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Dear Sir/Madam

Affordable Housing Working Group: Issues Paper

Corrs Chambers Westgarth welcomes the concerted effort by the Council on Federal Financial Relations to form the Affordable Housing Working Group to progress efforts to address the pressing need for more affordable housing in Australia.

1 Summary

Corrs Chambers Westgarth advocates the introduction of a "Model 1" type arrangement for Australia. We are of the view that this approach will be most likely to facilitate funding in both the Australian and international capital markets. It is the capital markets which are increasingly financing social housing across the globe, including social housing in the United Kingdom,[1] and offer longer-dated financing together with the deep liquidity required for institutional investors. Our recent experiences with the United States private placement capital market shows an increasing appetite for Australian credit exposure by institutional investors, and a willingness to consider a broader range of asset classes (for example, university student accommodation). These investors can also offer longer debt tenors, which increase certainty and minimise refinancing risk.

A "Model 1" type arrangement requires the following key attributes to make social housing financing attractive to the capital markets:

(a) some form of uplift in rental income (being in the nature of interest subsidies or taxation credits, referred to in this letter as **government support**) to ensure that income is sufficient to service the yield expected by investors; and

(b) a sufficient credit rating assigned to any funding arrangement by an internationally recognised ratings agency – this facilitates liquidity and access to the broadest possible investor base.

[1] Homes & Communities Agency, Quarterly Survey Q2 (July to September) 2015 to 2016, November 2015 notes that new facilities reported for that quarter totalled GBP 1.8 billion, with capital market funding making up approximately 30% of funding.

It will be only through the strong leadership of the Commonwealth government that a robust and comprehensive regime could be put in place nationally. Only Federal structures and regulation will strengthen the ability of specialist financing intermediaries and social housing entities to obtain suitable financing, which would inevitably result in the growth of affordable housing and social housing throughout Australia.

2 Government support to promote new housing stock

Efficient financing for the establishment of new housing stock in the United Kingdom is obtained through the use of credit enhancement, namely a guarantee provided by the government in respect of the obligations of the housing association.

However, we note the fiscal constraints that are currently being experienced by Australian government, both at a State level and at the Federal level. As such, the key to promoting an increase in new social housing stock may be an innovative mixture of tight regulation of the finances and operations of specialist financing intermediaries and government support (together with, if required, a special insolvency regime applicable to specialist financing intermediaries or lines of liquidity made available during periods of financial or housing market distress for such specialist financing intermediaries).

Although the provision of a guarantee by the government ostensibly introduces the contingent risk of increased government spending, it should not be support provided solely to transfer the risk of loss from the market to the government.[2] Nor should the provision of a guarantee by the government be viewed in isolation from strong regulatory overview of the social housing funding sector.

3 Strengthening of regulatory framework

The regulatory framework is acknowledged by Moody's as a critical component of any rating analysis of a housing association in the United Kingdom.[3] Importantly, it is through regulation and strong oversight of the finances of the specialist financing intermediary that the government may mitigate the risk of any implied or express form of government support, such as guarantees, liquidity facilities or other bailout mechanisms in times of financial distress.[4] Regulation and oversight in this context may mean:

(a) oversight of finances such that financial distress can be detected well before default;

(b) ability to intervene where specialist financing intermediaries are in financial distress with wide ranging powers to correct or minimise losses, such as transfer of management, execution of mergers with other funding vehicles or placing restrictions on the disposal of assets;[5] and/or

[2] Financing rental housing through institutional investment Final Report, volume 1, Milligan, Yates, Wiesel and Pawson, March 2013, p 48

[3] Moody's Investor Service Rating Methodology – English Housing Associations, p 4

[4] Financing rental housing through institutional investment Final Report, volume 1, Milligan, Yates, Wiesel and Pawson, March 2013, p 48

[5] Moody's Investor Service Rating Methodology – English Housing Associations, p 4

(c) controlling the borrowing limits of specialist financing intermediaries.

To some extent, the National Regulatory System for Community Housing (**NRSCH**) covers the points raised above. We would expect that the scheme be extended to ensure national coverage and that it would eventually become a mandatory scheme rather than the current voluntary scheme. Nevertheless, the NRSCH provides a solid foundation on which to build a stronger regulatory regime for the good governance and financial stability of housing providers and specialist financing intermediaries. Alternatively, such entities could be capably regulated by APRA and ASIC. Further, in addition to the requirements set out in relation to the NRSCH, good governance of such entities could be enhanced through the application of ASX best practice and by having an independent, skills-based board.

4 Other government support for financing through the capital markets

Government support in relation to the financing (or refinancing) of existing housing stock through the international capital markets may take on a different form from government support provided for the construction or development of new housing stock. Even in the absence of an "blanket" capital guarantee from government, Moody's has emphasised that a combination of other protective measures, such as "special legal status…carve-out from normal bankruptcy procedures, a pledge of financial resources including through capital replenishment, backstopping of operating losses or legal provisions transferring [specialist financing intermediary] debt obligations to the government upon dissolution"[6] may assist in lifting the credit rating of a specialist financing intermediary closer to that of the relevant government. A strong credit rating will assist specialist financing intermediaries in Australia to obtain the cheapest funding and access a broad, international pool of institutional investors. Such investors, in turn, may also provide long-dated financing for the Australian specialist financing intermediaries.

The provision of government support and effective regulation is crucial for the introduction of a new asset class for investors. This was acknowledged in the Financial System Inquiry Final Report, where the Inquiry saw merit in the government becoming involved by, among other things, "offering explicit public endorsement for the significant private sector interest in [the social impact investment] market".[7] With performance and track record over time and an increase in the confidence of investors in relation to that asset class, such support may take on a less critical role in future funding by institutional investors.[8] Therefore, it is our view that any government support that is needed to establish an affordable housing program should be designed to taper off over time as the asset class/sector matures.

Although explicit government support by way of guarantees or liquidity lines is less critical for financing existing housing stock (or refinancing new social housing stock that has reached practical completion), the government may still be required to maintain a role and to provide some form of government support in such

[6] Moody's Investor Service Rating Methodology – Government-Related Issuers, p 22

[7] Financial System Inquiry Final Report, November 2014, p 262

[8] Financing rental housing through institutional investment Final Report, volume 1, Milligan, Yates, Wiesel and Pawson, March 2013, p 36

circumstances. This is because it has been recognised that the preferred source of income to service debt financing for the specialist financing intermediaries is the rental income from the underlying housing assets.[9] However, given that the rental yields in the Australian housing market are relatively low by international standards, government support will play a larger role in encouraging specialist financing intermediaries to participate in Australia such that they can raise capital successfully in international capital markets. It is feasible that some form of taxation credits, like those that were implemented in the National Rental Affordability Scheme, may contribute to that support. We envisage that any government support would essentially be passed through the specialist financing intermediary to service the interest payments on any bonds issued in the capital markets.

5 Debt service through realisation of capital growth of housing stock

Housing associations in the United Kingdom have been, and continue to be, successful in raising debt finance in relation to their established housing stock with a mixture of rental income[10] as well as capital gains realised from the sale and purchase of housing stock throughout the term of the financing, subject to compliance with asset cover tests. However, we note that the sale of existing social housing stock to provide cash flow to help service debt obligations presents a significant issue in Australia given the different role that social housing plays in Australia when compared to the broader social housing market in the United Kingdom. For Australia, the sale of existing social housing stock would necessarily lead to disruption to vulnerable tenants, particularly the elderly and those struggling with employment and/or health issues, where the negative effects of moving house would be acutely felt. We consider this to be less of an issue for the social housing market in the United Kingdom.

An additional hurdle faced in Australia is that the existing stock of community housing properties are often bound by restrictive covenants which prevent their use for anything other than social or affordable housing. We would expect any reform proposal to address the situation that where these restrictive covenants are unduly restrictive, there should be some flexibility to allow for those restrictive covenants to be removed or eased where required to further the aim of increasing the stock of affordable housing (eg, by divesting assets to allow housing providers to replace them with more suitable or relevant accommodation resulting from, for example, demographic changes to social housing tenants). The same observation applies in relation to stock that has been developed under favourable town planning schemes – conversion to strata title for disposal in the market may be more difficult with a resulting negative impact on market value.

As such, in light of the points made above, we consider an emphasis on government support to be critical to successful financing of social housing and also of most benefit to social housing tenants. Strong government support is to be preferred over the sale of existing stock in order to service the debt obligations of

[9] Financing rental housing through institutional investment Final Report, volume 2, Milligan, Yates, Wiesel and Pawson, March 2013, p 22

[10] Such as, in the case of the London & Quadrant Housing Trust GBP250,000,000 3.75 per cent. Secured Bonds due 2049 capital market issuance, 44% of the total social rental income received is by way of housing benefits payable by local authorities.

specialist financing intermediaries. However, to ensure that affordable housing and social housing stock continues to grow in Australia and adapt to the requirements of an ever-changing demographic, some flexibility will be required to ensure that the sale of existing housing stock and purchase of new housing stock can be achieved without undue difficulty due to legacy constraints such as those noted above.

6 Clear tracing of incentive allocations

Finally, we note that one of the issues that financiers faced with the implementation of the National Rental Affordability Scheme was tracing the allocation of incentives at the participant level down to the relevant allocation at the level of individual dwellings. We would encourage the government, for any future social housing incentive regime, to implement a more transparent mechanism in which financiers are able to easily trace the allocation of incentive payments at an entity level, or, if required, at an individual dwelling level. Regardless of whether the allocation of government support for any future model is at an entity level, or at the level of individual dwellings, it is critical that financiers are able to easily ascertain the beneficiary of such government support.

7 Background on Corrs Chambers Westgarth: Australia's oldest independent corporate law firm.

Corrs Chambers Westgarth has a history spanning more than 170 years but is firmly focussed on creating opportunities for our clients in the rapidly changing business landscape.

With more than 600 lawyers, including over 110 partners, our people are consistently recognised for world class services and results. This year, 123 of our lawyers were listed as *Best Lawyers* in the annual *Best Lawyers* peer review.

Our clients want a law firm that is strategic, creative, flexible and able to work in their worlds. These are the qualities that characterise and differentiate our people: world class lawyers who are prepared to think big and do things differently.

Corrs is an independent Australian law firm committed to driving Australia's competitiveness and economic engagement. Our strong partnering relationships globally mean we are ideally placed to support clients whose businesses extend nationally and internationally.

Yours sincerely

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