

Council of Federal Financial Relations

Affordable Housing Working Group Issues Paper

A proposal to increase appropriate long term investment in affordable rental housing in Australia¹

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Submitted to

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Focus of the submission

This submission addresses the very real and practical challenges associated with channelling private investment towards affordable and social housing by drawing on international experience and extensive national consultation.

One of the challenges is the level of rent that low income households can afford. For those on a low and fixed income, spending 30% of their income on rent implies an austere existence, with the remaining income stretching to cover basic food, utilities, health care and transport costs. Many low income tenants pay much more of their income on rent and they are living well below the poverty line and foregoing basic items.

A different but closely related challenge is faced by investors seeking a reasonable and competitive return – both large and small. With a range of much simpler investment options to choose from, what would attract them to invest in affordable rental housing? There is clearly a very substantial gap between affordable rents and a rent which allows for a sufficient return to attract investment at a scale that is required to substantially increase supply.

This submission addresses how this quandary can best be addressed, focusing on the role of equity, revolving public loans, lowest cost private finance and deeper forms of revenue support for households on fixed statutory incomes channelled via well-regulated not for profit landlords. In particular the submission charts a pathway from small scale sporadic investment in rental property driven by potential capital gains and inflated by negative gearing towards an affordable housing industry supported by a more virtuous circuit of strategic government incentives and private investment, using bond instruments (initially) underpinned by government guarantee raising longer term, lower risk investment in affordable housing managed by well-regulated not for profit landlords.

The submission draws on extensive international experience in the financial models which underpin social housing, involving experts currently managing intermediaries and guarantee schemes in the UK, Switzerland and Austria. The research process informing this submission has been funded by the Australian governments via AHURI and has involved extensive consultation with governments, the community sector and financial investors since 2010.

We would like to recognise the catalysing role of Housing WA, who have supported AHURIs investigations into European social housing finance systems, the supportive role of the Department of Human Services in Victoria in the development of housing supply bonds proposals and leaders of the THFC and BIC in helping to define a suitable intermediary and guarantee for Australian conditions. The authors are optimistic about the work of NSW in establishing a Social Housing Fund and elaborating an Affordable Housing Finance Corporation, with the NSW Housing Federation. Our hope is that their support and ongoing efforts will bear fruit nationally, as this is what Australian households expect and where the strength of the government's funding capacity can best be utilised and the collective effort of CHOs can be most effective.

Summary

Australia is facing a developing housing affordability crisis. Falling home ownership rates and a declining public housing sector are resulting in rising demand for private rented housing. However, existing market failure in the private rented sector means that increasing numbers of lower income and otherwise disadvantaged households are struggling to access housing suitable to their needs and resources. There is developing a structural shortage of low rent dwellings in Australia's cities and regions. This has very real and adverse implications for the living standards of affected households, and broader negative impacts on the productivity and competitiveness of the Australian economy.

Efforts to date to stimulate the growth of a robust, expanding non-profit housing association sector based on attracting large, continuing flows of private investment have had only modest success. There is a need to bridge the gap between what professional and institutional investors require by way of risk-adjusted returns and the capacity of well managed and regulated non-profit housing associations to fund sustainable affordable rental provision, while ensuring that rents charged are affordable by those currently priced out of the market.

In this submission we:

- (a) Specify the incomes of low income households priced out of the rental market and define **the gap** between the affordable rents they can pay and the market rents investors demand
- (b) Outline the various **policy tools** and financing instruments advanced countries use to address this gap;
- (c) Detail the requirements of **Bonds** designed to expand the supply of housing available at sub-market rents to eligible households in need, which can targeted towards either public, retail and institutional investors or a mix.
- (d) Outline a simple **funding mechanism** targeted to institutional investors which aims to deliver a regular pipeline of AAA-rated bonds to investors and pass on lower cost finance to CHOs.
- (e) Detail the creation of an independent, non-profit financial intermediary – the **Affordable Housing Finance Corporation** to pool the borrowing demands of not for profit providers, issue bonds and efficiently pass on the benefits in terms of lower cost longer term cost investment. The AHFC would be governed by a professional board to which directors are appointed, drawn from the financial and legal sectors, government and the non-profit housing sector. This body would report regularly to Parliament to ensure that the taxpayers' interests are protected.
- (f) Argue why a carefully crafted, **capped government guarantee** should be established to build a new asset class quickly and

efficiently, as in Switzerland and the UK that operates as a “last call” or backstop reassuring bond investors that they will receive coupon payments and debt redemption.

- (g) Details that in order to **minimise the risk** that the guarantee will be called upon, a series of “first-call” reserve mechanisms must be put in place to protect the taxpayer.
- (h) Key elements described in the preferred model are based on schemes now operating **successfully in the UK and Switzerland** which underpin the delivery of affordable rental housing alongside **suitable levels of equity support and revenue assistance via regulated not for profit landlords.**

IN SUMMARY, It *is* possible to design and implement a new policy regime and institutional mechanism able to substantially **boost private (notably, institutional) investment** in expanding the supply of affordable housing in contemporary Australia. However, strong, strategic government leadership is required. International experience over decades has demonstrated this fact. Government can get “more bang for its buck” in this field by sensibly leveraging its strong credit rating in the way the AHFC approach entails but it must also ensure that the growing non-profit housing sector is able to make use of the low-cost debt provided through this mechanism by way of **matching capital and revenue support**, as outlined in the preferred model.

A proposal to increase appropriate long term investment in affordable rental housing in Australia²

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Australia in context

Few material concerns are more important to Australians than the homes they live in.³ Secure, affordable housing contributes to our sense of security, individual wellbeing, health and supports family stability. Affordable housing provides households with the capacity to access other life needs such as education, recreation and access to employment opportunities. It is not only important to overall community well-being but also economic stability and growth.

Despite the importance of housing, regrettably the lack of affordable housing continues to be one of the most persistent and corrosive problems eroding the quality of life amongst Australian households over the last quarter of a century. The work by the Australian Housing and Research Institute (AHURI) and the National Housing Supply Council (NHSC) tells us that the great Australian dream of secure, affordable home ownership is now fading for many households. Today, almost one third of all children are part of a household that rents their home (Hulse et al, 2011:37-39). The implications of this trend are multiple. While families with children have borne the brunt of housing stress and involuntary mobility, couples without children are also having difficulty moving out of rental accommodation and maintaining home purchase obligations in order to advance their housing aspirations (Hulse et al, 2011, Wood and Ong, 2012)⁴.

As Australian society ages, older households will increasingly meet the cost of aged care by drawing on their accumulated housing wealth (Productivity Commission, 2011). Obviously this is not possible for renters. Outright ownership amongst over 65s is anticipated to decline by 10% by 2046 (Yates and Bradbury, 2010 in Wood and Ong, 2012; see Table 1). Hence, sub-standard care and poverty looms close for many elderly private renters (Morris, 2009) and those with outstanding mortgage debt on retirement. Clearly, keeping down the costs of rental housing amongst low income tenants and building bridges to affordable home ownership⁵ reduces their chances of living in poverty in old age.

This submission to the Council on Federal Financial Relations Working Group is about how to grow an appropriate and responsible range of housing choices for Australians by better

² This submission is based on research carried out over many years by the authors and others, supported by the Australian Housing and Urban Research Institute and the WA Government. A list of relevant reports is appended as Attachment 1. This research and other sources are cited throughout the text of the submission. The "Guarantee" report on which our preferred model (see final section of submission) is drawn from Lawson et.al, 2014.

³ Senate Enquiry into http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Former_Committees/hsaf/report/c02#c02f8

⁴ A list of relevant research documents is included as Attachment 1. All references cited in the text are detailed in the Bibliography.

⁵ While not a focus on this Submission, there is a real opportunity to build bridges to home ownership via CHOs. In many schemes in Austria and the UK, tenant equity contribution and mortgage rent staircasing are the norm. The WA Government's Opening Doors scheme is also a pioneer in this regard and there is real potential for models to evolve in partnership with Australian CHOs across Australia.

utilising the tools at government's disposal and harnessing circuits of savings and investment via the superannuation sector, to the benefit of the nation's housing future.

Table 1 Declining rates of ownerships across Australian households

Home ownership rates by age of household reference person, Australia 1961-2011											
Age	1961	1966	1971	1976	1981	1986	1991	1996	2001	2006	2011
15 - 24 years	34	30	26	25	25	26	24	22	24	24	25
25 - 34 years	60	58	56	60	61	58	56	52	51	51	47
35 - 44 years	72	71	71	73	75	74	74	70	69	69	64
45 - 54 years	75	76	76	76	79	79	81	79	78	78	73
55 - 64 years	78	78	79	78	81	82	84	83	82	82	79
65 years and over	81	80	80	75	78	80	84	82	82	82	79
All households	72	70	69	68	70	70	72	69	70	70	67

Source: Yates 2011 (for 1981 to 2006 data); data for 2011 provided by Yates (based on the ABS most recent 2011 Census).

Research by AHURI and the NHSC confirms that:

- House prices are rising faster than incomes
- Home ownership is declining amongst young and established pre-retirement households
- There is a falling share of social housing available
- There is increasing pressure on rental markets
- Affordability problems are stubbornly persistent
- Cities are becoming more socially polarised
- The market is not responding
- There are growing and well documented shortages of housing, particularly at the affordable end of the rental market.
- Failing housing markets threaten productivity and growth potential
- Low income earners are now living far from job rich inner cities, spending much more on transport and long commutes and cities have become much more polarised.

Existing market processes are having a negative impact on Australia's ability to adequately house not only its current population but also future generations of households. The benefits of rising house prices have not been shared evenly and the trickling upwards of housing wealth is diminishing social and inter-generational equality. Driving housing stress and social polarisation is the lack of support for a well-focused supply strategy and continuing reliance on tax incentives that fuel over-investment in existing housing. Reform of these market defining tools is well within the grasp of good government policy. National leadership can promote more beneficial market processes and more socially inclusive, sustainable and productive housing outcomes for all.

The rental market has the potential to provide an important refuge, oasis and stepping stone for an increasing number of households. However, compared to other advanced economies Australia's rental housing is the least secure and most neglected pillar of our housing system (Hulse et al, 2011). Our welfare system is not design with renters in mind and many pensioners are renting in poverty.

A modernised Australian housing policy would support and expand housing choices for a range of households. It would be implemented and co-ordinated across relevant government agencies responsible for implementing urban plans, social welfare policies, as well as improving labour market productivity, economic stability and environmental sustainability.

It is now well recognised that current provisions, such as the negative gearing of existing rental properties, entice small scale investors to make highly geared, speculative investments in existing dwellings. This has fuelled price rises in established areas and undermined the secure occupancy of tenants they house (Wood and Ong, 2010). The risk posed by speculative investment by self-managed superannuation funds has also been raised as a cause for concern by the Reserve Bank (RBA, 2013).

Alongside taxation conditions fuelling investment in *existing* housing are the high development costs of new housing on a constrained urban fringe, where revenue strapped local governments lack the capacity to develop infrastructure in advance. Upfront development fees directly impact 'first generation' purchasers, rather than being shared across a wider spatial area and longer time frame. The relatively high cost of new housing in less established or accessible locations compared with existing homes, coupled with high transport costs, has in turn influenced the pace of new construction on the fringe. Inadvertently, metropolitan strategies prioritise expansion of housing development in job poor areas (Rawnsley and Spiller, 2012:135).

Increasingly the design and focus of these measures are being questioned by experts (see Wood and Ong, 2010, 2012, Milligan et al, 2012, Berry and Williams, 2011, Yates, 2012, Rawnsley and Spiller, 2012, Gleeson, Dodson and Spiller, 2012 amongst many other experts) and given critical attention by media commentators (Gittens, Kohler, Joye, etc). As in the 1980s, housing issues have led to the formation of numerous stakeholder alliances such as Australian's for Affordable Housing, Housing Summit, Urban Alliance and generated numerous parliamentary Inquiries at state and Commonwealth levels.

However, the Australian government is yet to develop a comprehensive response to these conflicting pressures.

Before its abolition, Australia's National Housing Supply Council found that up to 20,000 new social and affordable dwellings are needed each year for the next 10 years just to retain a modest five per cent share of the social and affordable stock in Australia (Australian Government, 2009 see also subsequent updates to 2013 now online).⁶ The cost of meeting this would amount to around \$7 billion per year, based on a median cost of \$350,000 per dwelling (Lawson et al, 2012).

With declining public finance allocated for public housing, it is essential to attract private finance to expand supply overall in the rental housing sector and in particular guide lower cost investment towards new affordable rental housing provided by landlords with a mission to provide secure decent quality, affordable rental housing. This requires much more carefully designed public measures and mechanisms to ensure that investment reaches landlords which share this commitment, such as not for profit community housing organisations (CHOs) that serve a range of households from young people at risk of homelessness, to people with disabilities and key workers in high cost urban locations.

⁶ The estimates are based on combining projections of future household growth with the increases in dwellings that would be needed to address the estimated current shortfall over a 10 year period (Australian Government 2010: 89).

Co-operative national leadership, with a long term commitment to expanding affordable rental supply is needed to expand and secure long term and appropriate investor interest in affordable rental housing.

Recent efforts have been welcome but are not sufficient on their own. The social housing initiative (SHI) directly lifted affordable rental output by 20,000 dwellings but ongoing efforts have been very disappointing. The National Rental Affordability Scheme (NRAS) offering tax credits for below market rent dwellings for 10 years produced thousands of dwellings and generated interest in investment in new supply from individual investors but has been abolished.

What is required are sustained policy enhancements that recognise the potential of a well regulated not for profit sector (including legislated limited profit business models as defined in Austria, Switzerland and the UK) and investment portfolio needs of institutional investors in order to unlock much greater volumes of investment and channel these towards efficient, mission-driven affordable housing managers, such as not for profit community housing organisations.

National leadership can be demonstrated by governments acting as both an enabler and investment partner. In housing this could entail tax incentives for additional affordable and sustainable housing (via the continuation of a relaunched better targeted version of NRAS) plus government guarantees backing investment to reduce perceived risk, as well as equity contributions in the form of subordinated public loans or government land. Strategic actions such as these would channel lower cost institutional investment to appropriately regulated landlords serving the housing needs of those households not met by current market processes.

IN SUMMARY, well-founded, evidence-based research shows that Australia lags European and North American countries in recognising the scale and severity of housing affordability problems. Governments in Australia have begun to address the complex issues entailed but have, to date, lacked the sustained leadership and determined policy innovation necessary to make a significant positive impact. Rental housing markets in Australia are failing to deliver acceptable social and economic outcomes, putting at risk the wellbeing of current and future generations. Our social welfare net does not anticipate high housing costs, as experienced by many low income tenants in the PRS. This state of affairs has not arisen because of a lack of sensible options; successful approaches are in place and working on other countries. Indeed, Australia is an outlier in the group of OECD countries in this respect. The impact of the global financial crisis has made governments everywhere sensitive to the impact that poorly regulated housing markets can have on national economic performance. Organisations like the International Monetary Fund, OECD, World Bank and the World Economic Forum have stressed the need for national governments to monitor and, where necessary, intervene in housing and financial markets in order to prevent those markets from failing in ways that would undermine the growth and stability of their economies and exacerbate inequality.

The remainder of this submission concentrates on what governments can do to facilitate desirable outcomes from the housing system.

Defining the gap between affordable rents and reasonable market returns

The Issues Paper defines affordable housing as:

that which reduces or eliminates housing stress for low-income and disadvantaged families and individuals in order to assist them with meeting other essential basic needs on a sustainable basis, whilst balancing the need for housing to be of a minimum appropriate standard and accessible to employment and services.

It focuses on private investment to address the necessary supply of affordable housing.

For the purposes of a well-defined and delineated funding model, it is important to define the key parameters “low-income and disadvantaged families and individuals ... and housing stress”. This is important when defining a feasible level of private investment alongside other tools and subsidies.

As mentioned clearly in the Issues paper:

The ABS reports that, of the around 3.6 million lower income households⁷ in Australia, 26.8 per cent had housing costs that were greater than 30 per cent of their gross household income. 40.3 per cent of low income households with a mortgage had housing costs of above 30 per cent, compared with 50.1 per cent of renters. This equates to around 657,000 low-income households across Australia in rental stress and around 318,000 low-income households in mortgage stress.

Getting down to detail ,the ABS also defines the average weekly equivalised income of low income households in 2011 as being \$475 per week. In its latest release the ABS defined this as just \$407 in 2013⁸. Most low income households are reliant on Commonwealth pensions. The weekly statutory allowance for single job seekers is \$262, for Aged Pensioners \$433 and single parents with one or two children \$531. A couple without children who own their own home on retirement and drawing on their aged pension entitlements would be quite comfortable on the OAP as it was designed with owners in mind (Castles, 1998). However, as stated clearly in the Issues paper, many renters reliant on statutory allowances are now in poverty.

According to the ABS (2011), one in four low income households in Australia rent their home in the private rental sector and only 1 in 14 of these households have access to the public rental system. Given the relative size of the community housing sector, the proportion accommodated there is very small. The mechanism for setting rents across the rental sector

⁷ To enable analysis of various tenure groups in the ABS Housing Occupancy and Costs publication, a lower income group is formed comprising the 38% of people with equivalised disposable household income between the 3rd and 40th percentile. This group is referred to as lower income households.

⁸ See 6523.0 - Household Income and Income Distribution, Australia, 2011-12 <http://www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/6523.0Main+Features22011-12?OpenDocument> and also the later release in 2015 of 6523.0 - Household Income and Wealth, Australia, 2013-14 <http://www.abs.gov.au/ausstats/abs@.nsf/Lookup/6523.0main+features12013-14>

vary, with the private sector setting market rents sensitive to vacancy rates and demand, the public sector setting market rents but gearing rents charged to incomes and the community housing sector increasingly setting rents at 75% of market rent.

With home ownership declining amongst older age cohorts (Yates, 2015), it can now be said that Australia has moved into an era where ownership on retirement cannot by any means be a certainty. Thus, either pensions need to be supplemented, the affordable housing system developed and boosted or a strategic mixture of both. This paper argues a mixture of both with the important growth in affordable housing assets.

We assume an affordable housing industry that would target those households which the current private rental market is not adequately serving. This mission driven industry would enable low income households to access decent housing such as single people and families reliant on a fixed statutory income. These households include young people looking for work who may be eligible for Newstart Allowance, single people over 65 years reliant on the Aged Pension and single parents receiving the Single Parents Benefit. They may also include working households on low casual incomes.

In order to design an effective affordable housing system accessible to these low income households, it is important to recognise their constrained capacity to pay rents, as this helps to define what is required in additional tenant revenue to make affordable housing projects viable. Often low income households are reliant on temporary, casual or low paid work. For those outside the workforce, their statutory incomes are fixed, as defined by social assistance payments such as Newstart, the Age Pension and single parent benefits, and do not follow closely market changes and differences in housing costs across regions and locations. Indeed, statutory incomes are not linked in any consistent way to the cost of providing decent housing in the private rental market and this is why renters are often in housing stress.

Below we consider the income of Newstart, Age Pension and Single Parent recipients in relation to the rents they are able to pay if the 30% benchmark was adhered to, keeping in mind that sufficient residual income must be left over to provide for basic needs such as food, utilities, health care and transport. Also detailed are the levels of rents anticipated by investors in the PRS.

A number of assumptions have been made: the average cost of a new one bedroom dwelling is estimated to be \$350,000 and a new two bedroom dwelling \$400,000. It should be noted that non-profit organisations can only charge 75% of market rent as per an ATO ruling affecting charities. Further, it is assumed that investors would anticipate a 5% rental yield. Maximum rates of Commonwealth Rent Assistance have been included and current base level pension and benefit levels are assumed.

Table 2 Household income, affordable rents, market rents and the shortfall

HH	Pension	CRA.	Dwelling cost	MRW 5% yield.	HARW 75% market	AR 30%+CRA	Shortfall HARW- AR	Shortfall MR-AR
Weekly \$								
Single Jobseeker	262	65	350,000	336	252	78 + 65 = 143	118	193
Age Pensioner	433	65	350,000	336	252	130 + 65 = 195	57	141
Single Parent with 1-2 child(ren)	531	75	400,000*	385	289	159 + 65 = 224	107 65	161

MRW Market rent per week, HARW Housing Association rent per week at 75% MRW, ARW Affordable rents per week at 30% of Pension plus CRA, CRAW Commonwealth Rent Assistance per week. *Assuming a two bedroom dwelling for a single parent household.

Thus, if a 5% yield were to be derived from dwellings based on approximated market costs, and rented to low income tenants, receiving Jobseeker allowance plus CRA, there would be a shortfall of \$118/week between what the tenant could afford to pay and the a modest yield anticipated by the landlord. In order to pay the full market rent, based on 5% yield from value, he or she would have to crowd the one bedroom dwelling with an additional tenant who is also able to pay affordable rents. This helps to explain the overcrowding situation that many young low income people in major cities around Australia find themselves (Hulse et al, 2011).

A similar financial predicament faces single retirees reliant on the full Age Pension. A private landlord expecting a modest return on the property investment and accommodating an older single tenant reliant on the full pension, would require him or her to pay 67% of their income (pension plus CRA) on rent, leaving the tenant with only \$162 per week for food, utilities, medical expenses, etc.

In the third case of the single parent with one or two children, to pay market rents, would require 63% of their income (including CRA), leaving \$221 per week for all the basic necessities of a family. Again this situation is common amongst single parents of young children in the private rental sector (Hulse, et al, 2011).

It should be stressed that these are indicative calculations and do not include any supplementary benefits that some people in these case categories may qualify for.

In order for this substantial housing stress to be either “reduced” or “eliminated” (CFFR, 2016:3) the Commonwealth government needs to add a new stream of income subsidy for certain households at the bottom end of the housing market and channel this via landlords providing affordable rental housing (charging 75% of market rent) in the not for profit sector. Such a subsidy could be targeted and should reflect regional differences in rent levels in order to avoid dead weight costs to government if, for example, they simply increased CRA universally.

Increasing rent support and channelling this through appropriate landlords will also lower the cost of private finance as the revenue to repay debt is much more secure – statutory payments are, in terms of a revenue base for landlords, government guaranteed.

This revenue support could be delivered via a direct operating revenue supplement paid to regulated providers or new form of NRAS. What is needed is an annual rental subsidy at about the level of NRAS (at least \$10,000 per dwelling per year indexed) paid directly to the not for profit landlords over a minimum 10-year period, matching a long dated bond term (to fit with the proposed low yield housing bond discussed below).

Such a level can be justified by pointing out that the Defence Housing Authority (DHA) provides a 50% rental subsidy of (on average) \$15,000 per year to house service personnel. Such a subsidy would also cover the shortfall outlined in the Table above in most cases.

However, in order to borrow to supply more housing, the Housing Associations must have an adequate equity base from which to leverage funds from. In order to build up that equity base they can mix income groups – low to low-middle (bottom two income quintiles) – **and** access our proposed low yield (guaranteed) housing bond.

From this starting point, this submission addresses how this gap can best be filled, focusing on equity, revolving public loans, lowest cost private finance and deeper forms of revenue support for not for profit landlords.

Policies to increase affordable rental supply

The private rental housing sector in Australia has been sizeable (around 20–25% or more of occupied dwellings) since the 1960s but it has operated in policy and market contexts that have favoured individual rather than large-scale, long term investors. Typical investors in private rental housing are individuals or families owning their own home and renting out one or two further properties.

Traditionally, social housing in Australia was funded through public grants and public loans to State Housing Authorities and Community Housing Organisations. However, investment through these means has been in long term decline, resulting in new supply levels falling well below household formation rates. Today, Australia has one of the lowest rates of social housing amongst advanced economies, including the US. Unlike the US, it has not developed a sustainable investment stream such as the Low Income Housing Tax Credit or Austria's Housing Construction Convertible Bond. Nor has it established a market for longer term lower cost private investment, such as Swiss Bond Issuing Co-operative or The Housing Finance Corporation in Britain. Despite almost 20 years of Australian research on models to boost investment, surprisingly little has been done and Australia now lags sorely behind other OECD countries.

In the past, under a social housing subsidy program, the Commonwealth government has determined to:

subsidised efforts by Eligible Providers to raise additional funds, through gearing, for the provision of an increased level and range of housing services for low and moderate income households. (Department of Housing and Regional Development, undated) ⁹

Programs such as the Local Government Community Housing Program (LGCHP) played a catalysing role, supporting partnerships between key stakeholders and promoting innovative responses to local needs. A brief return to supply policy in 2009-2012 generated 19,700 dwellings and repaired or maintained a further 81,000 dwellings as part of the successful Social Housing Initiative under the National Partnership Agreement on the Building and Jobs Plan. Housing supply subsidies directly addressed homelessness and built accommodation for people with disabilities, the elderly, Indigenous households and those fleeing domestic violence. Subsidising supply directly also had a strong economic multiplier (1:1.3) generating up to 14,000 jobs (9,000 in construction) and boosting Australian Gross Domestic Product (GDP) by an estimated 10 basis points during 2011-2012 (KPMG, 2012).

The LGCHP program and the recent Social Housing Initiative (SHI) stimulus, both of which gave a strong impulse to supply, no longer exist. The National Rental Affordability Scheme (NRAS), while a very important new tool for attracting investment, had just begun to generate suitable levels of interest from long-term institutional investors when it was abolished.

Unlike many European and US schemes established over the past 25 years, Australian efforts orchestrated by various governments to attract institutional investment into rental housing have been 'piecemeal and fragmented' or have lacked essential policy support. Milligan et al. (2009) argued that growth in affordable housing necessarily requires a long term investment path involving a substantial commitment of dedicated public funds coupled to forms of cost-effective private financing. Since 1996 disinvestment in social housing has occurred (Australian Government 2009, p.135). The previous Rudd Government, as noted,

⁹ See National Partnership Affordable Housing, Social Housing Subsidy program http://www.federalfinancialrelations.gov.au/content/npa/housing/social_housing_subsidy_program/NP.pdf

made positive moves to address the identified shortfall in affordable rental housing in Australia via the successful Social Housing Initiative and the National Rental Affordability Scheme (NRAS). However, many organisations with NRAS allocations have been unable to obtain private finance at any cost (Lawson, et al 2014). Additional measures are required to channel and sustain adequate levels of private finance to achieve adequate supply targets.

The vast bulk of Australia's social housing is public housing developed in the period 1945-1980. Provided by state and territory governments, this was financed through long-term low-cost loans via the Commonwealth Government. However, to the limited extent that new social and affordable housing has been developed over the past 10-15 years, it has increasingly involved not for profit providers rather than state governments themselves. At the same time, there has been an assumption that private financing (or 'leveraging') will form a component of the package. This may take place either:

- directly – e.g. private finance secured by a community housing organisation to match public funding in underwriting a particular scheme, or
- indirectly – e.g. community housing organisation raises finance to underwrite wholly privately funded affordable housing as a complement to, and condition of, receiving wholly publicly funded housing.

The first of the above approaches is exemplified by the Victoria State Government program committed in the 2007/08 State Budget, whereby \$300 million was earmarked for not-for-profit organisations to build 1,550 new dwellings predicated on the CHO contributing 25% of capital costs (Victoria Auditor General, 2010).

The second of the above models is demonstrated by the 2008 Social Housing Initiative (SHI) as implemented in NSW. Here, the state government directly constructed 6,000 dwellings under the stimulus program, with these wholly publicly funded dwellings being subsequently transferred into not-for-profit CHO ownership in return for a commitment that recipient landlords would then borrow new funds based on the transferred units' cash flow. The borrowed funds would then be used to construct or purchase privately funded dwellings approximating to 20% of those originally received (KPMG, 2012). The asset transfer aspect of this policy was predicated on the assumption that with a larger balance sheet, CHOs would become more attractive to lenders. Further, the cash flow from the transferred Nation Building dwellings could support debt that could be used to purchase or construct the leveraged dwellings.

The only national funding program for affordable housing currently ongoing is the National Rental Affordability Scheme as initiated in 2008 to stimulate the development of 50,000 dwellings by 2016. Given that NRAS support comes via (time limited) annual payments rather than capital subsidy, there is again a requirement for privately raised development funding. The recurrent NRAS subsidy (which still has a few years to run), which is paid in cash to not-for-profits, is in this way designed to be leveraged as the basis for private bank lending.

Given the funding and policy context outlined above, access to private finance is essential to not-for-profit housing agencies aspiring to develop (or, indeed, acquire) new stock. In doing so, they will be looking to minimise costs through achieving the lowest possible interest rate with favourable terms attached by the lender.

However, encouraging an adequate flow of investment into the supply of affordable housing in Australia remains a major challenge for CHOs and concerned governments (Berry and Williams, 2011, Milligan et al, 2013, Lawson, et al, 2014).

An appropriate balance of supply and demand side subsidies will be required on a long term basis, with the balance to be adjusted over time to reflect dynamic housing needs and

market conditions. The following section of this submission concerns the type of mechanisms successfully employed in other countries, such as housing bonds and specialist financial intermediaries and guarantees. A later section adapts aspects of some of these approaches to Australian institutional and market conditions.

Established funding mechanisms internationally

AHURI research¹⁰ has examined growing international experience in steering private investment towards affordable rental housing through well designed government regulations tax incentives and subsidies. Private investment does not flow towards loss making affordable rental housing for low income households. It needs other supports as well, such as grants, discounted land allocations, public loans (revolving or subordinated as equity) and mechanisms to reduce the private debt such as guarantees and pooling mechanisms.

The various tools used by governments are summarised in Table 3 below:

Table 3 Financing mechanisms for affordable housing

<i>Mechanism</i>	<i>Brief outline</i>
Grants	Directly able to influence housing supply, but limited to available funds and political commitment to housing. Often used to lever and secure other sources of funds.
Discounted land price	Traditionally a key vehicle to manage urban development outcomes, where governments are major land holders. Can be applied specifically to affordable housing goals. Subject to land availability and market conditions and public asset sale regulations.
Public loans	Traditionally the primary financing strategy for social / affordable housing. Cost-effective fund-raising. Revolving liquidity (through loan repayments) can offer longer-term reinvestment potential. Recently, curtailed by public sector borrowing limits and the attractiveness of low private mortgage rates. So-called 'soft' loans, may not require same security as for private finance.
Protected circuits of savings for specified investments	Used to achieve a dedicated flow of affordable credit for affordable housing programs. Sustained in some countries, while others have dismantled them to improve competitiveness of local banks amid foreign competition.
Bank loans	Increasingly play a role in financing affordable housing, either partially or entirely. Vulnerable to changing financial conditions and alternative investments. National approaches vary in cost-effectiveness and the appropriateness of the fund-raising and distribution mechanisms.
Interest rate subsidies	Useful in the early phase of a mortgage to reduce higher relative costs. Containing the cost to government over time relies on steadily rising wages and house prices and stable interest rates.
Tax privileged	Used to channel investment towards affordable housing and to

¹⁰ Lawson, 2013, Lawson Gilmour and Milligan, 2010, Lawson, Milligan and Yates, 2012, Gilmour, Washer and Lawson, 2013 and Deutsch and Lawson, 2013, Lawson and Milligan, 2007

private investment	compensate investors for lower rates of return and profit restrictions.
Intermediaries	Specialist financial institutions to assess and pool borrowing demands and raise investment, can be public corporations, not for profits organisations or private companies. As reviewed in Lawson, 2013, Deutsch and Lawson, 2013 and Lawson, Berry, Hamilton and Pawson, 2014
Government-secured private investment	Government-backed guarantees to reduce risks to financial institutions investing in affordable housing, passed on at a lower cost of finance to affordable housing providers. A review of seven guarantees can be found in Lawson, 2013.
Tax privileges for providers of affordable housing	Many countries provide various tax privileges to registered organisations, for example income and investment deductions, depreciation allowances, reduced sales and property taxes, exemptions from income tax, fringe benefit tax and capital gains tax. These allowances can be channelled to compensate the efforts of the <i>preferred providers</i> towards achieving the social/economic policy objectives of governments, such as housing low-income households or meeting higher energy or environmental standards. Should replace NG provisions in in Australia.
Use of own reserves and surpluses	Mature housing organisations can leverage their balance sheets, reserves and surpluses to invest in additional housing, as required in Austria. Funds raised may be pooled to support weaker organisations or to promote innovation and competition, as in the Netherlands.
Use of tenants' equity	Some funding models incorporate a small tenant equity contribution, as in Switzerland and Austria. Governments may assist low-income tenants to make this contribution, as in Austria. Larger contributions may lead ultimately to tenant purchase of dwellings underpinning many rent to buy schemes.

Source: Updated and adapted from Milligan *et al.*, (2009) p.28 in Lawson et al, 2010.

Typically, these **tools are used together to form a mechanism** to channel investment towards particular segments of the housing market. In 2009, RMIT/AHURI conducted research¹¹ '*International measures to channel investment towards affordable rental housing*' describing established contemporary financing mechanisms that employ a variety of subsidies and incentives to attract large-scale commercial finance.

Alongside a six country comparison of the UK, France, the Netherlands, Austria, Switzerland and the US (Lawson et al., 2010), two detailed field work studies were also completed, on the UK's Housing Finance Corporation (Gilmour, Washer and Lawson, 2012) and Austria's Housing Construction Convertible Bonds (Deutsch and Lawson 2012) and later an update of European social housing policies was completed in 2011 (Pawson, Lawson, and Milligan, 2011)¹². The financial models covered by this body of work are summarised in Table 4 below:

¹¹ Commissioned by the Western Australian Government, published on AHURI Ltd.website.

¹² Commissioned by the NSW Government, unpublished

Table 4 Social housing financing models, selected countries

<i>Selected country</i>	<i>Financial model</i>	<i>Brief outline</i>
Austria	'Structured finance model'	Long term low interest public loans and grants, combined with commercial loans raised via HCC Bonds and developer/tenant equity sustains tightly regulated form of cost rent limited profit housing. Promotion supported by municipal land policy and land banking.
Denmark	'Mortgage loan model'	Bulk of funding derived from private mortgage loan (84%) complemented by local government grant (14% of building expenses) and guarantee and tenant contribution (2%). Recently National Building fund for Social Housing has partly financed new dwellings (Scanlon and Vestergaard, 2007).
England	'Mixed funding model'	Since 1989 the financing of housing association development has involved capital grants from central government matched by bank loan or bond finance supported by rental income streams. Latterly, effective (or explicit) subsidies have also been provided by developer contributions secured through the planning system). However, this system was substantially modified in 2011 under the coalition government's new 'affordable rent' regime which reduces government grant per dwelling and entails newly built homes being let at quasi-market rents. A guarantee was introduced in 2013-2015 (extended to 2016) in order to secure scarce private funding (Lawson, 2013).
France	'Protected circuit model'	Tax free household savings scheme (CDC) finances off market loans to HLM providers along side state and local subsidies, tax incentives and other loans. Land provided by local authorities and development contributions. All CDC loans are guaranteed by the central government.
Netherlands	'Capital market and revolving fund model'	Replaced direct loans and subsidies with guaranteed capital market loans and rent assistance. Dutch guarantee fund (WSW) and Central Fund (CFV) provide security and assist to reduce financing costs. Associations are free to determine own investment strategy, asset base and surpluses are intended to be used as a revolving fund to achieve social policy outcomes. A structured guarantee on private loans is shared by government and the non-profit housing sector.

Germany	'Demand assistance model'	Federal government has withdrawn from direct supply support and shifted towards demand side subsidies. Municipalities develop own programs and housing companies are private entities, with a variety of shareholders. Private investment in social housing is promoted via tax concessions and economy of scale and privatisation has been very rapid. Rents and eligibility depends on level and duration of public subsidy. Production levels declined and foreign investors are selling better quality stock (Droste and Knorr-Siedow (2007)).
Scotland	'Mixed funding model'	Since 1989 the financing of housing association development has involved capital grants from government matched by loan finance supported by rental income streams. In 2009 Government initiated the capital grant-funding of local authority housebuilding, supported by cross-subsidy drawn from the entire local authority rent base. To stretch public subsidy further, housing associations have subsequently been required to adopt a similar financial model and to observe a target for public funding per dwelling at no more than £40,000 – drastically lower than the £75,000 being recorded under the traditional funding model. Public funding will also be stretched further by a shift towards a 'mid-market rent' (80% of market) product targeted towards low income working households and delivered by housing association non-charitable business subsidiaries.
Sweden	'Capital market model'	Corporate tax exempt Municipal housing companies have always been financed by capital market loans which were sometimes backed by municipal guarantees, grants as well the MOH own resources. In the past interest rates subsidies were provided by the central government but these have ceased.
United States	'Private equity model'	The LIHTC has been the main mechanism for attracting private investors to affordable housing since 1986, underpinned by legal obligations for financial institutions to invest in 'poorly served' areas (the Community Reinvestment Act). For-profit and non-profit developers compete for tax credits allocated by states on different terms and priorities within broad national rules. The equity finance raised by syndicated sales of credits is complemented by various other project subsidies – soft state loans, allocations from state block grants, planning contributions – and by mortgage finance. A tax-exempt bond program complements the LIHTC. Targeting to the lowest income

	households is assisted where links to the Housing Choice Voucher Program operate – however vouchers are severely rationed (Schwartz, 2010; 2011). A variety of guarantees exist on private finance for affordable housing investment (Lawson, 2013).
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Source: Pawson, Lawson and Milligan, 2011

Further, a more detailed report (Lawson et al, 2010) contextualizes the following mechanisms within their local market and institutional settings:

1. dedicated and tax-privileged savings deposit system for affordable housing in France
2. housing tax credits in the US
3. specialist financial intermediary with public guarantees in Switzerland (Bond Issuing Co-operative)
4. specialist financial intermediary (the Housing Finance Corporation) in the UK
5. social housing mortgage guarantee scheme in the Netherlands
6. housing construction convertible bonds instrument in Austria.

The **mix of public and private funding** that is being used in each of the examples above has helped to create and sustain a diversified housing delivery system, supplying a range of housing services from emergency accommodation and affordable rent to rent to buy. While most international systems use non-profit housing organisations as their main providers of affordable and social rental housing, public and private companies also play a key role in delivery.

More recently, AHURI research has described in detail the features of some of the most successful mechanisms identified: the Austrian Housing Construction Convertible Bond (HCCB) (Deutsch and Lawson 2013), Swiss Bond Issuing Co-operative (SBIC) and UK Housing Finance Corporation (Lawson, 2013), which for more than two decades have helped to deliver adequate, affordable and secure rental housing. In the case of Austria, long term support for affordable rental housing supply has ensured more stable housing and construction markets, lower rental housing costs and promoted economic and financial stability in that country.

Austria, a federation with nine regional governments, has sustained low cost investment in its well regulated affordable rental housing sector via the use of tax exempt Housing Construction Convertible Bonds issued by several participating banks, which are of potential relevance to Australian conditions. Austria's experience suggests that an appropriate bond instrument, sufficiently backed by government, can establish a robust and competitive investor market for affordable rental housing. Beyond the tax exemption, governments play a key role in co-financing developments with long term loans and provide a clear legislative framework for cost rent limited for-profit housing.

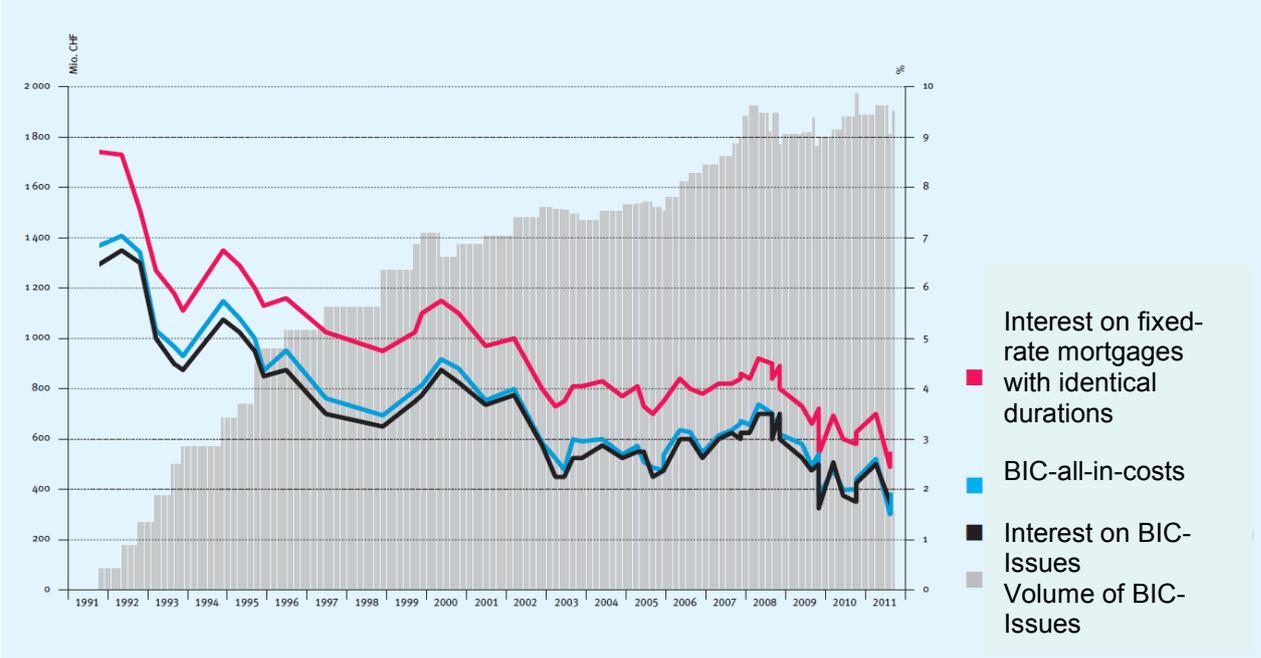
The key message from the Austrian model specifically (and from the international experience generally) is that low cost private finance for affordable rental housing needs to be coupled with risk reducing measures such as public collateral, repayment guarantees, adequate levels of assistance and well regulated providers. **Government involvement is critical.**

For example, the Swiss Bond Issuing Co-operative is a joint venture of the non-profit sector and the Federal Government Housing Office, established in 1991. It pools the financial demands of its members, being limited profit housing providers and meets these demands by

issuing five to 15-year fixed bonds covered by a federal government joint guarantee. This process allows smaller providers to access long-term, low cost finance from pension funds for affordable rental housing at typically 1-1.5% below comparable market rates and just above Swiss Government Bonds. Beyond the guarantee, the federal government contributes to a revolving fund, which provides low cost loans, which is administered by two umbrella organisations of housing co-operatives.

The long term performance of the Swiss intermediary is illustrated below:

Figure 1 Interest costs on finance for affordable rental housing providers, relative to similar mortgages without guarantee in Switzerland (Gurtner, 2011)



In the UK, the Housing Finance Corporation was established under the stewardship of the National Housing Federation in 1987 to pool the borrowing demands of smaller housing associations and raise long term (20 to 35-year) debt finance from pension and annuity funds at very competitive rates (1-2% above UK treasury bonds). For almost three decades the UK system has channelled finance towards smaller providers. Notably it has been strongly underpinned by subordinated grants and rent assistance (housing benefit) paid direct to the landlord, as well as appropriate sector regulation and secured financing.

In 2012, to boost investment in new supply, the UK Treasury announced a guarantee to lower the cost of finance and thus delivers more affordable homes. In summary,

- HM Treasury was instrumental in design of the scheme involving debt guarantees to underpin up to £10billion of investment in rental housing.
- Department of Communities and Local Government announced debt guarantee schemes for both affordable and private rental housing in 2012.
- There was a competitive tender and THFC was licenced to issue bonds for affordable rental housing with the governments guarantee.

- The guarantee secures 'investment finance' rather than more risky development finance.
- It also limits government exposure, as the guarantee covers only 80% of the scheme and the registered landlord contributes 20% of its own equity, which provides a cushion against the possibility of the guarantee being called.

Table 5 (Williamson, 2014) outlines the rationale for the guarantee and the expected impact on the cost of funding. It was presented to the National Housing Conference in 2013 by Piers Williamson, long time CEO of THFC soon after the guarantee was launched.

Table 5 Different private funding routes and impact on the cost of funding for affordable rental housing in the UK

Different funding routes	UK 'Full Faith' Guarantee	European Investment Bank Funding	Housing Association raised bond or private placement funding	Bank
Rating:	AAA/Aa1	AAA/Aaa	AA-/Aa3 → BBB+/Baa1	
Cost of Finance:	Gilts + 0.45-0.5%	Gilts + 0.45-0.5%	Gilts + 0.9-2.00%	Much Higher!
Potential Saving in today's money per £5m borrowed:	£500,000-£1.14m	£500,000-£1.14m		

Importantly, the guarantee was coupled with a revolving fund to contribute development finance for construction in the private rental sector and accompanied by deep demand assistance via the landlord, providing a secure revenue stream.

Beyond that indicated by the table above, the guarantee eventually opened up access to very long term finance (up to 30 years) and substantially reduced the cost of this finance to even below British government bonds (gilts). Importantly, being a not for profit intermediary attracted very substantial low cost European Investment Bank (EIB) investment.

The results of the UK guarantee between 2012 and 2015 are as following:

- Involved 47 Housing Associations
- Provided very low cost long term finance which helped to finance 13,000 new homes
- Attracted £1.23 billion bonds and EIB funding
- Enabled lowest cost funding via the THFC in all 29 years of its operation
- During the period of the guarantee it enabled the THFC to provide best-in-class funding, with a 1.4% cost saving on alternative routes

There is a further £1 billion of underutilised EIB funding available and is the largest facility ever provided by the EIB. The UK government extended the guarantee to 2016.

These examples demonstrate that lower gross yield can be achieved via a modest tax incentive and/or a guarantee coupled with equity and income support, increasing effective returns to investors and providing a pool of cheaper funds to be passed on to the affordable housing sector. **An important outcome of these programs is that there has been a zero default rate on the guaranteed bonds sold to investors.** Funds raised by housing bonds can meet clearly defined policy targets if loans are made available only for publicly approved projects to permitted regulated providers. In this way, under appropriate intergovernmental arrangements, Australian states and territories can continue to play an important role designing programs to respond to regional needs, national economic imperatives and market conditions.

Learnings from these instruments have been summarised by Lawson (2016) and Hamilton (2014) in various presentations as below:

Bonds intended to be cheaper than bank loans

Lower interest rate is reflection of lower risk

Bolster the borrower: national regulation

Bolster the equity in the project: competitive allocation of adequate subsidies (grants, loans, tax incentives)

Bolster the repayment stream: return of NRAS, improved income support

However, deeper credit support needed to offset this being a new instrument, housing stigma, property risk

Requires some form of back-stop guarantee to get low rate.

Financial institutions and superannuation funds

Well regulated, professionally audited and transparently managed not for profit housing associations, are, as noted, the Australian government's preferred delivery mechanism for affordable rental and social housing. This is evidenced by their central role in the SHI, the NRAS, stock transfers and the establishment of the National Regulatory System. However, without long-term commitment in the form of defined co-financing arrangements and appropriate enhancement for private investment, they are unlikely to be able to fulfil their mission as providers of affordable rental housing at sufficient scale to address the emerging affordability crisis.

A robust commercial lending market for CHOs has not emerged and remains immature with a limited number of engaged lenders. Evidence gathered from CHOs (Lawson et al, 2014) reveals considerable variation in their financing terms. For private financing conditions to improve, much more stable and substantial assistance in the form of government backing and intermediation is required.

Promising research has identified the potential of superannuation funds to invest in this sector, and found strong support for investments with a structured government guarantee. (Milligan et al, 2013, Lawson et al, 2012, interviews with fund managers, 2013, Lawson et al., 2014). The forthcoming AHURI report (Lawson et al, 2014) goes into considerable detail on the investment needs and experience of managed funds, learning from their role in infrastructure and fixed income investments.

Unlike the case in Europe, larger Australian institutional investors, such as superannuation funds and insurance companies, have little experience of investing in affordable rental housing directly. In order to reduce the cost, increase leverage and broaden access to finance, Australian governments need to establish a clear program of long term co-financing affordable rental projects to provide starting equity and secondly, a structured guarantee to attract long term private debt investment in them.

The following paragraphs consider the role of Australia's large and rapidly growing managed funds in more detail and their potential as investors in affordable rental housing.

Superannuation funds as a positive circuit of Australian savings and investment.

Thirty years ago the Commonwealth government created a new circuit of savings and investment known as (compulsory) superannuation.¹³ In just two decades, broad based compulsory contributions by employees and employers have generated one of the fastest growing pension schemes amongst advanced economies (Towers Watson, 2013).¹⁴ Today, several Australian funds: Australian Super, QSuper and First Super are amongst the largest

¹³ A circuit of compulsory savings underpinning Australia's pension system was legally established in 1992 by the Superannuation Guarantee (Administration) Act 1992. Funds which managed these compulsory savings are regulated under the *Superannuation Industry (Supervision) Act 1993* known as the *SIS Act* and the *Financial Services Reform Act 2002*.

¹⁴ Australian funds grew by 11.2% 2002-2012, compared with 8.9% during the same period for the 13 largest funds worldwide (Towers Watson, 2013:15).

100 pension funds in the world.¹⁵ By 2013, the value of funds accumulated and invested in Australian superannuation was \$1.62 trillion (APRA, 2014), greater than the nation's GDP for the same year.

Superannuation funds aim to generate sufficient incomes for policy holders' retirement, to reduce their reliance on and supplement the Aged Care Pension. During both the accumulation and payout phase, fund managers invest to meet specific portfolio goals. Despite the global economic downturn, Australian's largest funds were able to provide strong returns (13.7%) in 2013 (APRA, 2014).

Australia's fast growing 'super' funds play an important role in household welfare in retirement and simultaneously in the nation's infrastructure development. In this space, affordable housing can be considered alongside infrastructure, as generating returns not only for members, but also for the wider Australian community.

While it is anticipated that Australian super funds will play an important role as investors in goods and services of national economic significance (Infrastructure Partnerships Australia, 2010), so far their infrastructure investments tend to be found outside Australia, in countries as diverse as China and Poland (Vamos, 2013). Funds argue that Australian infrastructure investment poses too many obstacles in terms of liquidity, strategy alignment, and high risk Greenfield projects, with complex and expensive bidding processes. They also contend that Australian infrastructure often lacks a consistent pipeline of investments, and furthermore, funds lack in-house expertise to assess dynamic risks adequately (FSC/EY, 2011). In order to justify the risk of investment, liquidity constraints, and complexity, the required rates of return are high (IPA, 2010).

Implications for affordable housing investment

Learning from these insights, housing researchers have proposed appropriate measures to enhance the attractiveness of investment in completed, ready-to-tenant affordable rental housing provided by well-regulated housing providers. Revolving public loans would be required to finance initial construction, prior to long term institutional take out (Berry and Williams, 2011, Lawson, et al, 2012, Milligan et al, 2013).

It is widely considered that private investment, as with any mortgage-backed product, must be supported by adequate equity and revenue streams. Non-profit financial intermediation and government guarantees have been the tried and proven tools of the many European models reviewed and summarised above (Lawson, 2013) and have enjoyed growing government support and financial sector interest since the global financial crisis (GFC).

In Australia, pooling and vetting by a professional not for profit financial intermediary under government stewardship at a distance combined with a guarantee, could effectively address the inefficiencies and high costs of fragmented commercial borrowing, one off financing costs and for profit intermediation.

For governments, a guarantee can be justified on the basis that affordable and social housing is a form of social and economic infrastructure which contributes to urban productivity, liveability and environmental sustainability of Australian cities and regions. For

¹⁵ Followed closely by Start Super, Uni Super and Commonwealth Superannuation Corporation, Retail Employees Superannuation Trust, Hesta and Sun Super (OECD, 2013:13)
<http://www.oecd.org/pensions/PensionFundInfrastructureAustraliaCanada2013.pdf>

funders, investment in completed, turnkey projects can provide a relatively low risk form of investment when compared with other infrastructure developments. This is particularly the case where completed, tenanted properties are of good quality, well located and efficiently managed by not for profit landlords.

Investment based on secure rent revenue can also be supported by adequate rent assistance and voids minimised by lengthy waiting lists (since there exists a permanent excess demand for sub-market rental housing), which in turn support stable revenue flows to support moderate returns from low risk mortgage-backed bonds.

Pension and insurance funds clearly have the potential to invest in this fixed income asset class, which could be offered by pooling borrowing demands of numerous regulated rental housing providers and bonds issued by a specialist intermediary with vetting and monitoring powers over participating borrowers.

Well-rated securities are increasingly sought by managed investment funds, especially by defined contribution pension funds and annuity schemes, or in response to policyholder requirements. New international banking regulations also require the holding of higher quality assets such as AAA rated bonds.

Attracting pension funds to a new asset class such as affordable rental housing requires a solid business case justification, long-term policy commitment and much more active facilitation than currently exists by key stakeholders, notably housing providers and co-financing governments.

Once a business case has been provided and in order to help establish a market for investments, governments need to guarantee investments in co-financed, appropriately regulated not-for-profit landlords. This enables sound long-term rental housing providers to attract lower cost, longer term private funds.

As in Switzerland and the UK, governments and providers can also help to facilitate the establishment of a specialist financial intermediary, in order to identify, aggregate and assess borrowing demands in order to issue a suitable scale, risk/return and pipeline of guaranteed bonds for investors. As noted above, related discussions are already taking place in Australia, with regards to the establishment of a financial intermediary to facilitate infrastructure investment (Crowe, 2013, Coalition, 2013, SMART, 2014, RAI/EY, 2012).

The following sections develop this potential further, by proposing to providers, governments and investors, suitable instruments and mechanisms channelling investment towards affordable rental housing. It focuses on the design of a debt instrument and intermediary appropriate to the long term investment needs of affordable rental housing providers, outlining the implementation requirements to substantially grow Australia's supply of long term rental housing via investment from the managed funds sector.

Housing Supply Bonds Model¹⁶

The primary purpose of any financing instrument should be to attract larger volumes of appropriate investment, under improved terms and conditions to those that exist currently to ensure the supply of decent quality, secure and affordable rental housing. International research demonstrates that raising funds at scale will require a dedicated financial mechanism and appropriate institutions that are fit for purpose to raise and distribute funding.

There has been growing Australian interest in the development of a financial instrument and intermediary to attract investment to the not-for-profit sector more broadly, and in reforms to expand the corporate bond market in Australia and provide greater access to retail investors.

In 2010, the Productivity Commission highlighted the lack of access to capital by not-for-profits and the need for a specialist financial intermediary to raise funds for the sector. In 2011, the Senate Economics References Committee recommended that the Australian Government examine ways to create incentives for investment in the social bond market, via enhancements such as tax credits, government guarantees and/or a top-up on social bond coupons. Specific proposals have also been put forward by charitable organisations, such as the Benevolent Society, who have argued that franking credits should be applied to social bonds (Lawson et al, 2012:2).

In 2015, the Senate Inquiry considered a wide range of submissions and made numerous relevant recommendations, including recommendation 40, one of the few supported by the Government:

“The committee recommends that the Federation White Paper process give due consideration to the proposal for the introduction of housing supply bonds using the Australian Housing and Urban Research Institute's (AHURI) research as a starting point for its consideration.

Furthermore:

The committee also recommends that the Australian Government establish a cross-sectoral high level industry and government Housing Supply Financing Task Force, as proposed in the AHURI report. It would provide advice to governments on the potential for a Housing Supply Bond in Australia and investigate other mechanisms for private investment.” (paragraphs 23.45–23.46)

The Housing Supply Bonds HSB proposal¹⁷ was developed with funding from AHURI Ltd. by Lawson Milligan and Yates in 2012, working with industry specialists both in Australia and Europe. The research process involved extensive consultation with a wide array of stakeholders in Australia, including institutional investors, regulators, public finance specialists, housing providers and public policy officials. The basic **requirements for a financing instrument to support investment in affordable rental housing**, as determined by industry consultation are outlined in Table 7 below.

¹⁶ For full details see, Lawson et.al. 2012.

¹⁷ The final report, presentations and media coverage can be accessed here <http://www.ahuri.edu.au/publications/p30652/>

Table 5 Requirements for a financing instrument to support investment in affordable rental housing

Terms and conditions of housing supply bond?	<ul style="list-style-type: none"> ✓ A straight forward, low risk, low yield and long term instrument required to provide cheapest funds ✓ Enhancement required to reduce risk and enhance low yield ✓ Tax incentives need to be devised so they are equally valuable to those with high and low tax rates ✓ Guarantees are very interesting for low risk long term investors - insurance funds, certain portfolios of super funds, banks, retail investors
Financial intermediary?	<ul style="list-style-type: none"> ✓ To pool funds for scale ✓ Specialist knowledge of sector ✓ SPV to issue bonds, linked to provider loan obligations ✓ Optional forms: Public, not-for-profit, for-profit
Regulatory requirements?	<ul style="list-style-type: none"> ✓ Beyond benchmarks, ensure sector regulation meets investor standards ✓ Strengthen financial capacity of providers and reduce risks to lenders ✓ Use to promote innovation, collaboration and solutions rather than impede growth
Related requirements?	<ul style="list-style-type: none"> ✓ Capacity to repay based on revenue stream ✓ Rent assistance and eligibility policy critical ✓ Long term and consistent policy vision by governments ✓ Facilitative planning and land supply to reduce development risk

Source: Lawson et al. 2012

Following this feedback¹⁸, a suite of bonds, known as Housing Supply Bonds was designed to reflect the management, taxation and yield requirements of different types of investors that were identified through the research. The main purpose of these different instruments is to demonstrate their different impact on the cost of investment in affordable and social rental housing and the cost government.

¹⁸ Research involved a focused literature review, building on earlier international comparative research and (Lawson, Milligan and Yates, 2010 and the Austrian case study Deutch and Lawson, 2010/2013) as well as 25 face to face stakeholder interviews across three states, three intensive industry meetings facilitated by research team b/n international experts IIBW and Esrte Bank and industry partner AHS and a focused workshop involving 18 stakeholders with the research team, industry partners and experts. An additional public seminar was also held with over 85 attendees to present the research. A number of senior policy maker consultations meetings were held on the draft model reaching policy makers including the inter jurisdictional Housing Policy Research Working Group HPRWG.

This suite of instruments comprises 1) public loans as equity; 2) tax exempt coupons on special purpose retail bonds providing mezzanine finance; and 3) guaranteed (AAA equivalent) bonds suitable for fixed income portfolios of super funds, to provide senior loans.

In summary:

- public bond issues (NAHA Growth Bonds) which will provide for equity via conditional revolving public loans (a long term loan asset attracting low or zero interest);
- a tax incentive (e.g. 6% tax free coupon) on mezzanine investment in social housing retail bonds (Tax Smart Housing Supply Bonds) and
- a guarantee on bonds linked to senior loans in approved co-financed projects (supported by NAHA growth bonds). More detail on the structure of this guarantee and related financial intermediary is provided in sections below and developed further in Lawson et al, 2014)

Cost to governments

The costing presented below is based on raising \$7 billion to finance 20,000 affordable rental dwellings, and is intended as an ongoing national program, with state and local governments and importantly SHAs and CHOs as key partners. Given the well-established shortage of affordable rental housing accessible to low to middle income households and experience from the last NRAS round, 20,000 dwellings is considered a responsible and feasible target. It could of course be piloted on a smaller scale in particular States and Territories with ready capacity and commitment.

The AAA Housing Supply Bonds' cost to government is predicated upon an assumed 0.5% default rate based on settings in the UK for senior term debt for community-managed affordable housing. If these bonds are to provide 70 per cent of the \$7 billion required, then \$4.9 billion is to be financed with AAA HSBs. The cost of a 0.5% default rate equals \$24.5 million each year for 10 years (or \$245m if provided as an up-front contribution) for each \$7 billion tranche issued.

The Tax Smart bond costs are based on the assumption of a tax free 6% coupon rate. This provides individual investors on the top marginal tax rate of 46.5% with the equivalent of a before tax yield of 11.2% and corporate investors on a 30% tax rate with the equivalent of a before tax yield of just under 8.6%, seen as being approximately that needed to attract retail investors to such bonds. The cost to government, therefore, is the amount of tax foregone by making the coupon tax free. Assuming 20% of funds are raised through Tax Smart bonds, and a 40% tax rate as a hybrid of corporate and personal tax rates, this cost equals \$7 billion x 20% x 6% x 40% = \$33.6 million per year (or \$336 million over 10 years for each tranche).

The third instrument is the revolving NAHA Growth Fund equity component that funds the first 10% of project costs. The annual cost to government each year for 10 years is the interest foregone on the \$700 million. Assuming the borrowing cost for government is 5%, then the annual cost to government for the NAHA growth bonds equals \$700million x 10% x 5% = \$35 million or, if provided as an upfront cost, \$700m for each tranche. Figure 2 below provides a indicative illustration.

Once again, the main purposes of Housing Supply Bonds is to catalyse thinking about the effectiveness and cost of different routes which can be used to channel investment towards

affordable housing providers – either via the direct fund raising capacity of government, the use of tax incentivised retail investment, government guaranteed institutional investment or a mix.

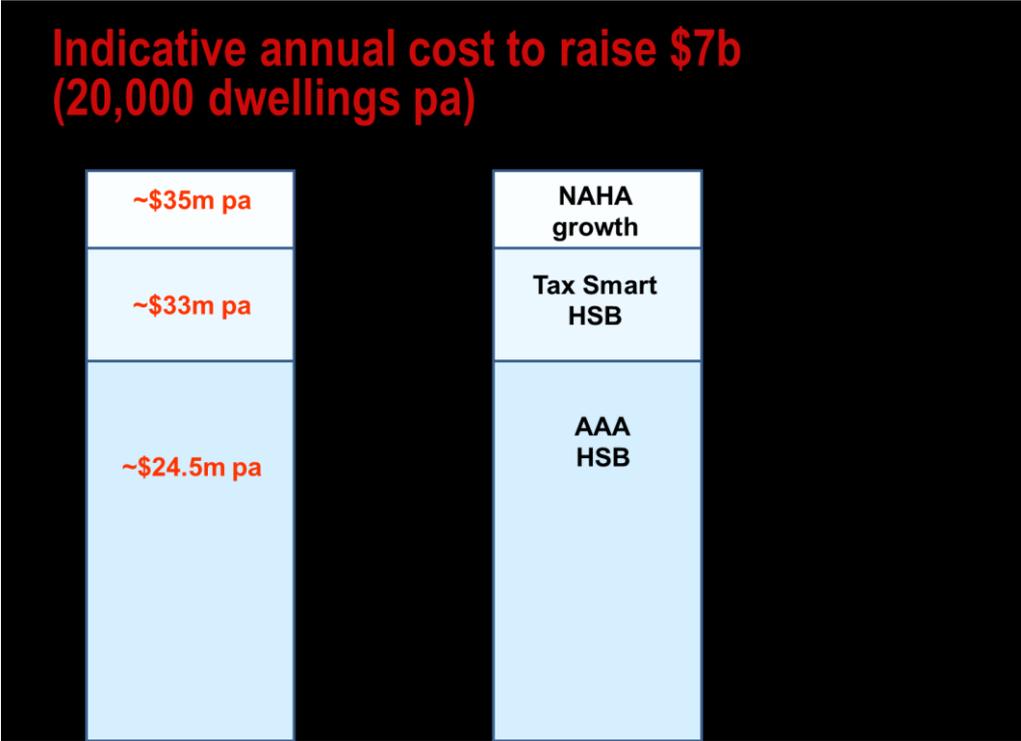


Figure 2 Indicative cost of HSBs

The report recommended that a prudent first step would aim to provide a robust, long term costing and market testing of the bonds proposal, refining proposed yields, the nature of enhancements and their cost to government. Such a process should be expert and independent, and consult with and strategically involve key stakeholders. The report Lawson et al (2012) outlines the tasks involved as follows:

Affordable Housing Finance Corporation Model¹⁹

Another key mechanism for channelling investment is a specialist financial intermediary. *Specialist* intermediaries are required who understand the sector. SFIs can pool smaller community housing organization demands, issue bonds on the capital market or private placement, and allocate raised funds to appropriately regulated and accountable housing associations.

In 2014, research was completed by AHURI towards an appropriate model for a financial intermediary and guarantee for Australian conditions, following extensive industry consultation and exchange of international expertise. The Final Report was published in 2014.

This model is simpler than the HSB approach, focusing on the critical role that the government guarantee can mesh with the overall structure of financing rental housing provision, as this is likely to be cheaper for government in the longer run and more attractive and less complex for institutional rather than retail investors.

Again the proposed financial intermediary adapts the established Swiss and (recent) UK approaches outlined in Lawson (2013) to the needs and market conditions present in Australia following extensive national and international consultation²⁰. The Final Report [Enhancing Affordable Rental Housing Investment via an Intermediary and Guarantee](#) (Lawson et.al. 2014) offers a well-developed proposal for a private investment mechanism for affordable rental housing, to be underpinned by government and operate across all participating states and territories. An intermediary combines the aggregated investment demands of the affordable housing sector, in order to provide a suitable scale of and pipeline demand for bond issues targeted at Australia's growing superannuation sector. Further, the proposal manages risks through appropriate regulation, sufficient revenue, subordinated debt and specialist financial intermediation.

Figure 3 below provides a schematic representation of the key elements and linkages, which are outlined in more detail below.

¹⁹ For full details see Lawson et.al. 2014.

²⁰ This consultation involved focused literature reviews on international experience in SHGs and role of managed funds (Lawson), Australian policy, debate and practice with GGs (Berry), provider capacity and investor appetite (Hamilton and Pawson) A total of 44 stakeholder interviews were conducted in Europe and in Australia (across four states). There was intensive finance sector, public and third sector Industry involvement via a Think Tank (24 participants) facilitated by research team and international experts a, hosted by Australia's largest super fund, Australian Super. An additional public seminar was held at the National Housing Conference, with over 800 attendees, involving the chair of the Swiss Bond Issuing Co-operative and CEO of the UK Housing Finance Corporation. Further contributions to public debate were made via quality media, submissions to the Commonwealth and NSW Senate inquiries, publications in international professional journals as well as Peer reviewed and online publication of a Final Report.

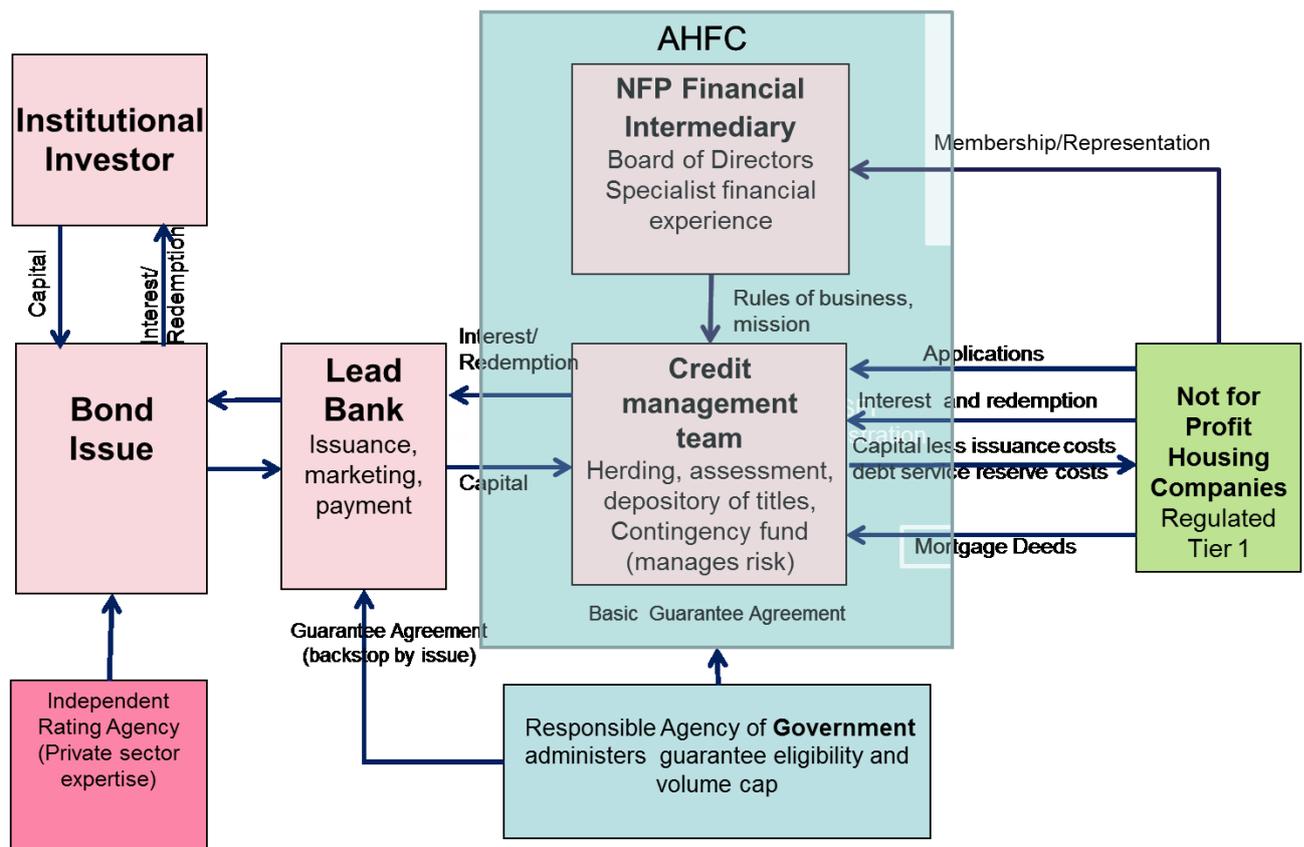


Figure 3 Affordable Housing Finance Corporation (AHFC) Model

Implementation requirements

The first step is the creation of an independent non-profit entity (“NFP Financial Intermediary” box) comprising an expert Board of Directors the majority of which are to be drawn from the financial sector. Government and the non-profit sector would each appoint Directors as well. A possible composition could be: two Directors appointed from government, two Directors from the non-profit sector and five Directors from the business, finance and legal sectors. The organization and board would be independent of government but be accountable through requiring borrower compliance with the National Regulatory System and monitoring the robust reporting requirements imposed on the borrowing non-profit housing providers. The Board would report annually to Parliament, detailing the lending eligibility criteria, the volume of loans allocated, the addition to the affordable rental stock achieved, the incidence of any default events (actual or avoided) and the actions to take in mitigation or enforcement.

This Board would require directors with extensive experience and expertise in financial management and credit assessment in order to oversee the professional management of the borrowing process (“Credit Management” box). The latter would be responsible for aggregating borrowers in the non-profit housing sector; in Australia this would initially be restricted to those organisations eligible for Tier 1 status under the National Regulatory System.

The Commonwealth would sign an overarching agreement with the Financial Intermediary guaranteeing the payments due to bond purchasers if non-profit providers default on

payments; this guarantee would be structured and provided separately on each issue up to an agreed total cap for an agreed period. International experience indicates that each bond tranche should be separately guaranteed and each borrower's default risk managed separately (this view was strongly put by our international visiting experts, Piers Williamson and Peter Gurtner, respectively CEO of the UK Housing Finance corporation and Chair of the Swiss bond issuing agency). This approach maximizes the incentives for individual borrowers to meet all their debt obligations, since it will be clear to all parties that an individual borrower's default will not be bailed out by other compliant borrowers.

For each issue Management would assess loan applications from providers and recommend borrowers to the credit committee of the Board. Once the successful borrowers have been identified, the "lead Bank" issues and markets the bonds the duration of which would need to be tested for investor appetite. The bonds would be rated by a major ratings agency. The rating would depend on: the credit rating of the government providing the guarantee; the limitations or other structuring characteristics of the guarantee, the rating of the (Tier 1 and Tier 2) non-profit housing sector in Australia²¹; the quality of the Financial Intermediary (The Board); and the value of the individual properties backing the bonds. AFHC Management would hold the title deeds to the properties purchased by the providers as collateral for the loans financed by the bond purchase. Alternatively, title deeds could be passed to and held by a commercial trustee. The Lead Bank (which could be in-house) would manage the payments to investors.

In this model the investors' interests are protected by the government guarantee. From the government's viewpoint, the guarantee is a final backstop to be drawn upon only if:

- a) a borrower defaults after other procedures and processes fail, and;
- b) the reserves held by AFHC Management are insufficient to meet loan payments when due.

With respect to the second point above, there are two reserve funds that stand between borrower default and a call on the guarantee.

1. *Specific Reserve*: When passing through the capital loan to the borrower, Management retains the equivalent of one year's interest payment on the bond principal.²² This can only be drawn upon to make payments to the lender if and when the borrower misses a payment milestone. The borrower pays interest on the full face value of the bond while actually receiving the discounted capital sum to invest in housing. If all payments are made on time for the duration of the bond, then the borrower is credited with the intact reserve at redemption.
2. *General Reserve*. A small premium (e.g. 10-15 basis points) is added to the coupon rate paid by the borrower and held by AFHC Management as a general reserve to cover unexpected contingencies ("unknown unknowns").

²¹ Tier 1 and tier 2 housing provider meet a range of criteria enshrined in the National Regulatory System. Both these classes of organization have established a track record of delivering significant rental stock to the market and have well developed financial and managerial systems in place. The main difference between tier 1 and tier 2 is that the former have also successfully developed new affordable housing in addition to acquiring existing stock. See Chapter 4 in Lawson et al for more information on the non-profit housing sector in Australia.

²² Such a reserve was used by the UK's THFC to convince HM Treasury of the very low risk of the guarantee to government.

This is not returned to borrowers and accumulates as a further fund from which to manage possible but unforeseeable default threats.²³

The role of the reserves is to ensure continuity and certainty of payments due to bond holders during the period that Management moves to resolve the problems causing an individual borrower to miss repayment deadlines. The overarching agreement with government will specify the trigger points and steps to be taken for AFHC Management to step-in in this manner; these details will be harmonised with the procedures laid down in the National Regulatory System for Tier 1 and 2 non-profit housing providers.

In summary, the probability of the government guarantee being invoked in this model is very small due to:

1. The quality of credit assessment and management
2. The comfort provided by the independent credit rating agency
3. The level of maturity and experience of the Tier 1 borrowers
4. The monitoring and step-in powers over borrowers exercised through the National Regulatory System
5. The reserve funds held and accumulated by AFHC Management to maintain continuity of payments to bond holders

Moreover, further comfort is provided by noting the zero-default experience of the Swiss guarantee scheme during its ten years of operation and the introduction during 2013 of a similar scheme in the UK that likewise has had a zero default record.

Clearly government plays a key role in this approach, with the last-resort guarantee crucial in achieving a high rating and therefore affordable interest rate for each bond issue. However, government also ensures the appropriateness and robustness of the regulatory system (and has a direct and powerful incentive to do so). Beyond that, in order for non-profit providers to achieve financially sustainable access to the housing bonds issued, government will need to continue to provide both capital subsidies and recurrent subsidies, the latter in the form of CRA plus supplement to enable affordable rents and or a refined NRAS II. British and Swiss experience suggests that providers will need to contribute at least 20 per cent equity leveraged by bonds to acquire dwellings that can be rented at affordable (sub-market or cost rent) rents, as required by current ATO rulings. In Australia's housing market, decent affordable housing close to employment opportunities is simply not possible without subsidy or market intervention.

The importance of equity in raising private investment

The necessary equity slice could be generated in the longer term from CHO balance sheets, though at the current stage of sector's development, this avenue is limited.

There are a range of other strategies to provide this equity. Government capital grants (in cash or land), planning gains through rezoning land or increasing densities or a revolving low-or-no-interest public loan could assist in meeting this contribution. The latter option also provides opportunities for revenue generation (where the government lends to borrowers at higher interest than it raises funds, as in WA).

Lawson et.al. (2012; outlined in previous section) proposes a mechanism by which no-interest government loans substitute for a proportion of the equity required. Co-financing

²³ This simple to administer reserve has ensured that the Swiss Guarantee has not been called on for over a decade. It has enabled the accumulation of a healthy reserve fund by the Bond Issuing Co-operative and negated any need to rely on government support.

provides certainty of delivery, targeting in compliance with government objectives and is more beneficial to institutional investors than a tax offset from their income. Box 1 presents an example using both capital grants, no-interest loan leveraged by high grade bond finance.

Box 1 Example of Capital grant, no-interest loan leveraged by high grade bond finance

<p>Cost of dwelling: \$300,000</p> <p>Financed by:</p> <ul style="list-style-type: none"> Grant (10%) \$30,000 No-interest loan (20%) \$60,000 10-year Bond loan (70%) \$210,000 <p>Assumptions:</p> <ul style="list-style-type: none"> Interest foregone at 4% p.a. Default rate on guaranteed bonds = 0.5% (in line with international experience) Default on no-interest loan = 0.5% <p>Cost to Government:</p> <ul style="list-style-type: none"> \$30,000 + interest foregone on loan = \$2,400 p.a. for 10 years + \$1,050 expected bond default + \$300 expected no-interest loan default = \$55,350 over ten years (= \$50,816 present value at 4% social discount rate)
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Scaling up the example presented above, 10,000 dwellings, worth \$3 billion would cost government \$553,500,000 over 10 years or 54 million per year. The grant component could be provided as a cash outlay or through land transfer.

However, as the analysis in Lawson et al, 2014 demonstrates, the capacity of providers to take on debt is constrained by tight free cash flows characteristic of the sector. The cost to non-profit providers in the above example would be interest payments on the bond, say \$10,500 per dwelling acquired at 5% coupon rate plus amortised repayment of the no-interest loan by government over the 10 year period (it could be longer). Given that the providers would be charging sub-market rents, they would need to continue attracting CRA and NRAS-type subsidies in order to meet the level of financing commitments identified in the above example.

The UK model that informs this approach has been introduced after intensive modelling by the Department of Communities and Local Government and demonstrated the very low probability of the government guarantee being called; Piers Williamson, the CEO of the UK Housing Finance Corporation, underscored this point at the project Think Tank.

The proposed Affordable Housing Finance Corporation Model provides, in our view, the best way forward in current Australian circumstances for the following reasons:

- ✓ It is relatively simple and transparent and can be harmonised with the new National Regulatory System and state based Regulatory Systems for non-profit housing providers.
- ✓ It focuses on the untapped source of funds from institutional investors and meets the growing demand of superannuation funds for AAA-rated bonds.
- ✓ It fits well with existing government subsidy policies, notably CRA and NRAS and leverages the extent to which current sector competencies and strategies are progressing.
- ✓ It minimises the impact on government budgets.
- ✓ It provides lower cost of finance to providers, compared to other approaches, including the current reliance of CHOs on bank finance and, hence over the medium to long run is likely to maximise the sustainable expansion in the stock of affordable rental housing.
- ✓ Properly structured and managed, the Model reduces to negligible levels the probability of the government guarantee being called
- ✓ Australia can draw on the successful experience and expertise of other countries.

This AHFC proposal, grounded in extensive national research of industry stakeholders and successful international experience, forges a new funding pathway to institutional investment in affordable rental housing. The AHFC will have the expertise to issue rated bonds with a government guarantee for well-targeted rental housing developments.

The proposal overcomes many of the barriers cited by institutional investors, by offering suitable investment opportunities at an appropriate scale, simplicity and risk weighted return. It would fulfil the Australian government's commitment to increase private investment in rental housing, bridging the gap between Australia's affordable housing investment needs and the risk/return strategies of our large and rapidly growing super funds as they enter the pension phase of operation..

The proposal also aligns with the government's aim to develop deeper, longer term bond markets in general and specifically can inform efforts to grow investment in infrastructure. With strong government leadership and expert and adequately resourced implementation, the AHFC approach can strengthen Australia's housing choices and build a stronger, more secure, more equitable and more efficient rental housing market.

In conclusion - what are the benefits of channelling investment towards affordable rental housing in Australia?

Government efforts to stimulate private investment in new affordable rental housing can be justified as contributing towards:

- ✓ a tangible and substantial contribution towards expanding housing supply, progressively building Australia's long term assets in affordable rental housing;
- ✓ addressing a clear and unmet need for rental housing which is accessible and available for low income households as a refuge, oasis and stepping stone;
- ✓ ensuring that the housing supported by government incentives and subsidies is both affordable and secure, generating lasting benefits to family functioning, child development, individual health and economic and social participation;
- ✓ making more efficient use of limited public resources, exploiting government credit worthiness to full effect; by guaranteeing bonds investing in completed, approved developments;
- ✓ improving productivity by: promoting new medium density rental housing in well serviced areas, reducing the distance between affordable housing and employment opportunities, generating sustainable employment in the construction sector, supporting local economies and lifting regional and national GDPs;
- ✓ ensuring financial continuity and growth of well-regulated non-profit housing providers, strengthening the governments preferred suppliers of social housing by providing a pipeline for investment;
- ✓ bridging the financial demands of institutional investors and affordable housing providers, by aggregating borrowing requirements, financial intermediation and risk reduction;
- ✓ Provide a suitable vehicle for superannuation funds to meet both the risk-adjusted yields required by policy holders (and regulators) and their own social, economic and environmental corporate responsibilities to the wider community;
- ✓ strengthening economic competitiveness through improved access to the rental market by low income households, enabling a more flexible and productive workforce;
- ✓ enhancing national cohesion and social inclusion, sharing the benefits of secure affordable housing more fairly across the community and assisting those not served adequately by existing market and government processes.

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Attachment 1: Relevant Research

The submission draws on relevant published research, which is listed below and can mostly be accessed in full online:

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