest margins and over the widest range of maturities. For those able to transact, capital markets provide the most efficient means of raising funds.

For CHPs seeking long term funding to acquire dwelling stock, traditional bank lending has limitations. For example, banks are constrained in the term over which they can lend by regulatory requirements. With the exception of owner occupied residential mortgages, banks are typically limited to loans of five to seven years, which is not optimal for assets with an effective life beyond 35 years. In addition, capital adequacy regulation has added significantly to the cost of bank operation and produced higher interest margins and fees, meaning those without access to the capital markets are significantly disadvantaged.

To illustrate the level of disadvantage, consider the need to fund property for a period of 20 years. With access to the capital markets, a 20 year bond can be issued to fund the debt required. If bank debt is used, a five year facility will need to be re-financed four times during the same period, with the additional cost of each refinancing together with the uncertainty of any variations that may occur in debt margins.

Australian governments seek to minimise the cost of service delivery through co-investment from private sector participants to reduce the impact on government balance sheets and to maximise the efficiency of service delivery. This model is based on the principle that risk should be transferred to the party best positioned to manage and absorb it, since it will result in the lowest delivery cost to government. With CHPs playing a progressively broad and important role in new affordable housing supply, initiatives such as the NSW Social and Affordable Housing Fund (SAHF), Communities Plus or large property transfers, the sector needs to access debt efficiently. While the largest projects may be undertaken by consortia that include financial arrangers, CHPs must have access to efficient long term, low cost financing to efficiently manage the affordable housing stock that results, or have the capacity to participate directly in these initiatives.

The Intermediary will provide the CHP sector with the necessary access to the capital markets which are the most efficient and reliable sources of debt.

Commercial banks: on-going partners

Despite the limitations of the commercial banks' regulatory and funding constraints that limit their ability to lend on long terms to the CHP industry, they may nevertheless continue to enjoy exposure to this emerging market.

- Construction-phase debt is a natural match to the commercial banks' lending practices as it is short-term and related to property risk which banks understand well. The Affordable Housing Finance Intermediary will not fund construction, instead lending against operating-phase cash flows. The uptick in stable construction activity, predicated upon the government co-investment needed to initiate the intermediary, will provide increased opportunity for commercial banks. This construction activity will in turn be de-risked by the take-out refinancing offered by the intermediary upon completion.
- Comparable aggregations like the Victorian Local Government Funding Vehicle (LGFV) for local Councils also partner with commercial banks for warehousing/interim facilities. This would be relevant to the Affordable Housing Finance Intermediary. These interim facilities bridge between the underwriting/credit approval of projects to be included in a bond issue and the issuance of the bonds. This timing lag is caused by the assembly of a portfolio of adequate size for a bond issuance and the rating and book-building (marketing) processes. National Australia Bank and Commonwealth Bank provide these interim facilities for the comparable LGFV.

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REQUIREMENTS OF THE INTERMEDIARY

To be a credible participant in the institutional markets and maximise the benefits of a bond issue, the bonds must be included in the Bond Index. In addition, as the bonds represent a new industry sector and an asset class that relies on government support, the market will require evidence that government is committed to the sector over the long term, and that there will be a stable and consistent policy and regulatory environment. Delivering these elements will maximise the potential pool of investors, provide liquidity for the bonds and ensure the finest pricing.

Inclusion in the Bond Index

The index of traded bonds in the Australian market tracks the price at which bonds trade and play a major role in ensuring liquidity to an issue, since institutions are generally limited to holding bonds listed in the index. Inclusion in the index will also mean institutions will be comfortable including the bonds in their portfolios with limited analytical work. Inclusion will also make the bonds mandatory where institutions are seeking an index weighted portfolio, including offshore investors seeking exposure to Australian dollar risk. Inclusion in the index is a significant measure in maximising the pool of investors. Bonds included in the index will generally trade at finer margins than similar paper not in the index. This will enable the Intermediary's bonds to be included in the 'fixed income' category, rather than the 'alternative' category in institutional investors' allocations, further normalising this asset class.

To be included in the index, an issue will need to be:

- Rated as investment grade;
- Denominated in Australian dollars;
- Pay a fixed rate coupon; and
- Have a minimum issuance size of $100m.

Investment grade rating

An Investment Grade rating implies the highest quality financial obligor and applies to issue ratings of BBB through to AAA, and carries the finest interest rate margins. In determining its ratings assessment, the ratings agencies examine all risk aspects of the underlying business and management together with the history of the business meeting financial obligations in a timely fashion. To achieve and maintain an investment grade rating, an entity must meet high standards of governance, financial management and transparency. The bond issues of the Intermediary will require an investment grade rating, with a likely target of A to AA. The rating will be dependent on the quality of the underlying CHP cashflows supporting the loans provided by the Intermediary to the CHPs. While the CHPs are unlikely to be individually rated, their governance, management and operations need to satisfy the standard required of the investment grade issue rating. In this way the rating process carries through from the markets to the CHPs and will contribute to high quality management standards of the sector.

Regular issuance

Regular issuance will add to the familiarity of the Intermediary and its paper with the market and adds to the weighting of the issuer in the index. A programme of two issues per year would maintain the market presence and visibility of the Intermediary. However, in order for the Intermediary to issue regularly, the CHP sector will need a continuing demand for debt over the future years. This implies a substantial pipeline or programme of dwelling construction/ acquisition. To deliver such a programme, there needs to be a coordinated complementary long term government commitment for social and affordable housing expansion.

Commitment of Government

The barriers to the establishment of a new issuer in the capital markets, representing a new industry sector and a new asset class should not be underestimated. Investor scepticism is high as they will need to undertake significant analysis on the sector and the underlying credit of the bonds before investing. To warrant the effort, the sector debt demand and the bond issuance programme must be of sufficient size and longevity to justify the cost and the risk.

Where the industry sector is dependent on government policy, such as with the CHP sector, the commitment of government to maintain a stable and consistent policy and regulatory environment over the long term becomes paramount. Thus, it is essential that the markets have confidence that there will be debt demand sufficient to warrant continuing issues over several years. Unfortunately, the recent history around the NRAS programme only reinforces investor scepticism and amplifies the need for policy commitment that will not be overturned by a new government. Confidence around these issues can only be delivered by government commitment to a long term programme for social and affordable housing expansion. These conditions will provide the markets with strong indications of implicit government support that will enhance the underlying high credit quality of the bonds.

Support for the Intermediary may also be necessary at least during the initial years of establishing its market presence. This support could occur as a guarantee of either the individual issues or more broadly, of the obligations of the Intermediary. This guarantee may be either explicit or implicit. Direct guarantee of bond issues would obviate the need for any investor analysis of the underlying credit or structure of the sector or asset class, as it would simply trade off the credit of the guarantee. This may not be in the long term interests of promoting market acceptance of the sector as an issuer. However, a guarantee of the Intermediary has some justification given that it will be very thinly capitalised and seeking to transparently match its obligations under the bonds to those of the CHPs as its borrowers. This is akin to the guarantee that is provided to the Australian banks in support of their bond issuance programmes.

Government Policy and Regulation

Affordable Housing Policy Framework

Investors need confidence that government policy initiatives directly supporting affordable housing (such as rental subsidies), will not be subject to unexpected change will have a direct bearing on institutional appetite and will be reflected in the Intermediary's costs of issuance. A consistent policy framework provides confidence of a predictable risk profile for the asset class and reduces the credit analysis required for each new issue, thereby reducing the cost of investment to the investor and thereby, the borrower costs. The existence of a strong and consistent policy framework may also be a proxy for implicit government support for the bond issues.

National Regulation of Community Housing Providers

A single strong national regulatory system is essential in providing confidence for both government and investors. The continued existence of three separate regulatory frameworks will add to administrative complexity and ultimately the financing costs.

The Intermediary would currently be aggregating debt demand from CHPs across a number of states with slightly different administrative and regulatory regimes, supported by assets subject to these differing regimes. However, the bonds issued in support of the debt will be subject to a single term sheet. While it is not beyond the capability of good legal structuring to contractually harmonise these differences, it is more efficient to form one system across all jurisdictions. One regulatory regime would remove the extra layers of complexity these contractual arrangements create.

National Implications of the Intermediary

Though this Proposition Paper is sponsored by the NSW government through its Industry Development initiative for the Community Housing industry, scoping of the Intermediary has quickly pointed to a national scale. This is because both the minimum issue size and the geographic diversification that would maximise the efficiency of an aggregated financing require broad national focus. One state cannot generate adequate affordable housing pipeline on its own.

The Commonwealth has a critical leading role to play to harmonise the regulatory framework and eliminate the costs a disparate regulatory environment creates. This is particularly so, given that the Commonwealth is the ultimate beneficiary of any cost savings, as it directly or indirectly funds the majority of social and affordable housing. In addition, the national system's operation needs to be sufficiently flexible to evolve as the community housing industry and in particular the financial instruments become more sophisticated. In these circumstances, the regulators' financial review and engagement needs to be similarly sophisticated.

A stronger regulatory regime also requires improvements to its governance. It is unclear where responsibilities lie between the individual Registrars who report to their respective Ministers and the state / territory funding agencies. There is no independent oversight and no individual with responsibility for deciding upon or leading change. This will create uncertainty about the capacity for the Regulatory system to respond flexibly and swiftly to issues of systemic risk and changing operational environments. If the finance industry has reservations about the Regulator's capacity, the additional risk will be priced into the finance.

Features such as the ability of a regulator to facilitate step-in by qualified CHPs during events of financial stress provide confidence to the investors and rating agencies that government is invested in the viability of the sector. These factors will be reflected in the rating and pricing of the bonds. While the current national regulatory system does make registration conditional on inclusion of a 'wind up clause' (that requires community housing assets to be transferred to another not for profit or government agency) there is no information about the operation of enforcement powers and little publically available information until the late stages of the process. Furthermore, ruling out asset transfer to public housing bodies where the assets (and / or their rental cashflows) are used as security for the bond will be necessary. Equally, the visibility of the regulatory system needs to be enhanced through both publication of aggregated industry information and engagement with key stakeholders. The publication of more analytical reports akin to those issued by the English regulator, the Homes and Communities Agency, is recommended.

To attract private institutional finance to the affordable housing sector, the Commonwealth Government needs to immediately reengage with National Regulation and provide the leadership and direction currently lacking in the system.

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FITTING INTO THE REGULATORY LANDSCAPE: PROPOSED LEGAL AND REGULATORY STRUCTURE

The Intermediary vehicle will be incorporated as a not-for-profit company limited by guarantee. It will be established to raise both capital and funding, and to provide finance and related services to registered CHPs operating in Australia's social and affordable housing market. The company would seek tax exempt status and net profit would be reinvested into the company's business, with no distributions permitted to Members.

As a company limited by guarantee, the Intermediary would be classified as a 'public company' which is generally subject to a higher degree of regulation than a private company limited by shares. The Intermediary will hold an Australian Financial Services License (AFSL) and subject to regulation by ASIC. Because the Intermediary's purpose is the 'borrowing of money and the provision of finance' it will be required to register as a 'Registered Financial Corporation' for the purposes of the Financial Sector (Collection of Data) Act 2001 (Commonwealth). This imposes periodic reporting obligations to the Australian Prudential Regulation Authority (APRA). However, this is usually an accounting exercise, also covering information relating to the corporation, its executive team, related entities and the nature of its lending.

As a specialist financial intermediary, the company would have a financially experienced, independent, skills-based Board. These individuals would be recruited for their expertise in banking, the debt capital markets and credit risk, as well as additional experience in community housing, government or law. Its 'Members,' under the company limited by guarantee format, would be drawn from the proposed board membership.

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WHAT SCALE OF PROGRAMME WOULD ATTRACT THE INSTITUTIONS?

The need for scale has been identified, but what does scale mean in this context and how does it fit with the broad affordable housing demand? More importantly, what will attract the attention of the institutional investors?

Analysis of affordable housing need in NSW and nationally indicates that a national affordable housing expansion programme of around 100,000 dwellings over 10 years is required to maintain the existing ratio of available dwellings to households seeking housing. A programme of this duration and size is what is required to maintain the status quo and does not make significant inroads into waiting lists. Anything smaller amounts to a reduction in the existing level of support for social and affordable housing. (see appendix D: Basis for 100,000 dwellings over 10 years).

By consolidating this "business as usual" provision of housing into a committed long term affordable housing expansion programme, government will have essentially leveraged its existing housing arrangements to create the scale precondition for the CHP sector to engage with the institutional capital markets through the Intermediary, and gain access to the most efficient sources of funding.

How does a programme of this duration and size translate into an issuance task for the Intermediary, and the institutional investor market?

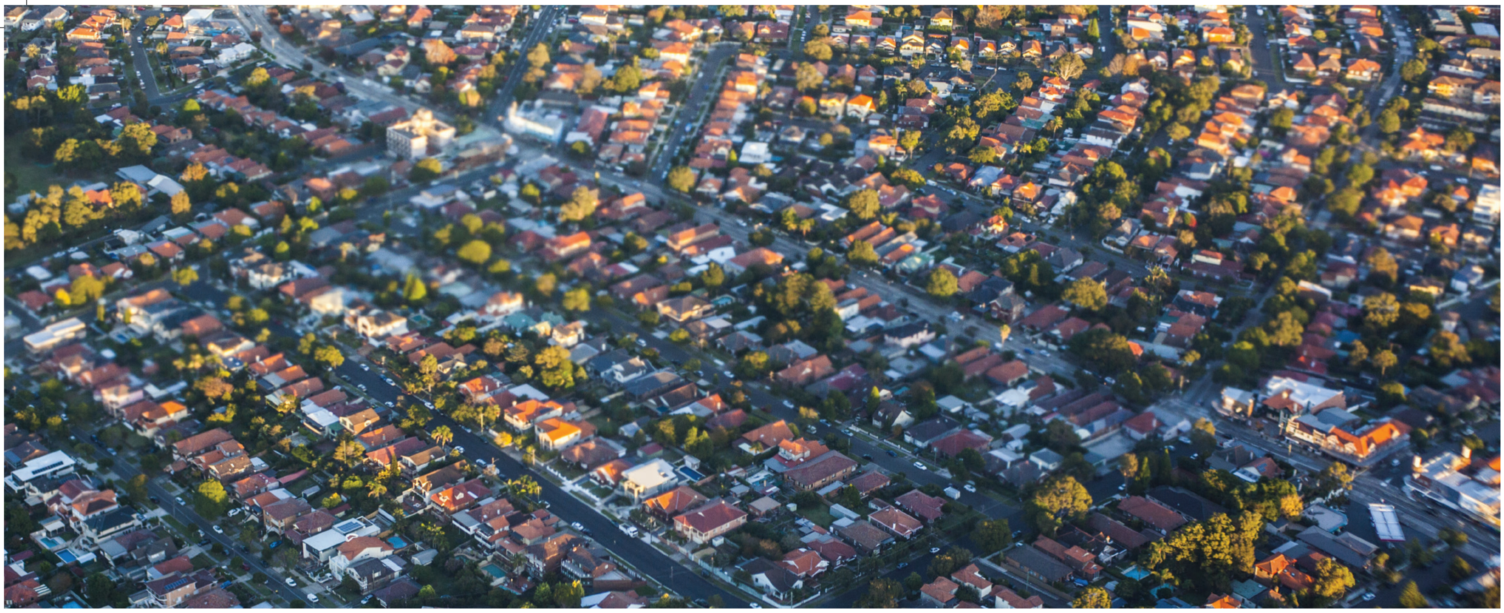
Using a simple assumption of an average dwelling acquisition price of $250,000, the annual capital requirement for the 10,000 dwellings would be $2.5bn. If we assume that 50% of this capital requirement is delivered via Intermediary bond issuance, the annual issuance task is $1.25bn, or $12.5bn over the 10 years of the affordable housing expansion programme. The balance would be delivered by government capital grant and other programmes.

A 10 year programme will mean that the Intermediary will need to regularly access the markets to issue bonds, and the bonds on issue will have a long term presence, since it is assumed the longest dated bonds will have a tenor of 20 years. This means that a 10 year programme will translate to a 30 year market presence for the Intermediary as an issuer. This presence will ensure the Intermediary's place as a familiar and established participant in the Australian debt capital markets.

To satisfy an annual issuance task of $1.25bn, the Intermediary will most likely make multiple issues each year. Each issue will be tranched into a range of maturities from short term to long term, to provide an amortisation profile for the debt over time. The bonds would be issued in Australian dollars with a fixed coupon, to eliminate foreign exchange risk and provide a fixed interest rate to the CHP borrowers. By building a maturity profile from the different tenors and issuing regularly into those maturities, the market will build a yield curve for the Intermediary's paper that reflects the CHP sector. This is powerful data for supporting the liquidity of sector's debt and supporting the new asset class that it represents.

The Intermediary will be more than a simple issuer of bonds to the market and the lender to the CHPs. It will be the representative and advocate of the CHP sector to the investor market. For this reason it is necessary that the Intermediary be an entity of substance with its own staff and capacity to manage the loans to the CHPs and the credit assessment and review process for the lending it undertakes. It will also manage the issuance process in conjunction with professional market makers. In this regard, it will largely reflect the structure and functionality of THFC in UK.

With an affordable housing expansion programme of this scale and an issuance programme to support it, the Intermediary will be an entity of credibility and substance and an institution in its own right in the capital markets.



For capital markets investors, the Intermediary offers:

- Access to a stable, secure, highly rated pool of long term borrowers via its bond issuance programme;
- Credibility and specialist knowledge and financial data on the CHP industry through the direct relationships with the sector;
- A robust new asset class and substantial long term participant in the bond index.

For the CHP industry the Intermediary offers:

- Access to the debt capital markets;
- Standardised lending terms;
- An entity established by the industry to serve their finance and growth needs, providing guidance regarding governance, structure and financial reporting standards necessary to borrow from the institutional markets;
- Credible representation of the CHP sector to the investor market, through a single specialist point of engagement.

For the government the Intermediary offers:

- A single, market credible point of engagement with the CHP sector through which policy can be implemented; and
- A credible party to manage the process of capital grant allocation to the CHPs via a contestable process, based on geographic need, as nominated by government. The capital grants would be linked to debt facilities provided by the Intermediary to CHPs to fund the necessary long term debt from the capital markets via bond issues by the intermediary. In this way the capital grant programme will generate the scale for the bond issuance programme and ensure the most efficient funding terms are achieved for the CHPs.

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OPERATION AND BENEFITS

The Intermediary will undertake full service credit and relationship management with the CHP sector and investor management with the institutional markets. To undertake these roles, it needs to become an entity of substance with staffing appropriate to its functions. While there may be a level of outsourcing of services initially, it is expected to move to full operational staffing rapidly following establishment. The concept of a fully outsourced, hollow intermediary is not recommended, because to have a market presence and credibility, the Intermediary must have the substance and capacity to function in the market in its own right.

Initial establishment costs will include drafting of full documentation to support employment, governance, and loan facilities to the CHPs, in addition to the initial annual recurrent expenses for employment, office and general administration. Estimates of initial establishment costs are:

- Initial entity establishment costs $ 5.0 m
- Initial annual recurrent operating costs $ 4.75m

Revenue for the Intermediary will be principally derived from issuance fees and loan margin fees. Issuance fees are charged to borrowers for each issue where they participate and are deducted from the funds raised. Margin fees are the interest margin over the bond coupon at which the intermediary on-lends to the borrowers and are payable over the life of the loan.

Financial viability depends on there being a sufficient volume of bond issuance and bonds on issue over time. Simple modelling, assuming annual issuance of $1.2bn (40% private debt funding of the $3bn cost of 10,000 dwellings), with issuance fees of 75 basis points (bps) and annual margin of 10 bps, indicates that the business will be cash flow positive within two years and will continue to generate strong income as the volume of issuance grows. In practice, this may take a little longer depending on the ramp-up assumptions for underlying dwelling acquisition/construction and hence the issuance volume in the early years will also increase. Where the Intermediary generates funds in excess of operating expenses, the retained earnings will be held as a first loss reserve that will enhance the credit worthiness of the Intermediary.

The benefits to the CHPs from borrowing via the Intermediary are expected to be as follows:

- Lower debt margins: As the Intermediary is not subject to the regulatory and capital adequacy requirements that apply to the commercial banks, and does not provide returns to shareholders, it has a lower cost structure and can operate on lower funding margins. The absolute margin over the appropriate term benchmark will depend on a number of factors including the credit rating achieved and the support levels provided by government, together with market conditions at time of issue. However the benefits of an aggregator can be illustrated by the most recent issue in June 2016 by THFC, which recently issued debt with a government guarantee and achieved a rate of 1.82%, a margin of 0.12% below gilts. While these circumstances are unique, in Australian terms this is equivalent to borrowing below the RBA benchmark.
- Lower issuance fees: Issuance fees are guaranteed to be lower than those offered by the banks, particularly when compared on an equivalent term basis. With bank debt averaging terms of 5 years, a refinancing of bank debt would be required four times during the tenor of a 20-year bond, with fees payable each time.
- Longer facility terms: Regulatory requirements constrain the banks in the term they can offer and are largely limited to a maximum of five to seven years. The Intermediary has no constraints and can provide funding at what ever term the bond investors are prepared to lend. For stable high quality credits, terms of 20 years or more are achievable. For example, THFC has achieved tenors beyond 40 years, although this length of term is rarely seen outside sterling and US bond markets.

- Fixed interest rates: Bonds are generally issued with fixed coupons which will translate into long term fixed rate debt, without the cost of swap transactions. This provides the CHP with certainty of funding costs on its projects, without the need to consider the impact of future variations in interest rates.

Once documentation and credit ratings have been established, further issuance becomes more efficient with lower costs for legal documentation and other components of the issuance process. This is where the benefits of scale will be achieved as the fixed costs of issuance will be amortised over increased issuance volume.

In general terms, as a specialist entity, the Intermediary is structurally a more efficient funding entity than the commercial banking sector. It is a thinly-capitalised pass-through entity with the lowest cost of capital; its not-for-profit status means it does not distribute to its members; its tax exempt status means there is no tax charge to be recovered within its fee structure; and as a transparent market intermediary, it can offer the tenor and terms available in the market directly to the CHPs with minimal incremental cost. However, this is only possible where sufficient scale can be achieved to access the capital markets.

By comparison, the commercial banks have a higher cost structure with an increasing regulatory requirement to hold capital against their risk-weighted assets and a need to earn a return on that capital. Other regulatory requirements also increase commercial banks' cost of funds. Furthermore, the need to more closely match asset life to their deposit terms limits the tenor of the loans that can be offered. Banks can provide efficient funding where short term, small scale funding is required and capital markets cannot be accessed, such as for construction facilities.

Based on a long term programme of issuance and achieving a minimum threshold issuance volume, the Intermediary can deliver these benefits to the CHP sector and be viable and fully funded from the fees generated from within the programme.

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SITUATING THE INTERMEDIARY WITHIN THE AUSTRALIAN ECONOMY

Establishing an Australian housing finance Intermediary in conjunction with a long term government programme for expansion of social and affordable housing stock will impact the Australian economy in three ways:

- It will create a new issuer of significant scale in the Australian capital markets, and create a new benchmark bond;
- It will act as a catalyst for consolidation and increased financial sophistication in the CHP sector with higher standards of financial accountability and market-responsive governance; and
- It will provide a stable, predictable base of residential construction that will smooth and normalise construction activity through economic cycles.

Impact on the Australian Bond Market

With annual issuance around $1.2bn and a programme over 30 years peaking at $12bn, the Intermediary will become a market institution in its own right. The significance of an issuer of this scale to the Australian bond market can be judged by reference to the existing size of the market.

Bonds on issue in the Australian bond markets total approximately $1,180bn and fall into three categories:

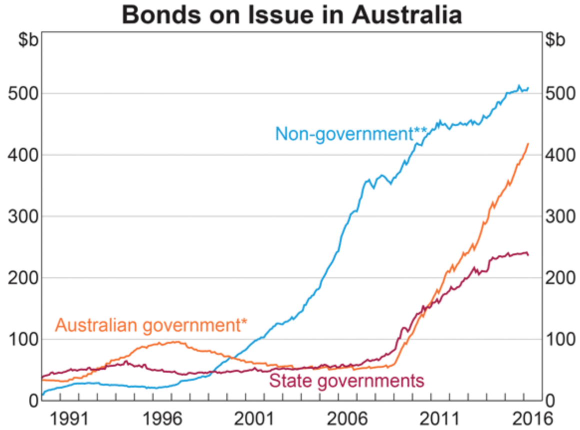
• Non-government	510bn
• Australian Government	430bn
• State Government	240bn
	$1,180bn

Non-government bonds on issue are further categorised into:

• Financials (largely banks and FI's)	170bn
• Non-Resident issuers	180bn
• Asset-Backed securities	110bn
• Non-Financial Corporations	50bn
	$510bn

The Intermediary's bonds will fall either into the Non-Financial Corporations or Asset Backed section of the Non-Government Bonds category, depending on the final structure. At approximately $12bn, the proposed issuance for the 100,000 dwellings programme would represent between 11% and 24% of these categories based on current volume of bonds on issue (Non-Financial - $50bn, Asset Backed - $110bn).

Bonds on Issue in Australia

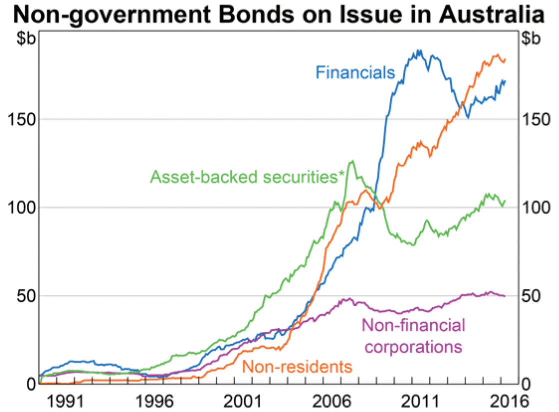


* Excludes bonds purchased by the Australian Government

** Excludes ADIs' self-securitisations, includes government-guaranteed bonds

Sources: ABS; AOFM; RBA; State Treasury Corporations

Non-government Bonds on Issue in Australia



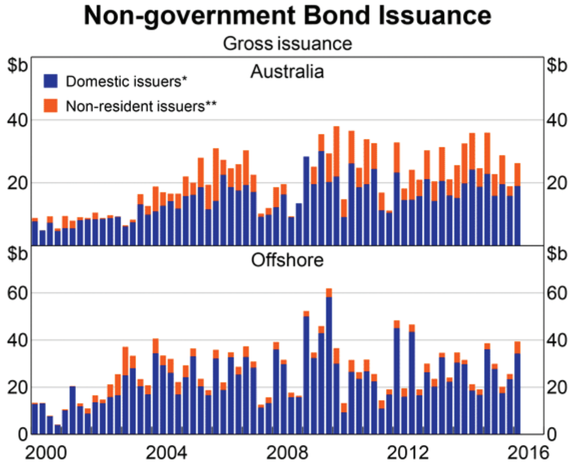
* Excludes ADIs' self-securitisations

Sources: ABS; RBA

In terms of annual issuance volume, the programme would average $1.2bn pa. Total non-government bond issuance by domestic issuers is approximately $173bn pa with approximately 60% being issued offshore. Annual issuance would represent a little under 2% of non-government annual domestic issuance.

These settings will make the Intermediary a substantial institution in its own right with sufficient scale and importance for its securities to be represented in all index based portfolios and ensure liquidity for its issues. In these circumstances, it is likely they will be purchased by foreign institutional investors seeking exposure to Australian currency risk and the higher interest rate yield compared to other currencies.

Non-government Bond Issuance



* Excludes ADIs' self-securitisations

** Offshore non-resident issuance includes Australian dollar-denominated bonds only

Source: RBA

Improved financial reporting and governance

The importance of maintaining investment-grade ratings for the bond issues will establish the financial and governance framework that the Intermediary must operate within. These ratings will ensure that CHP borrowers meet the high standards of governance, financial reporting and management required to meet the ratings criteria. The impact of this discipline across the CHP industry will result in a lift in the standard of sophistication and efficiency required by the sector. Failure to meet these standards will deny a participant access to the most efficient sources of funding and therefore create disadvantage for them. The improvements in operational efficiency and cost structure resulting from increased scale will cause the consolidation of the smaller CHPs with higher cost structures.

Economic stimulus of construction-smoothing and normalising activity

In addition to the primary objective of alleviating housing stress and reducing the housing waiting list, the economic impact of a programme for 10,000 dwellings per annum over ten years will be significant. A programme of this scale can be gauged by reference to the NBESP stimulus package as it is of a similar annual size, and delivered 19,600 dwellings over 2.5 years. Such a programme represents just under 5% of annual dwelling commencements. It will not impact or compete with sales or the supply of market based housing as these properties are not affected by the sale process. However, the length and stability of the programme will provide a level of base activity that will have a smoothing and normalising effect on the sometimes volatile cycles within the residential construction industry.

The Intermediary will become an institution in its own right, with influence in both the capital markets and the residential housing construction sector. A market-maker that both normalises an asset class in needed affordable rental housing and contributes to the depth of the Australian debt capital markets.

9

NEXT STEPS: ESTABLISHING THE INTERMEDIARY

This section sets out in broad terms the decisions and then tasks involved in establishing the Intermediary. It is not a comprehensive project plan. We make clear that unless the Commonwealth and (probably) State governments make a firm commitment to funding an affordable housing program the Intermediary is unnecessary. Alongside the Intermediary's establishment (and that of the government co-investment strategy) other desirable policy improvements should proceed; notably the creation of a truly National Regulatory System and the strengthening of its governance and practice.

1. The essential prerequisite for the Intermediary is a Commonwealth government announcement of a long term affordable housing expansion programme. Without a programme in need of funding, there is no need for the Intermediary. An announcement is essential in providing credibility and substance to capital market investors. The programme and the capital grant allocation process will provide the necessary certainty to enable investors and participants to engage with CHPs and the Intermediary. The programme will include a budget for the establishment of the Intermediary and its operation until its issuance and facility fees are sufficient for it to be self-sustaining.
2. We see the Affordable Housing Working Group of the Council on Federal Financial Relations providing a pivotal role in establishing the programme and assisting with the facilitation of the Intermediary. The Group has the benefit of being an existing expert body within government and is also able to leverage the work already undertaken. Working in conjunction with finance and housing industry leaders who have provided valuable input to the development of the Intermediary proposal, a working group can be set up to implement the establishment of the Intermediary.
3. Establishment of the Intermediary would commence with appointment of the Board and its CEO, who would oversee the preparation of the constitution and other governance and operational documentation, including incorporation, taxation and regulatory applications and registrations.
4. The timetable for establishing the Intermediary will be governed by the affordable housing expansion programme, although an initial proof of concept issue involving refinancing existing community housing sector debt may make it feasible to set up earlier – see below
5. Once the programme proposition from government has been determined, the Intermediary will work with government on the communication of the programme announcement to build and facilitate capital markets confidence through investor education.
6. Analytical work establishing indicative timing of debt demand will be undertaken:
   i. Housing facilitated by the programme;
   ii. Housing stimulated by current active programs: NSW SAHF, Communities Plus, leverage based upon long-term management transfer of social housing in several states.
   iii. Refinancing of existing CHP commercial bank debt: a kick-off issue or perhaps a 'smoothing' role in bond issues of the above activity.
   iv. Establish supportable private sector debt per dwelling based on available rental and CRA income.
7. Draft loan documentation between the Intermediary and CHPs.
8. Engagement with ratings agencies on credit quality of the Intermediary and the proposed issues.
9. Draft bond issuance documentation.
10. Book-building engagement with investors.
11. Security trustee process for properties to be mortgaged by CHPs.
12. Establish a relationship management system for each CHP.
13. Issue first bonds. Thereafter, recurrent, stable issues every year.

CONCLUSION

Establishing the Intermediary in the context of a long term programme for affordable housing expansion will be a critical part of the structural policy framework, delivery and management of social and affordable housing in Australia. It will provide the solution to the structural barrier that has prevented the affordable housing sector from accessing institutional finance. The Intermediary will create a new asset class and large scale issuer in the capital markets that will engage the superannuation sector and other institutional players, and facilitate financing of social infrastructure on the most efficient terms available. It will add to the depth and liquidity of the Australian bond markets and provide a significant base level of activity in the residential housing construction industry to smooth economic cycles. With the Intermediary in place, we can effectively address the long term social objective of eliminating housing stress with in the community.

The Financial Intermediary could compile independent, non-partisan data for the nascent affordable housing industry

Lack of investment data and track record is cited by institutional investors as a barrier to investment in aggregated rental affordable housing.

The National Housing Supply Council was established within Commonwealth Treasury from 2008 – 14. Its reports were widely cited as an underpinning source of industry demographic data by potential institutional investors. The body was eliminated in series of red-tape government department reductions in 2014.

The State and Territory Registrars of the National Regulatory System for Community Housing may start to embrace the role of promoting this aggregated, de-identified financial information as a means of promoting the community housing industry. Alternately, the proposed Housing Finance Intermediary could resurrect this function to increase data and investment certainty for potential investors.

APPENDICES

A. The Australian Housing Landscape

Australia has a documented housing problem. It has been developing over decades and shows no signs of improving on its own. Rental housing availability and affordability availability challenges lower income Australian households like never before.

ABS reports that fully 50.1 per cent of the lower income households in Australia who rent in the private market have housing costs greater than 30 per cent of their gross household income. This equates to around 657,000 low-income households across Australia in rental stress. Renters are forced to make trade-offs between other fundamental needs and may have limited mobility in pursuing training and economic participation.

Even further, there are 187,500 households on waiting lists for social housing across Australia and 403,767 currently occupied social housing dwellings. This equates to a ratio of 1.46 households seeking housing for every available social dwelling. Many more households are eligible for social housing but are not reflected on the waiting list.

If we are to address these problems, there is a need to increase the supply of affordable rental housing. NSW Premier Mike Baird has confirmed that increasing supply is the key to addressing rental housing affordability, and has taken brave steps to demonstrate how this can be addressed via the Social and Affordable Housing Fund (SAHF), Communities Plus, and future property transfer initiatives. This Intermediary is the next logical step that fits in to all these models. It will offer access to sophisticated cost-effective finance via the aggregation of these and other initiatives supporting affordable rental housing operation.

To give some perspective to the scale of the task, if we assume an objective of adding 100,000 dwellings of affordable rental housing over the next 10 years, and assume population growth at around 1.8% pa, then in ten years the waiting list will have increased to 202,975 while the ratio will have only reduced to 1.4 households per dwelling. In effect, this investment of $30-35bn would allow us to simply stand still in terms of the waiting list-to-dwelling ratio, and even then the absolute waiting list numbers will have increased.

Fundamentally, the facilitation of adequate housing to accommodate its citizens is an obligation of government. However, as with the provision of other government services, the participation of private sector operators, where possible, will provide efficiency benchmarks. Attracting private institutional investment into the sector has been seen as a pathway to the provision of efficient capital funding for new dwellings. However, despite various attempts through a number of temporary incentive programmes, the objective of sustainable long term institutional investment continues to elude us.

Substantial recent research and submissions in Australia have examined why this private investment has not eventuated. The most consistent themes identified have been:

- Scale/liquidity;
- Project financial feasibility; and
- Commitment of Government through consistent policy initiatives.

The issue of yield relative to risk is fundamental in this context and is the background against which all the other factors operate.

The Intermediary is the means of providing a point of contact between the non-profit affordable housing industry and the efficient sources of private finance in the debt capital markets. It aggregates that sector's demand for finance and provides a financially credible face to the institutional financial markets. It is designed to specifically address the documented barriers to investment in the simplest, most efficient way, based on both evidence and precedents most appropriate to Australia.

This initiative is timely. In fact, considerable evidence collection and market soundings have been undertaken recently by the Commonwealth government. The Treasury's Affordable Housing Working Group canvassed the concept of a debt aggregator in its Issues Paper published in early 2016. Of the over 70 public submissions provided in response, the majority support the development of a financial Intermediary. The establishment of the Intermediary provides the necessary next step of bridging between the comprehensive academic research and market sounding available to assess and advance the kernel of value to be exploited in the aggregation of non-profit rental housing financing.

B. Institutional finance of social and affordable housing: The Barriers to Investment

Yield

The fundamental barrier to private sector delivery of affordable housing is financial feasibility: investment in affordable housing does not provide comparable risk weighted returns compared to other asset classes. In fact, the returns are often negative.

Australian market rental housing has a low running yield and relies heavily on capital growth to supplement this. Property portfolios targeting social or affordable tenants are by definition rented significantly below market rents and capital growth can only be realised by trading in property from the portfolio, which leaves a tenant unhoused (contradicting the tenancy stability goals of the industry). Hence the raw yield is unsustainable to private sector investors and affordable rental homes cannot be built without some form of government support. This highlights the gap requiring government to either supplement the capital cost or the running yield.

Simply put, private investment is limited to the debt that can be supported by the available cashflow the affordable rental housing can generate. This is calculated by the rent and any other rental supplements that may be available, less operating expenses, maintenance and management costs, using a risk-weighted interest rate. The gap between the cost to provide rental dwellings and the supportable private debt is where the co-investment of government is required to facilitate construction.

The private sector debt calculated in this way is of high credit quality and a natural match for institutional investment that can be accessed by the Intermediary as proposed here. The debt is secured against the property, the underlying cashflows are underpinned by government benefit payments that can be directed through to the non-profit operator, and with substantial waiting lists, the vacancy risk is limited to the ability of the CHP to re-tenant a dwelling once it is vacated.

Scale and liquidity

Institutional investors like Superannuation funds need to invest at scale in tranches of $50 to $100m, while residential assets individually have values a fraction of that amount. In addition, there is a need for the assets to be packaged with appropriate management services since the institutional investor needs to be a passive, rather than active owner. In this context the requirement for an intermediary to aggregate portfolios of rental dwellings becomes clear. In the context of social and affordable housing, while there is already a level of aggregation of portfolios through the non-profit community housing sector (by state-regulated CHPs) for the provision tenancy and maintenance services, the debt demand of each CHP is sub scale for institutional investment. This sub scale debt has already resulted in debt margins, fees and loan tenors that are sub optimal and add to the cost of housing relative to the high quality cashflows that underpin the sector.

Likewise, institutional investors like super funds have liquidity constraints imposed by their regulators so they can respond to their members' ability to re-weight individual portfolios. Therefore, these large-scale investments must be liquid, or tradeable on short notice, or otherwise carry a liquidity premium to compensate.

What is therefore needed is a new market: establishment of a new asset class in portfolios of operating affordable rental housing. Market-making relies on scale of bond issues, investor acceptance of the underlying credit risk fundamentals, and normalisation of the asset class. Liquidity occurs when investors have a market where they can trade in an out of securities upon necessary re-weighting of portfolios. This market-making will only be possible over time upon recurrent regular issues of rental housing bonds by the Intermediary, or with other liquidity enhancements supporting this market.

C. Property Transfer: potential for leveraged finance through the Intermediary

One of the policies emerging across several Australian States for development of the non-profit housing sector is transfer of social housing dwellings to registered CHPs. Once tenants transfer their leases from the State to a private tenancy manger, the tenants become eligible for Commonwealth Rent Assistance (CRA) payments. The dwellings' asset and tenancy management will be conducted henceforth by the CHP, often with higher tenant satisfaction scores.

Once the modest cashflows generated by the social housing are supplemented with CRA, a modicum of debt finance can be borrowed by pledging those cashflows as repayment. These loans may then be used in turn to acquire or develop new affordable housing. But how much and can the Intermediary stretch this even further? Early hopes for leveraging 35 or 40 per cent new additional dwellings through title transfer of the Nation Building – Social Housing Initiative stimulus dwellings in NSW were found to be unrealistic. The social housing did not generate enough cash flow without cross-subsidisation by adding in further dwellings' rents. In reality, even with CRA and with CHPs holding title to transferred social housing, the cash flows are quite constrained and can only generate debt to fund new dwellings representing about 10 per cent of the transferred stock numbers.

More recent state property transfer initiatives in Tasmania, South Australia, NSW and Queensland have seen the States baulking at transferring title to the CHPs, opting instead for long-term management contracts. This is driven by the States' desire to retain ownership of the dwellings due to the value they represent on balance sheet, though this treatment may be currently under review.

Will management contracts constrain CHPs from borrowing if the lender cannot take traditional mortgage security over titles? The answer is in the term length of the management contracts. These management agreements, or long-term rights to the dwellings' net cash flow in return for provision of tenancy and asset management services, represent an "equitable interest" that is in many ways comparable to traditional property rights. Legal structuring can allow the bank or the Intermediary to take security over the management contract, or rights to that cash flow, as collateral for providing debt. But this is possible only if the term of the social housing management contracts is longer than the term of borrowing.

The Affordable Housing Finance Intermediary seeks to provide efficient finance that reflects:

a) the stability of the rental operating business that underpins it; and

b) the reasonable asset life of the underlying property.

Reflecting the parallel experience of the UK, the Intermediary ultimately intends to issue standard 30-year bonds. This reflects standard fixed-interest bond markets as well as the effective asset life of a well-managed residential dwelling that averages 35 years before requirement for major refurbishment. To lend at this tenor, underlying social housing transfers would need to be contracted at this term or longer.

The driver from a financial perspective is Loan Life Coverage Ratio (LLCR). LLCR is a ratio commonly used in project finance that is defined as net present value of cashflow available for debt service ("CFADS") /outstanding debt in the period. With management transfers that do not transfer title to the dwelling, only the cashflow within the term of the management contract will be considered. Therefore, the length of the property transfer contract dictates the longest tenor of debt acceptable to the capital markets. At the minimum tenor considered by the Intermediary of 20 years, property transfer management agreements would need to extend for 25 years. This is coincidentally parallel to the NSW SAHF's timeframe for recurrent affordable housing subsidy payments.

D. Basis for 100,000 dwellings over 10 years

Dr Judy Yates (Honorary Associate, School of Economics, University of Sydney; Senior Visiting Fellow, City Futures, University of NSW) has estimated that to maintain the (occupied) social housing stock at its current 4.8% share of the (occupied) dwelling stock in NSW, an additional 2,000 dwellings are needed each year. To ensure lower income households who currently face housing stress in the private rental market are affordably housed, a further 2,900 dwellings are needed in each year. In other words, a total of 4,900 dwellings is needed each year, or some 100,000 dwellings over the next 20 years. This translates to some 50,000 dwellings over 10 years for NSW, which is assumed to be approximately half the national housing demand.

Based on the Productivity Commission Report on Government Services 2016, at June 2015, there were 403,767 social housing dwellings across Australia, with 187,500 on waiting lists for social and community housing, making a total of 591,267 households seeking housing. This is a ratio of 1.46 households seeking housing per available dwelling. Assuming annual population growth of 1.8% pa over 10 years, the households seeking housing is projected to grow to 706,743. With an additional 100,000 dwellings, the ratio moves to 1.40 households per available dwelling. The ratio is essentially unchanged, notwithstanding the provision of the additional dwellings.

On the basis of these two analyses, it has been assumed that the provision of 100,000 additional dwellings over 10 years is a fair approximation of maintenance of affordable housing stock ratios.

E. Case study of The Housing Finance Corporation UK's history and recent borrowing structures

The UK government initiated the Housing Finance Corporation in the late 1980s as an aggregator to intentionally raise funds from insurance companies to expand social housing after a 'right-to-buy' initiative depleted social housing supply. The THFC was developed with the support of the National Housing Federation, the peak body for Housing Associations. The Housing Finance Corporation (THFC)'s CEO (Piers Williamson) refers to his company's business as 'fund-matching:' providing an interface for long-dated investment to flow through to stable long-term asset management in affordable rental housing.

The THFC is a non-profit, unregulated finance company which allows it to be extremely efficient and competitive in its pricing. Because it does not take deposits nor provide financial advice, it is not a regulated bank which would have a much greater staffing cost to manage the necessary compliance.

THFC works with fixed fees and no profits are distributed. Instead, surplus from operations is allocated to reserves that provide liquidity and buy time in the case of payment default. This limited capital - £25 million against a loan book approaching £5 billion is felt to be more than adequate. THFC's stable credit rating of A+ accommodates this thin but efficient capitalisation: a AAA rating would require higher reserves and be arguably too conservative.

The THFC internalises most of its functions. It performs all its own credit review and compliance monitoring, as well as book building and trustee functions arranging security for its bonds. Naturally there is a reliance on external legal advice, but otherwise, THFC eschews outsourcing other than IT and HR, which is also common across its Housing Association borrowers.

According to Williamson, it is important in initially designing an entity like the THFC that company structure is not too constrained, as business and policy priorities change. THFC's corporate structure, in fact, now comprises fifteen different companies, each of which issues different bond instruments.

The THFC had operated for over twenty years aggregating the debt finance demands of moderately-sized Housing Associations in the UK when the global credit crunch hit. It experienced no defaults and in fact grew: after the downturn, the THFC established subsidiary Affordable Housing Finance (AHF) to administer the UK's guarantee programme, with identical corporate governance and staff including CEO Piers Williamson.

The UK government established the Affordable Housing Guarantees Programme (AHGP) to provide credit support to £3.5 billion in lending to affordable housing providers between 2013 and 2015. The program was so successful in lowering the cost of borrowing and stimulating housing construction that it was ultimately extended by a year to 2016.

By May 2015, debt issues privately placed on behalf of Housing Associations were attracting interest rates lower than UK Treasury borrowing rates. By the end of 2015 the Programme had raised £1.4bn of extremely low-interest rate debt that fund 13,500 rental dwellings developed by 45 UK Housing Associations. The guarantee is a full 'belts and braces' underwriting for 30 years, and therefore will live until 2044. The guarantee is indeed on the government balance sheet as a note, but liability is zero, therefore has no impact, nor even any funds set aside for contingency.

The THFC doubled its staff to 19 people when it secured the administration of the government guarantee contract through competitive tender. The organisation is still incredibly lean relative to other specialist lending institutions.

In June 2016 AHF issued £27m in debt as a conduit on behalf of a single Housing Association for a price of 1.82%, which was 0.12% below the 'gilt' rate of UK government borrowing. This is the second fixed-rate transaction lower than 2% and the lowest to date. The funding was provided by the European Investment Bank (EIB), like many of the other bonds issued under the guarantee. The EIB funding features very long availability periods. This provides a long forward commitment of funding which provides flexibility during the construction period before new dwellings are tenanted.

While the THFC has no explicit government control on its board, in the Affordable Housing Company where a government guarantee is involved there are two government appointees on the board. The UK government took the decision not to extend the guarantee program further past 2016 due to its shift in policy focus toward entry-level homeownership away from rental. However, despite conclusion in March 2016, the program is allowed to issue guaranteed loans until the final funds currently under credit review are lent.

Piers Williamson said 'The AHGP was first developed at a time of housebuilding market failure. Today we see both a market arguably in rude health and changed governmental priorities in terms of tenure choice'.

F: Proposition Paper Methodology and Reference Basis

This Proposition Paper was commissioned to build upon extensive prior research into developing an affordable housing financial intermediary for Australian conditions. Its timing responds to the significant recent development of financial experience in the community housing industry and the alignment of focus on housing shortfall by the Australian Commonwealth and several state governments, notably NSW who funded this initiative via the NSW Federation of Housing Associations Industry Development initiative, and the Western Australian government who initiated research in this area in 2011.

The authors Philip Frost and Carrie Hamilton are responsible for this content. Each has extensive background in affordable housing finance both in Australia and overseas, and they bring background from the Australian commercial banking sector and community housing sectors in both property lending and debt capital markets to this initiative. The Financial Intermediary Proposition Paper was conducted through early 2016 and is based upon the following methodology:

1. Reaffirming international precedents established in the timely AHURI literature of 2012-14 publications
2. Conducting focused interviews to update community housing debt demand and debt capital markets finance conditions
3. Commissioning Corrs Chambers Westgarth to investigate the possible legal, regulatory and governance arrangements and constraints for a financial intermediary
4. Financial modelling of the bond issuance profile and indicative terms of debt and repayment based on researched CHP costs and lender financial assumptions,
5. Coordinating with industry and government groups throughout development including the NSW Community Housing Financial Officers Forum, PowerHousing, the Commonwealth Affordable Housing Working Group and the National Forum of Housing Registrars, and
6. Compiling evidence, cost/benefit justification, and proposed entity establishment and process into this Affordable Housing Financial Intermediary Proposition Paper.

The authors are grateful to the Financial Intermediary Reference Group members and other key stakeholders who have been continuously consulted through the initiative for timely input:

- Dr. Julie Lawson, RMIT AHURI centre, author of the three key academic papers that underpin this applied Business Case noted below along with on-going research
- Mr. Piers Williamson, CEO The Housing Finance Corporation, UK
- Many executives from the Community Housing industry, NSW, providing detailed case studies of current borrowing terms and social/affordable housing construction/acquisition/operating/administrative costs
- Mr. Richard Brandweiner, Chief Investment Officer, FirstState Super
- Mr. Kevin Roche, Partner, Greenstone Partners. Independent debt capital markets advisor
- Mr. James Waddell, National Australia Bank Director, Capital Financing Solutions in the debt capital markets including community housing and the Local Government Funding Vehicle in Victoria
- Mr. Chris Jones, Commonwealth Bank, Community housing lending
- Mr. Justin Minneef, Commonwealth Bank Director, Local Government Funding Vehicle aggregated Council bond issuance, 2015 – 2016
- Mr. Trevor Danos, former Partner, Corrs Chambers Westgarth, advisor on establishment of the National Regulatory System for Community Housing and NSW private lending tripartite agreements
- Mr. Jeremy King and Mr. Michael Capsalis, Corrs Chambers Westgarth Melbourne
- Ms. Maggie Smyth, acting Registrar of Community Housing, NSW
- Mr. David deCarvalho, Deputy Secretary Housing Policy, Department of Families and Community Services, NSW
- Professor Hal Pawson, UNSW and co-author of "Enhancing affordable rental housing investment via an intermediary and guarantee" (AHURI 2014)
- The NSW Federation of Community Housing Associations, providing deep support in industry cost benchmarking and administrative assistance

Research basis:

This Proposition Paper is not a stand-alone document. It seeks to advance recent academic research toward implementation based on current market soundings across the community housing, debt capital markets, and government sectors. Just as the proposed Financial Intermediary seeks to bridge the housing and finance spheres, this Proposition Paper is not an academic document but seeks to bridge the in-depth scholarship that precedes it with the contemporary debt capital markets in Australia. For further detail on the progression of research leading to this paper, please see the sequential AHURI publications in bold below among the other references consulted.

- **2012: "Housing Supply Bonds: A Suitable Instrument to Channel Investment Toward Affordable Housing in Australia?"** J. Lawson, J Yates, V Milligan. AHURI/RMIT Research Centre, May 2012. Final Report No 188.
- 2013, 2014, 2015 Annual reports. The Housing Finance Corporation, UK.
- 2013: "Financing and institutional arrangements for the provision of affordable rental housing in Australia" (Investigative Panel) V. Milligan, J Yates, H Pawson and I Vizel. AHURI/University of New South Wales Research Centre, March 2013 Final Report No 202
- **2013: "Positioning Paper: The use of guarantees in affordable housing investment—a selective international review,"** Lawson, J. (2013) AHURI Positioning Paper No.156. Melbourne: Australian Housing and Urban Research Institute.
- **2014: "Enhancing affordable rental housing investment via an intermediary and guarantee"** J. Lawson, M. Berry, C. Hamilton and H. Pawson. AHURI/RMIT Research Centre, April 2014. Final Report No 220
- 2015: "Next Moves? Expanding affordable rental housing in Australia through institutional investment" V. Milligan, H Pawson, P Williams, and J Yates. City Futures Research Centre, University of New South Wales, March 2015.
- 2016 Commonwealth Treasury Affordable Housing Working Group Issues Paper plus
- First State Super and multiple submissions to Commonwealth AHWG addressing an affordable housing financial intermediary

This Affordable Housing Financial Intermediary Proposition Paper prepared June 2016 by Philip Frost and Carrie Hamilton, sponsored by the NSW Federation of Housing Associations.

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