Options for unlocking institutional investment in affordable housing

SUBMISSION REGARDING AFFORDABLE HOUSING WORKING GROUP ISSUES PAPER

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Industry Super Australia

ABOUT INDUSTRY SUPER AUSTRALIA

Industry Super Australia is a research and advocacy body for Industry SuperFunds. ISA manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of over five million industry super members. Please direct questions and comments to:

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SUBMISSION TO AFFORDABLE HOUSING WORKING GROUP

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EXECUTIVE SUMMARY

Industry SuperFunds

Industry Super Australia (ISA) undertakes collective projects on behalf of a number of Industry SuperFunds and affiliated entities with the objective of maximising the retirement benefits of the millions of industry super fund members. There are 15 Industry SuperFunds, in addition to wholly owned entities including IFM Investors (IFM), a multifaceted investment manager; Industry Super Property Trust (ISPT), an unlisted property fund manager and developer; and ME Bank.

Over the decade to 2015, assets under management of Australian Industry SuperFunds (the Funds) have risen from $45 billion to $209 billion and continue to grow rapidly. Industry SuperFunds manage assets for over 5 million members – or half of the workforce. The Funds are run only to benefit members, which includes directing all profits from investing to members. The Funds employ a unique investment strategy, reflected in asset allocations that have resulted in superior and less volatile investment returns on average over the long term.

Asset Allocation

Industry SuperFunds invest in both listed assets such as equities and fixed interest but also have a relatively high exposure - close to one-third of assets under management - to illiquid assets such as unlisted infrastructure, unlisted property and private equity. When preparing this submission, we have therefore considered both potential listed and unlisted channels to investment in Social and Affordable Housing (SAH).

Residential investment

The Funds have a significant strategic equity exposure to property, particularly unlisted property. Exposure to residential property has typically been limited to the development and sale of such assets. Regarding SAH, there have been some discrete investments and the Funds are continuing to explore sustainable investment models capable of delivering investment returns commensurate with the level of risk.

In recent times, there appears to have been a renewed interest amongst Industry SuperFunds and their affiliates in examining investment opportunities within the SAH sector. This has, in part, been galvanised by the recent interest of Australian governments culminating in the establishment of the intergovernmental Affordable Housing Working Group (AHWG) and its drive to identify innovative models to increase the supply of SAH.

Investment Rationale

The objectives of Industry SuperFunds in exploring options to invest in affordable housing include, first and foremost, that such investments could play a role in enhancing risk/return outcomes in a diversified investment portfolio. Secondly, improved outcomes around SAH may help ensure our members achieve a comfortable retirement. Thirdly, improved access to geographically diverse mixed housing can help deliver economic and social outcomes, which support maximising long-term retirement benefits.

A Competitive Source of Funding

Industry SuperFunds are potentially well-placed to invest directly in affordable housing, because of their investment beliefs, regard for externalities and business model. Industry SuperFunds seek to maintain a long-term investment time horizon and operate under a business model that looks after the long-term interests of beneficiaries, and does not include incentives in distribution to churn or encourage member switching, which in turn supports relatively high levels of liquidity. This model, combined with Industry SuperFunds efforts to achieve scale and a collective approach to investment, enables direct investment, which is often able to achieve better investment outcomes by eliminating intermediaries and ensuring direct control of assets.

Market Drivers

Affordable housing, by definition, offers sub-market rental income (generally acknowledged at 75 per cent of market rents). It is therefore very unlikely, without policy support, that investment in affordable housing will deliver rates of investment returns that will satisfy institutional investors. Investing in affordable housing can also involve high transaction costs, due to the myriad private intermediaries and government agencies involved in the delivery of such accommodation.

As the Issues Paper notes "housing exists on a continuum" meaning that "trends within other components can have flow on effects for availability of affordable housing (Figure 1). The general appreciation of house prices and rents since 2000 has been influenced by a number of factors. However, first amongst these is the so called "supply gap" and inelastic or unresponsiveness of housing supply to increases in housing demand.

Figure 1 – Housing Continuum

As such, we agree with the focus of the Issues Paper in support of policies that will increase the supply of housing more generally and in so doing ease price appreciation generally and more specifically for social and affordable housing. We do not canvass taxation settings in this submission but note that there is merit to the argument that negative gearing be limited to new dwellings.

The debate about how to secure housing on an affordable basis for Australians has been ongoing. Most policy proposals place government – either its balance sheet or organising capacity or both – at the heart of solutions. Industry SuperFunds believe that a market failure – inelastic supply – contributes to the issue. Insofar as institutional investment is sought as part of the solution, such investment must be a market-based solution aligning the interests of the community, government and investors.

Preferred policy options

Debt: The Bond Aggregator Model (BAM)

The Bond Aggregator Model could be effective at bringing greater institutional investment into affordable housing. The model we recommend envisages the establishment of an Affordable Housing Corporation that would interface between institutional investors and housing providers similar to the AHURI model and the UK Housing Finance Corporation. The Affordable Housing Corporation helps to overcome collective action problems by assessing and aggregating funding proposals from affordable housing providers. Government credit support for bonds issued by the Corporation helps to address the risk/return challenge of affordable housing investment.

Equity: The Densify Recycling Model (DRuM)

We also present a direct equity investment model that could create a pipeline of mixed housing developments that would require relatively less fiscal outlay by government, deliver social and affordable housing to the community and provide acceptable investment returns to our members. This model focusses on increasing returns and creating a project pipeline by "densifying" existing development and then recycling the proceeds.

1. Industry SuperFunds

1.1 Industry SuperFunds

Australia's superannuation savings are one of the world's top five pools of retirement savings. Superannuation assets stood at $2 trillion as at December 2015 and are on a 20-year trajectory towards $6 trillion, rivalling the projected assets of Australia's banking system.

A number of not-for-profit industry super funds, known as Industry SuperFunds, have a tradition of acting cooperatively. Collectively, these Funds are guardians of $209 billion in assets on behalf of their five million members – half of the Australian workforce.

Industry Super Australia (ISA) undertakes collective projects, including research and advocacy, on behalf of Funds and their members.

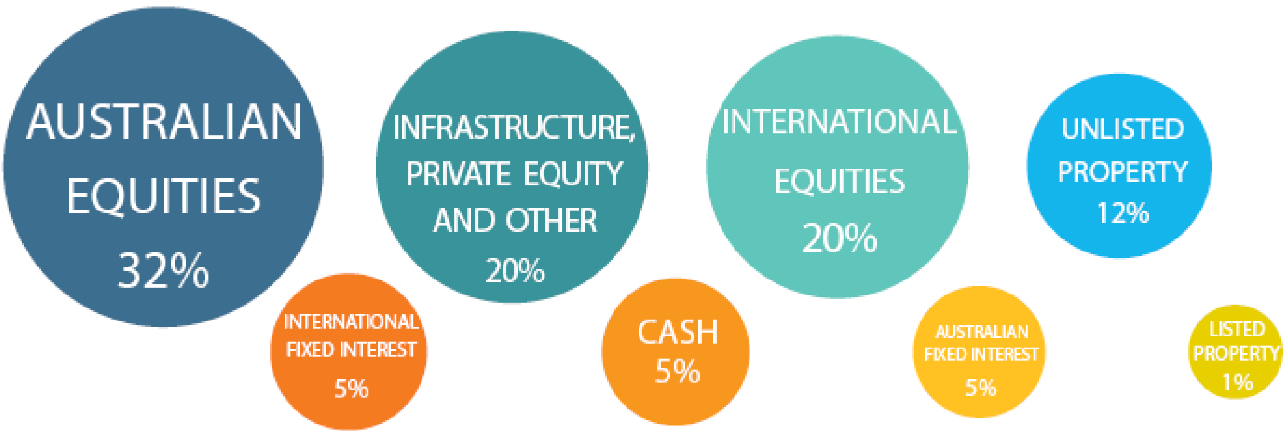
In addition to ISA, other collective vehicles include:

- IFM Investors - a multifaceted investment manager holding assets of $57 billion as at December 2015, including investments in listed equities, private equity, infrastructure and debt investments.
- Retail bank ME Bank - originally founded to provide people with access to affordable housing. Today it also offers a range of low- cost banking products including term deposits and transaction accounts for individuals and businesses.
- Industry Super Property Trust (ISPT) - a property fund manager and developer and one of Australia's largest unlisted property fund managers with over $11 billion of funds under management through investments in and development of commercial, retail, industrial and residential properties. In particular, they have successfully partnered to deliver residential estates and apartments.

1.2 Investment strategy and asset allocation

Industry SuperFunds have a unique, long-term investment strategy and related asset allocation that seeks to capture value and manage risk through diversified investment in both listed and unlisted assets here in Australia and offshore. In considering potential avenues for investment in affordable housing we have examined both direct and less liquid investments and investment through liquid, listed mechanisms.

Figure 2 – Industry SuperFund asset allocation (average of default strategies)



Source: Australian Prudential Regulation Authority

1.3 Industry SuperFunds and affordable housing

While Industry SuperFunds have a significant strategic equity exposure to property, particularly unlisted property, their involvement in residential investment is typically limited to the development and sale of such property. Where the Funds have considered or are considering investment in affordable housing it has largely been via the fixed interest component of the portfolio. A number of the Funds have looked or are actively looking at fixed interest investments where the income is derived via the National Rental Affordability Scheme (NRAS). However, the cash flows from such incentive schemes have not always been sufficient to generate a return commensurate with risk.

We welcome the establishment of the Independent Working Group, which is charged with developing a new Social Housing Capital Investment Fund based on packaging and aligning social housing income streams in order to generate an appropriate return and guaranteeing those income streams for an agreed period. A number of the Funds have indicated that the risk of policy change does act as a deterrent to investment in affordable housing.

Meanwhile, a number of entities are currently investing or examining opportunities in the affordable housing space. Cbus and IFM Investors are actively exploring fixed interest options. ISPT is examining the scope for a new model for equity investment. ME Bank is well advanced in developing a model for reducing financing constraints in affordable housing through "shared-equity" arrangements. HESTA has already established a strategic exposure to investment in a not-for-profit community group to enable them to purchase management rights for a number of NRAS properties.

1.4 Investment rationale

1.4.1 Overview

Industry SuperFunds are exploring options to invest in affordable housing for a number of reasons, including, first and foremost, the role such investments could play in enhancing risk/return outcomes in a diversified investment portfolio. Secondly, what role such housing could play in ensuring our members achieve a comfortable retirement. Thirdly, how improved access to geographically diverse mixed housing could deliver economic and social outcomes, consistent with improving wellbeing in retirement.

Modelling by Industry Super Australia (ISA) and Rice Warner shows that a majority of Australians are not expected to achieve income sufficient to generate a comfortable standard of living in retirement. Continuing to pay a mortgage or 'unaffordable' rents further diminishes the prospect of Australians enjoying a dignified retirement.

1.4.2 A comfortable standard of living in retirement

In addition to enhancing the risk/return/diversification of our members' investments, Industry SuperFunds have a further interest in the development of affordable housing, to improve the quality of life of our members during their working/pre-retirement lives. Specifically:

> *"Affordable housing is that which reduces or eliminates housing stress for low income earners and disadvantaged families in order to assist them in 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."*[1]

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[1] CFFR (2016) Affordable Housing Working Group: Issues Paper

The issue of affordable housing comes into sharp relief when Australians retire. Even under the assumption that a person owns their home outright, prevailing tax and transfer policy settings are not meeting community expectations of a comfortable retirement for all.

- For all Australian's retiring through 2055, more than half will not have incomes sufficient to support a comfortable living standard, taking into account the Age Pension, superannuation income and income from wealth outside superannuation.
- For those retiring in the near term, over two thirds will be on incomes below a comfortable standard. The situation is particularly perilous for women, with a substantial majority of women projected to receive incomes below a comfortable standard.
- The living standards of retirees will improve as the superannuation system matures, but not enough. Around half of all Australians retiring in 2055 will still have incomes insufficient to support a comfortable living standard despite being in the super system for approximately 40 years.

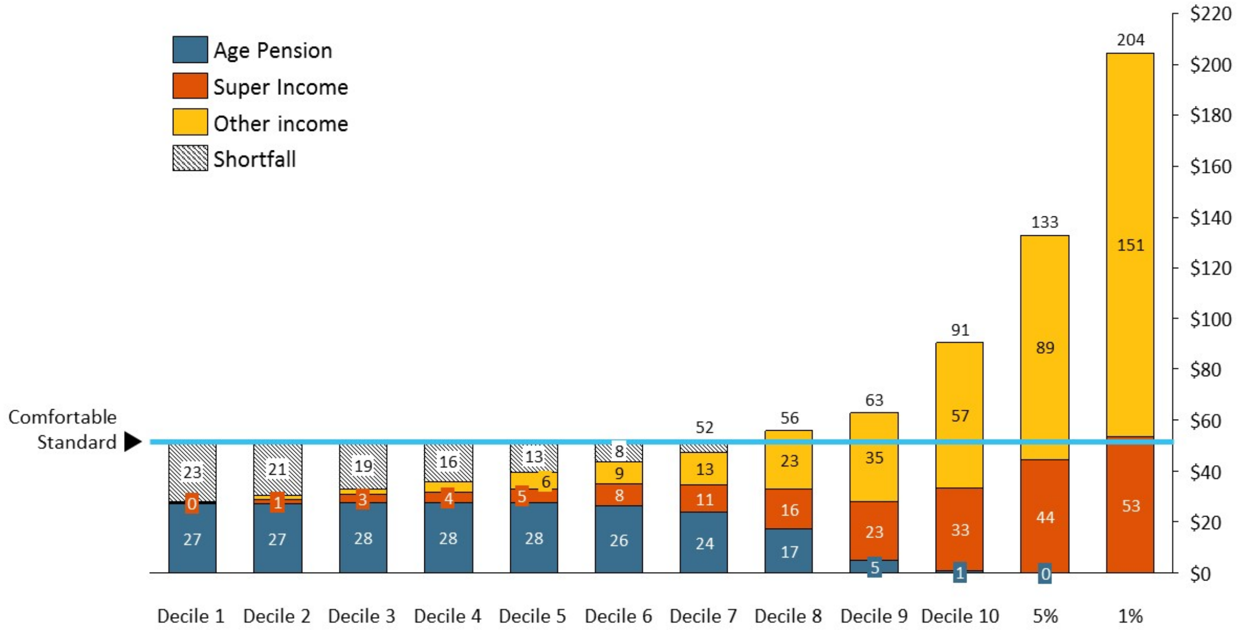
Figure 3 illustrates the challenge faced by single women retiring in 2025. Even assuming such a person owns their own home, only those in the top 3 deciles can be expected to achieve a comfortable retirement.

Research has been undertaken to determine the additional costs in retirement for people paying private rent or servicing their mortgage debt examining three scenarios (i) a single woman living in Melbourne and in private rental, (ii) a couple living in Sydney who have mortgage debt and (iii) a single man living in regional New South Wales in private rental. For example, women in category (i) are growing at a rate of 19 per cent per annum and have a superannuation balance in 2015 of $73,629. The shortfall between a modest standard of living which includes housing costs and the likely income from this balance is $171,034.[2]

[2] Per Capita (2015) Inadequacy of retirement income adequacy measures

Figure 3 – Retirement incomes by source

Single females, retiring at 2025, 2014 prices, by income decile, $'000s



Source: ISA/RiceWarner modelling

2. Affordable Housing Working Group

2.1 Objectives

We welcome the primary focus of the Affordable Housing Working Group (AHWG) on the introduction of innovative, transformative and implementable financing models. These models will focus on the social housing sector and the private rental market and be targeted at low income households. Its objectives are:

- Identify potential financing and structural reform models that increase the provision of affordable housing (social housing and housing in the private rental market) for those on low incomes;
- Provide assessments of potentially viable proposals put forward by stakeholders; and
- Outline the best method to progress further any models that are identified as potentially viable.

2.2 Definition of affordable housing

Affordable housing is commonly defined as housing where rent is 25 per cent below market rents. Social housing is usually defined as housing where rents equate to 25 per cent of Centrelink payments including the rental allowance.

We would however, suggest that affordable housing be defined more broadly to include new homes for purchase by low income households as is the case in the United Kingdom. As Prime Minister Cameron recently noted:

> *"For decades there has been one assumption…that is affordable homes in our country should only be available to rent...The result, unsurprisingly, is that we created 'generation rent'. Well I want to see*

'generation buy'. We're saying, yes, affordable homes must be built, but they can be affordable to buy rather than rent"[3]

Industry SuperFunds would also recommend policy that supports projects that provide a mix of affordable and social housing, along with housing at market rates. This could have a significant impact on the economics of any particular projects and also avoid creating areas of disadvantage. Consideration should also be given to the creation of additional income streams resulting from local retail and other concessions.

2.3 Barriers to increased private investment in affordable housing

The Issues Paper clearly identifies the key barriers to increased private institutional investment in affordable housing in Australia. There are certain barriers, however, where there are differences among institutional investors that introduce nuances, such as in respect of:

- *Scale* - institutional investors prefer scale because it reduces the relative impact of largely fixed costs of investing, such as due diligence. A number of large scale and diverse investment opportunities can help institutional investors diversify by taking relatively small parts of a broad set of assets, with beneficial effects on portfolio risk. Nonetheless, many institutional investors, particularly those with a long-term horizon, recognise that they must invest in smaller scale opportunities to facilitate later opportunities of greater scale, and that a failure of institutional investors to participate in small transactions (even indirectly) can undermine the long-term vibrancy and innovation of an economy. For this reason, efforts toward aggregation and collective action are supported.

- *Liquidity* - while some institutional investors are likely to hold investments for a number of years, the business model and funding of the investor can affect its capacity to invest in illiquid assets. Regulation of funds can effectively require that only a certain proportion of the total portfolio be invested in assets that are illiquid, to enable the investor to disinvest quickly to meet redemptions and other cash requirements. While liquidity is desirable for risk management purposes, it has drawbacks. One is lower returns, insofar as illiquid instruments typically receive a premium. Less well known, but important, is the incentive effects of liquid instruments on investors and the entities receiving investment, particularly in respect of equity investments. Companies owned by a greater proportion of long-term investors tend to undertake relatively more capital expenditure and R&D. The propensity for share prices (and certain management remuneration) to drop sharply based on sentiment is reduced. Investors who are unable to divest quickly are more likely to support the development and execution of long-term strategies by management.

3. Drivers of housing affordability

3.1 Introduction

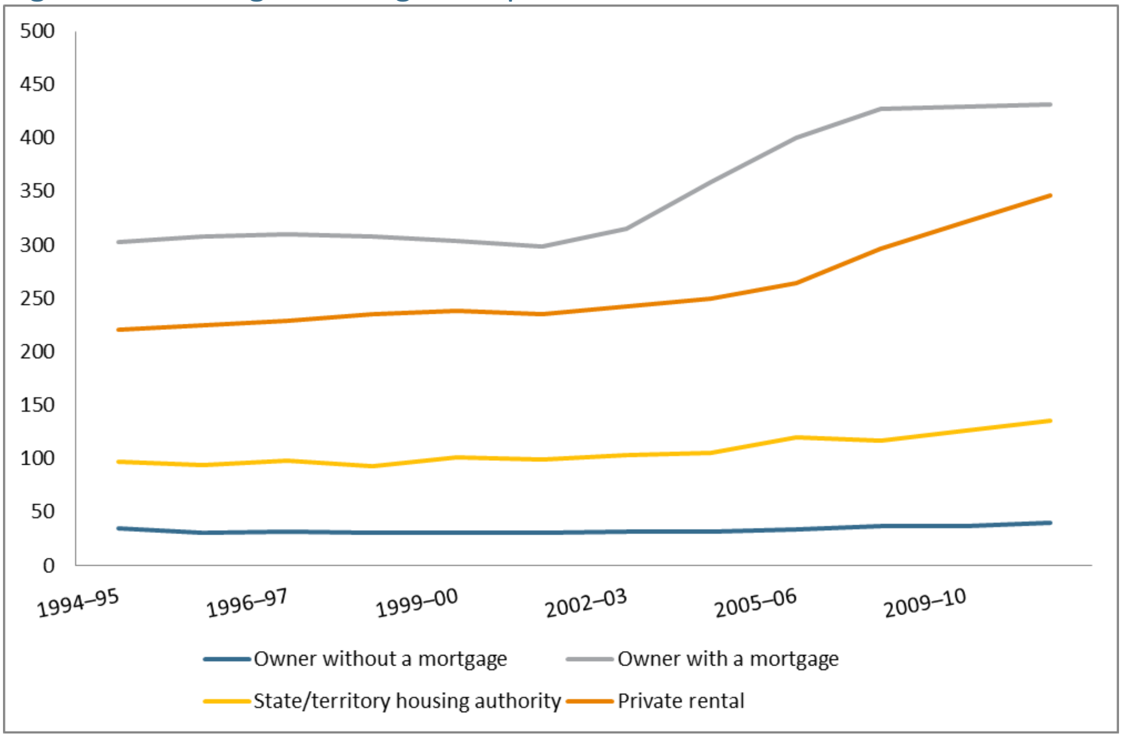
As the Issues Paper notes "housing exists on a continuum" meaning that "trends within other components can have flow on effects for the availability of affordable housing." The general appreciation of house prices and rents since 2000 has been influenced by a number of factors. However, first among these is the so-called "supply-gap" due to the inelastic or unresponsiveness of housing supply to increases in demand.

[3] Prime Minister of the UK, David Cameron (2015) This is a government that delivers

3.2 Changes in housing affordability

The cost of housing, through both home-ownership and renting, has increased significantly since 2000. Mortgage costs rose steeply prior to the GFC while rental costs have continued their increasing trend since the mid-2000s (Figure 4). The recent housing price increase, especially in capital cities, will flow through to mortgage costs.

Figure 4 – Average housing costs per week

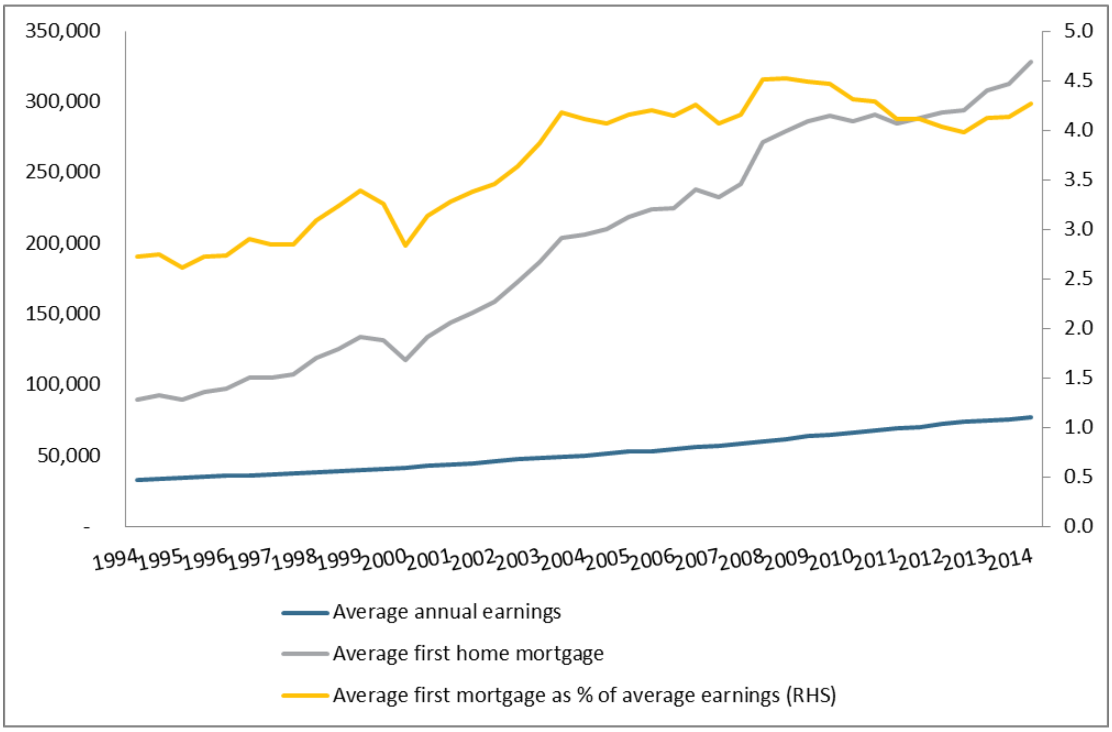


Note: Amounts in 2012-13 dollars
Source: ABS (Cat No 4130.0 – 2011-2012)

Increasing mortgage size relative to wages

The increased cost of housing is evident in the first home buyers' market with the average mortgage size – both in absolute terms and relative to average wages – increasing during the same period. The size of the average first mortgage is now almost four times the average annual wage, increasing from 2.5 times the average wage in 1994 (Figure 5). This increased cost has occurred despite interest rates on mortgages falling over the same period: standard variable rates fell from 10.5 per cent per year in 1995 and 1996 to 5.95 per cent per year in 2013.

Figure 5 – Average mortgage size of first homes and average annual earnings (nominal)



Source: ABS (Cat. No 5609.0 and 6302.0 – Jan 2015)

Demand and supply

The price of housing is a function of supply and demand.

Housing demand is driven by growth in population and social trends such as new household formation and divorce rates. In the future, the underlying demand pressure is almost certain to continue to increase, with new population projections by the Australian Bureau of Statistics (ABS) indicating the Australian population will increase by between 70 per cent and 120 per cent by 2061.[4]

Housing supply is, however, subject to a variety of constraints which add to the development costs and the speed of delivery. The Reserve Bank of Australia (RBA), along with the Productivity Commission and other industry observers have noted that there are a number of supply side constraints that increase the cost or time for the delivery of new properties.[5] These include:

- Complexity of the planning and approval processes
- Provision of and funding of infrastructure for greenfield developments
- Land ownership
- Public attitude towards infill developments

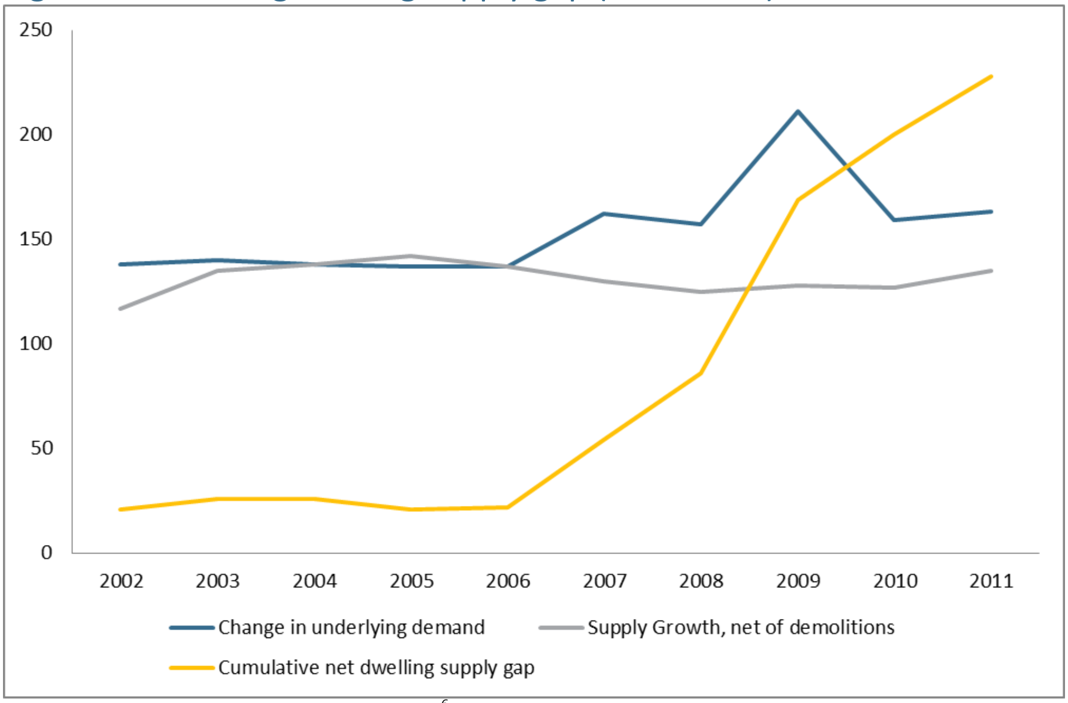
[4] ABS (2013) Cat. 3222.0

[5] Wing Hsieh, David Norman and David Orsmond, *Supply-side Issues in the Housing Sector*, Reserve Bank of Australia, September 2012, <http://www.rba.gov.au/publications/bulletin/2012/sep/2.html>

3.3 The "supply gap" and the inelasticity of supply

A growing body of empirical evidence suggests that in recent years, supply has failed to respond to the growth in demand creating an increasing housing supply gap (Figure 6).

Figure 6 – Growing housing supply gap (thousands)



Source: National Housing Supply Council estimates[6]

Although the aggregate figures show a supply gap, they probably understate the magnitude of the gap, because there is significant demand in key inner urban areas, whereas much of the new supply occurs on the metropolitan fringe. These figures also do not take into account the undersupply in particular segments of the housing market, such as affordable and community housing.

3.4 The magnitude of supply inelasticity

Ideally, market forces should respond to price signals, and housing supply should increase in relation to price increases and return to some equilibrium in terms of wages. However, housing supply shows low degrees of elasticity.[7]

Table 2 shows the severe estimated price elasticity for Sydney for the 15 years up to 2006. Elasticity below one is considered low, and reflects market conditions where an increase in demand is primarily transferred to increased prices, rather than an increase in quantity supplied. The analysis indicates that Sydney suffers from severe price inelasticity.

[6] National Housing Supply Council, 'Housing Supply and Affordability – Key Indicators 2012'

[7] Price elasticity is a measure of the effect of a price change or a change in the quantity supplied on the demand for a product or service

Table 2 - Elasticity of Housing Supply (Sydney)

Region	Strata	Non-Strata	All Property
Inner ring	0.35	0.08	0.26
Middle ring	0.84	0.10	0.31
Outer ring	0.66	0.38	0.43

Source: Gitelman and Otto, 'Supply Elasticity in the Sydney Housing Market'

The key factor driving housing affordability challenges is inelastic supply. Recognising this dynamic allows a more constructive consideration of the current policy responses, and should help to design more effective policy solutions or financing models.

4. Debt and equity models

The Issues Paper identified a number of existing models for both debt and equity, namely the UK Housing Finance Corporation (debt) and the US Housing Partnership Equity Trust (equity). In this section we canvass two Australian models – the proposed AHURI model (debt) and the Defence Housing Australia (DHA) Model (equity). It is important to note that the DHA model is not an SAH model. Nonetheless it provides a unique insight into how the deployment of equity on a large scale can be achieved.

4.1 The Australian Housing and Urban Research Institute (AHURI) model

The Australian Housing and Urban Research Institute (AHURI) released a position paper in 2014, detailing a solution to lower the cost of finance for affordable housing investments by establishing a guarantee scheme similar to other jurisdictions.[8] The proposal aims to correct market failures by providing affordable housing to lower and moderate income households, which would have follow-on effects across all segments of the housing market.

This policy proposal has the potential to "overcome many of the barriers cited by Institutional investors like Australian superannuation funds by offering suitable investment opportunities at an appropriate scale … It would meet the risk/return strategies of large and rapidly growing superannuation funds…It also meets the policy objectives to increase private investment in affordable rental housing and build a stronger and more efficient rental housing market"[9]. AustralianSuper, Australia's largest super fund was an early supporter of this model.

The proposal by AHURI involves two key changes that correct market failures. Firstly, it seeks to overcome the problem of scale, monitoring of investment and information asymmetry by establishing an expert not-for-profit financial entity, the Affordable Housing Finance Corporation (AHFC).

The AHFC would do the following:

- Assess and aggregate demands of affordable housing stock providers (registered Community Housing Organisations (CHOs);
- Combine the approved borrowings of CHOs and raise funding from long-term, lower yielding bonds issued to institutional investors; and

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[8] http://www.ahuri.edu.au/publications/projects/p53019

[9] http://www.ahuri.edu.au/publications/projects/p53019

- Distribute the funding and monitor CHOs' proper and effective use of the funding.

Secondly, the AHURI proposal provides uplift in the risk-return profile of the investment through a government credit guarantee on bonds issued by the AHFC. This is particularly desirable given that the income stream on the bonds primarily rests on repayment for affordable housing by low and moderate income households.

Arrangements similar to the AHURI proposal are common across a number of jurisdictions, and have been successful in increasing housing supply.

Positive features of the proposal

AHURI's proposal is worth considering because it:

- Focuses on a supply-based solution
- Facilitates the development of a private investment market in affordable housing, including the provision of funding from superannuation
- Bridges the gap between Australia's affordable housing investment needs and the risk/return strategies of large super funds
- The overseas experience demonstrates government guarantees have minimal impact on government budget and do not affect the government's credit ratings. Most of these bonds have had no defaults, requiring no payments by governments.

4.2 The Defence Housing Australia (DHA) model

Defence Housing Australia (DHA) presents a successful model of large scale private investment in the provision of housing. A number of key features of the model might be adapted to expand housing supply in Australia.

The DHA Model

DHA's role is to provide housing and related services to Defence personnel and their families. To achieve this, DHA is an active participant of the Australian residential housing markets, engaging in the following activities:

- Acquiring and developing land,
- Constructing and purchasing housing,
- Raising funding in financial markets through a unique sale and leaseback program,
- Property management, including tenant and leasing arrangements and property maintenance.

Sale and leaseback program

One innovative feature of the DHA model is the sale and leaseback program, where DHA sells properties to private investors on the condition that they lease the property back to DHA. The lease duration can vary from medium term (three years) to longer term (six to twelve years). The leases include the following provisions:

- A guarantee that rent is paid (even if the property is vacant)[10],

[10] DHA is a wholly owned government enterprise, so the guarantee is essentially a government guarantee. The shareholder Ministers of DHA include Minister for Defence and the Minister for Finance and Administration

- The rent is at market value, reviewed annually by independent valuations experts,
- Minimum rental guarantee: the weekly rent cannot drop below the starting rent,
- At the end of the lease, DHA refurbishes the property.

DHA also assumes the role of a rental property manager, including routine maintenance. It manages tenants, who are Defence force personnel and their families. DHA charges a high management fee of 16.5 per cent of rental income. This fee is higher than those charged in the private rental property management market, which are typically around 7 or 8 per cent.[11]

The sale and leaseback program has proven to be successful. In June 2014, DHA managed 18,577 properties across Australia worth around $10 billion. Around two-thirds of those are owned by private investors, and leased back to DHA.

The innovative sale and leaseback program is a primary source of funding for DHA. It helps to reduce capital requirements of the organisation, while maintaining an adequate level of housing stock for defence force members.[12]

In a sense, the DHA program undertakes property selection and management, and fundraising, to overcome collective action problems, with a government minimum rental guarantee to private investors; these features have successfully helped to shift private capital into the kind of housing stock that is desirable for public policy or Defence policy purposes.

4.3 Lessons from AHURI and DHA's models

Some important lessons can be drawn from the AHURI and DHA models, which should be considered carefully in forming affordable housing policy to attract private funding, including superannuation.

Both models have a central entity to manage development and assets, aggregate assets, and manage demands for financing. The creation of this specialised entity is important since few if any institutional investors have the capability or willingness to directly manage residential property issues. This model is also more efficient in terms of scale.

The two models offer two alternative financing options:

- AHURI's model suggests debt financing, where investors can buy government guaranteed bonds
- DHA's model offers equity financing, where investors purchase housing units and get guaranteed rental as income for a medium to long-term period.

The choice of financing will depend on a number of factors, such as investors' preferences and market conditions. However, both models require government coordinating action, and some form of government guarantee to attract investors, who require an uplift in the risk-return profile of investments in affordable housing. This may be a result of the difficulty assessing the credit risk of a broad range of renters, particularly in the affordable housing space.

The above set of features seems essential to attracting funding from institutional and other investors.

[11] Phibbs, Peter & Hanna, Bronwyn, Lessons of Defence Housing Australia for affordable housing provision, AHURI research

[12] Defence Housing Australia Annual Report 2013-14 <https://www.dha.gov.au/annual-reports/2013-2014/21_property_investment_and_lease_management.html>

5. Proposed models in practice

5.1 Model 1 -The loan/bond aggregator model

5.1.1 Background

There have been a series of barriers to entry preventing the large scale investment of institutional investors in the affordable housing sector. These barriers have been the lack of scalability, liquidity, consistency of Government policy and the inability to find an investment structure that provides an adequate return on capital for the investment risk borne. We note that there has recently been encouraging signs from all parties involved in the space to work through the details to remove or mitigate some of these issues and allow a long term and large scale deployment of institutional finance in the affordable housing sector.

At a high level, across the various models that we have seen through time, a bond aggregation model is the most widely canvassed option in order to attract institutional investment into the affordable housing sector and is our preferred model. We note that this model (or a version of it) has been proposed by many participants, with some papers providing more granular details. This model has the broad support of a number of research and housing interest groups.

Most of the models proposed in this space have commonality with the existing UK Housing Finance Corporation model which raises institutional debt capital for affordable housing projects. We note that the UK model has been in place since the establishment of The Housing Finance Corporation in 1987 and has a long and successful track record in raising long term and low cost debt for the affordable housing sector. It should be recognised this structure is linked to the provision of affordable housing as an asset – it is not linked to service provision to tenants outside this remit.

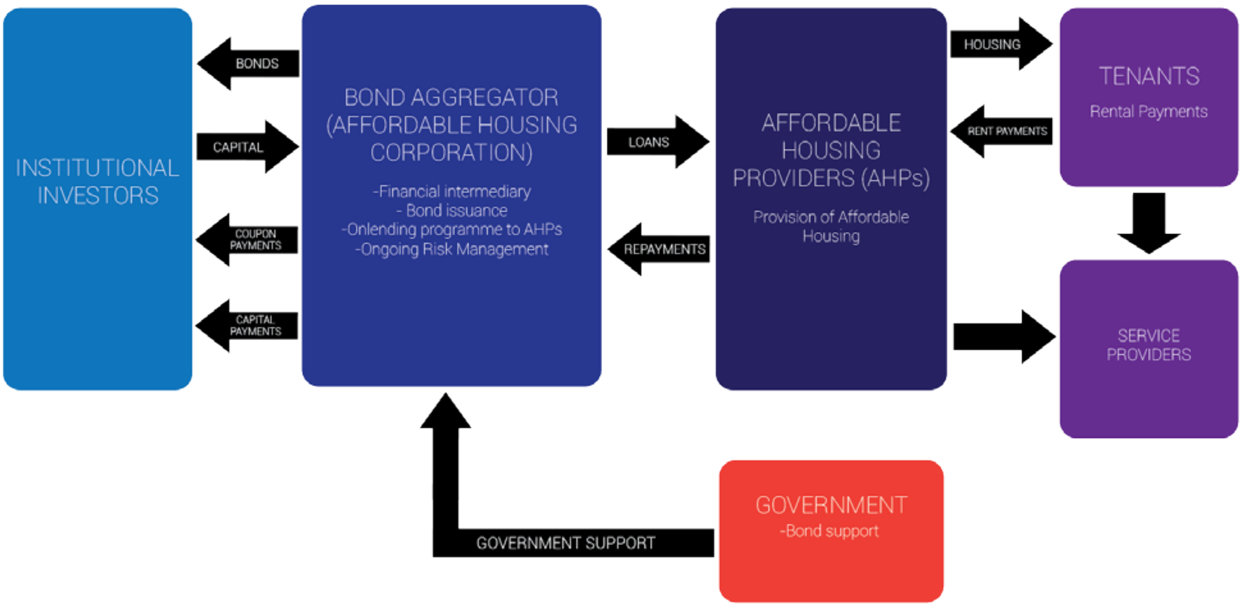
5.1.2 Description

The three key organisations required to facilitate large scale investment in the affordable housing sector are: the providers of affordable housing (Community Housing Providers, cooperatives, and similar organisations), the providers of long-term institutional finance and the Government. An indicative model to achieve a platform for institutional investment in the affordable housing sector would be to establish a specialist National Bond Aggregator (or "Affordable Housing Corporation") that would coordinate the interface between these parties and issue bonds to the institutional investors.

In order to play a stable long-term role in the provision of affordable housing, The Affordable Housing Corporation needs to comprise a strong Board with members drawn from a variety of sectors. In establishing an Affordable Housing Corporation style structure, consideration should also be given to the ability to build up equity or reserve funds, somewhat akin to the reserves held by the Treasury Corporations over a period of time.

Figure 7 provides an indicative overview of this structure.

Figure 7 – Bond/loan aggregator model



5.1.3 Roles and Responsibility

This specialist Affordable Housing Corporation, which would act in a similar way to a Treasury Corporation, would be responsible for:

- Performing credit assessments of approved affordable housing providers (community housing providers, cooperatives, private sector etc.)
- Aggregate approved credit for affordable housing provider into bond packages
- Issue bonds of varying maturities to institutional investors, and
- Collect repayments and pay coupons to institutional investors

To alleviate institutional investor concerns regarding the underlying counterparty risk and the return premium that would be attached to this, the Government would need to provide some degree of support to this structure. We further note that there have been different versions of the model put forward with varying levels of Government support from implicit guarantees or first loss pieces through to a fully Government guaranteed debt programme.

Should the bonds be issued on a less than fully Government guaranteed basis, a specialist bond aggregator that has the ability to issue bonds on terms commensurate with the underlying credit risk of the debt structure would be best placed to source the funds from the debt capital markets. In this case, the aggregator is critical in order for credit consistency to be achieved across all affordable housing debt and therefore provide the scale and scope required.

The responsibility of the affordable housing providers will be to coordinate and drive the development of new housing stock (land, construction and development, maintenance and operations).[13]

[13] The Affordable Housing Provider will also be responsible for delivering additional services to residents. However, as previously indicated, this does not fall within the remit of the bond risk allocation.

5.1.4 Implementation

This model could be trialed or, at a minimum, market soundings taken. We note that in this model, the Affordable Housing Corporation would be responsible for both issuing the Affordable Housing Bonds as well as providing the on-lending facilities to the various AHPs providing the housing and services. The Government's role would be to provide support to the bonds, adjusting their risk-return profile.

We note that the new intermediary would require legislative underpinnings and would need to be overseen by the Parliament or a regulatory body.

Pre-requisites for implementation

- Development of a panel of prequalified organisations able to deliver affordable housing
- Interim and long-term projections of demand for affordable housing

A detailed business case should be established before funding for a development is undertaken.

5.1.5 The benefits of this approach in addressing the affordable housing problem:

- Increase the supply of affordable housing;
- Large scale institutional investment will be available to finance affordable housing;
- The structure will bring a level of consistency to the institutional debt offering, facilitating the scale required for institutional finance to be deployed;
- Government support will ensure reasonable pricing;
- The financial intermediary (which may be Government owned and operated) will have the discretion to direct financing to service providers that have the greatest capacity to deliver cost effective housing;
- More structure and diligence around the demand, availability and delivery of affordable housing over the medium and longer term;
- Eventual liquid secondary market of housing bonds – we note that this is a medium to longer term objective and may bring issuance costs down over time;
- Creating an ongoing supply of housing bonds.

How this Approach Overcomes the Barriers to Entry for Institutional Investments

Scale: Sounding from the industry super funds sector suggests a healthy appetite for housing bonds if they are appropriately structured and are based upon a commercial rate of return (on a risk-adjusted basis). In very general terms, a 0.5 per cent initial allocation of assets under management to housing bonds as part of a diversified bond portfolio would translate into a sector-wide investment of $1 billion[14]. In terms of new annual inflows, a 0.5 per cent allocation would translate into an additional $200 million per annum.

Risk/return: The expected return on housing bonds would be commensurate with the level of risk implied relative to an AAA-rated Commonwealth Government bond. For a fully guaranteed structure, such a bond can be expected to trade in line and at the same level of volatility as a vanilla government bond of equivalent duration. As the level of Government support diminishes, the return requirement for the bonds will increase. We note that the scope to connect long-term capital owners with long term capital users provides a good fit for funding long-term affordable housing projects thereby reducing the project's refinancing risk.

Liquidity: The setting up of a market for a new security means that an illiquidity premium may need to be paid at the outset until the market matures. However, the anticipated underlying demand for newly issued bonds, the creation of a secondary market through time with regular issuance and the inclusion

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[14] Based on APRA data. Industry SuperFunds held 9 per cent of their portfolios in Australian Fixed Interest as at December 2015

of those bonds in market indices against which funds are managed should in due course deliver a more liquid market.

Diversification: By opening a new market segment up to the institutional investor, diversification benefits can be realised. In addition, the aggregation of exposures across CHPs provides a level of diversification benefit by reducing the concentration of the assets backing the debt financing to a specific region or market segment. We note that the potential for the issuance of longer dated bonds would provide investors with the opportunity to invest capital over a longer term horizon while still earning a commercial return on a risk-adjusted basis.

Investor awareness: Bonds or fixed interest is a well-established, deep, liquid efficient asset class with which all fund managers are very familiar. It should find a natural home in their portfolio.

Government support: As we have noted above, the bonds would preferably have some level of Government support in order to achieve the lowest cost financing outcome for the housing providers, while also creating an instrument that is more closely aligned to a government bond from a risk perspective.

5.1.6 Recommendations

We recommend that the Affordable Housing Working Group undertake the following:

- Work together with industry and other stakeholders on the granular details underpinning such a model and look to undertake an initial pilot programme
- Engage with offshore entities operating similar models to gather their experience and learnings
- Advocate for Government policy in this area to be stable and consistent to ensure investors are able to confidently consider such opportunities from a long term perspective
- Advocate for an ongoing robust regulatory environment surrounding the Affordable Housing providers

5.2 Model 2 – Housing trusts/equity

5.2.1 Background

Industry SuperFunds have a depth of experience and expertise in equity investment in property. Industry SuperFunds have a significant strategic allocation to property of $46 billion or 11 per cent of funds under management as at December 2015.[15] Exposure to residential property has typically been limited to the development and sale of such assets. Regarding SAH, there has been some discreet investments by the Funds. Since affordable housing by definition offers sub market rental income, there is a prima facie challenge that equity investment in affordable housing could be expected to deliver sub-market risk-adjusted investment returns. This would need to be corrected for institutional investment to be generally available. In order to establish a strategic allocation in SAH, this option seeks to increase risk-adjusted returns and create a project pipeline by densifying existing development and recycling investment proceeds to avoid stranded assets.

5.2.2 Description

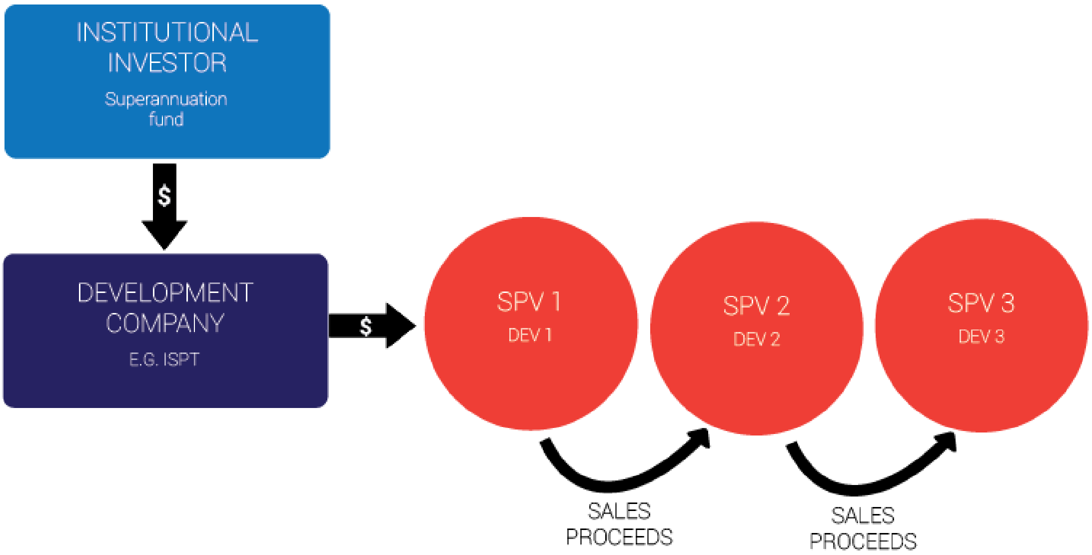
Under the proposed densifying recycling model, an institutional investor would invest in an existing housing development via a property trust. The property trust would redevelop the asset but in the process increase

[15] APRA (2016) Statistics : Quarterly Superannuation Performance

the density of the asset so as to increase the revenue yield of the development. This would likely include a mixed development of SAH and mainstream housing. It could involve building in open spaces or building upward. The yield could also be enhanced by introducing retail or other concessions onto the site.

Once the project is complete, it is sold in whole or part and profits are distributed to the original investors. However, the proceeds are then used to purchase another site for redevelopment and densification. As such, the densification recycling model can create a pipeline of projects for re-development. One key aspect of the model is that it aligns the interest of community members in need of affordable housing, governments who don't have the financial capacity properly to maintain let alone redevelop existing housing assets and investors seeking a market rate of return for their members.

Figure 7 – Densification/recycling model



5.2.3 Roles and responsibilities

This model is predominately a private sector solution, but there are important roles that government would need to be willing to play. First, government would need to be willing to sell public assets for redevelopment and establish a standardised process for achieving planning approval regarding densification. When the time comes to sell redeveloped assets, some funds may want to buy and hold these assets as long-term investors as they do with brownfield infrastructure. Second, government must, independently or working with industry, develop a roadmap of properties for redevelopment and recycling – if there is not certainty around the redeployment of institutional investment funds, proceeds of sale of redeveloped assets are more likely to be finally distributed to end investors, and the development company closed. Third, government should carefully consider earmarking some or all of the proceeds of its initial sale for new development or other supply expansion.

5.2.4 Implementation

Preliminary work is required to determine if the uplift in returns is sufficient to make this a viable option. Initially a business case should be prepared, most likely by institutional investors and property trusts. Subject to this, a trial could be initiated on a select development.

5.2.5 Benefits

- A sustainable and ongoing supply of social and affordable housing
- Reduced pressure on government finances
- A potential new asset class with attractive returns
- Improved social outcomes from mixed developments
- Geographic diversity reduces congestion and increases productivity

5.2.6 Overcoming barriers to entry

Scale: The development recycling model does not have the ready scale that the bond aggregator model has. However, over time the model could achieve scale if there is a clear and sizeable roadmap, and if sale proceeds continue to be reinvested.

Risk/return: Densification does present a means for elevating investment returns to commercial levels without necessarily any additional risk. Risk however, must be carefully managed.

Liquidity: The asset will not be liquid in that it is readily redeemable. However, there is a market for acquiring and disposing of these types of assets.

Diversification: Such investments would result in the diversification of risk in a new asset class but it seems there would be a reasonable correlation with other direct property investments.

Investor awareness: Investors would be aware of the infrastructure asset recycling model upon which this proposed model is based.

Guarantees: We do not envisage any guarantees would apply but the freeing up of government fiscal space for maintenance means government may make some contribution to projects by uplifting returns.

5.2.7 Recommendations

We recommend that the Affordable Housing Working Group:

- Work together with industry and other stakeholders to evaluate the potential of the densification and recycling model, including the propensity for government to sell public assets for redevelopment, the potential to establish a roadmap of transactions, and whether the economics of the transactions would satisfy all parties.

5.3 Model 3 – Housing cooperatives/shared equity

5.3.1 Background

As noted in the Issues Paper, housing co-operatives are not-for-profit legal associations formed for the purpose of providing access to housing for members. They seek to blend the provision of affordable housing with housing at market prices and depending on the model, potentially inject shared equity. Shared equity co-operatives involve a mix of funding from government and private sources. The housing provided may have originated from grants or loans which enables affordable housing to be offered.

Currently public shared equity models operate in the United Kingdom, United States and Canada and in jurisdictions across Australia (Queensland, Western Australia, South Australia, Tasmania and the ACT).[16]

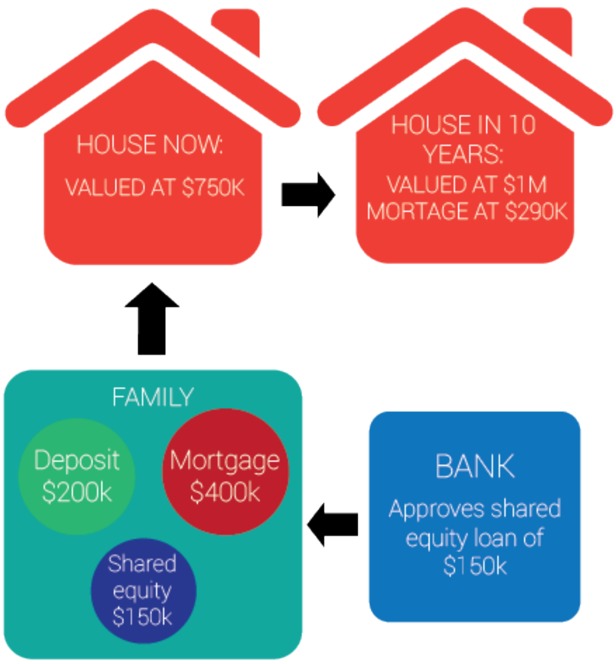
[16] ME Bank (2015) Housing Affordability

There are/have also been private for-profit shared equity schemes in the US and UK and in Victoria (Homesafe) and SA (Rismark). Some models work through a co-operative and some deal directly with the borrower.

5.3.2 Description

Industry SuperFunds may, in some circumstances, be attracted by the shared equity model. ME Bank is currently considering offering a shared equity model which operates on a one-on-one basis. It is proposed that ME would leverage its existing infrastructure to facilitate the initiative. All loans would be originated via ME's direct channels and ME would be responsible for all credit assessment.

Figure 8 – Shared equity model



While shared equity will be contracted with the individual, loans will be pooled and assigned to a Special Purpose Vehicle (SPV), consistent with what currently occurs for standard home loans. The SPV will be unrated and shared equity loans will not be comingled with standard loans. The SPV will issue a note that provides a pass through of principal and interest from the shared equity loans to the note holder.

Under such an arrangement, the homeowner and ME Bank would benefit from any equity appreciation of property proportional to the down payment. For example, if the down payment loan is equal to 10 per cent of the original purchase price, then the lender receives a 15 per cent share in the equity appreciation of the dwelling. Down payment loans usually are made with no interest or at a low interest rate.[17]

The impact on housing affordability of shared equity programs is ambiguous, but is unlikely to have a material positive effect on housing affordability. To the extent that shared equity loans are directed into existing housing, they are likely to make housing less affordable. However, shared equity investment targeted at new dwellings could help increase supply and not drive up prices. However, it should also be

[17] For a detailed explanation of the model and case studies: ME Bank (2015) Housing Affordability

noted that shared equity may give people the capacity to buy more expensive houses, again potentially driving up prices.

5.3.3 Overcoming barriers to entry for institutional investors

Scale: This approach can generate some scale but not compared with, for example, the bond aggregator.

Risk/return: Where the buyer is seeking affordable housing, competitive returns may not be available

Liquidity: The SPV would support some liquidity but the loans themselves would be relatively illiquid.

Diversification: There is some opportunity for diversification into residential housing.

Investor awareness: The shared equity model has been around for a long period but is not mainstream.

Government guarantee: Some form of guarantee could be sought if this approach were to be targeted at affordable housing, but further work would be required to explore this option.

5.4 Model 4 - Impact investing models including social impact bonds

5.4.1 Background

This model allows investors to pursue investments that offer sound investment outcomes for investors as well as positive outcomes for the community. These investments are undertaken consistent with the duty of superannuation funds trustees under Section 52(2)(c) of the Superannuation Industry (Supervision) Act 1993 to always act in the best interests of members and under Section 52(2)(d)(i) of that Act to always give priority to the interests of beneficiaries.

5.4.2 Description

Industry SuperFunds are open to participating in social impact investment either through equity or debt investment. HESTA has led by example. HESTA has a mandate under the fund's social impact component of its portfolio, implemented via Social Ventures Australia. Under that mandate, HESTA made a loan to a not-for-profit community group – Horizon Housing – to purchase management rights for a number of National Rental Affordability Scheme (NRAS) properties for social and affordable housing and a loan for the acquisition of a compliance function for a further number of NRAS properties. The overarching social impact of the two loans was that the excess cash flow that was generated enabled Horizon Housing to purchase additional new homes in Queensland.

The operational elements of the model are shown in Figure 9. Effectively there are four operational elements;

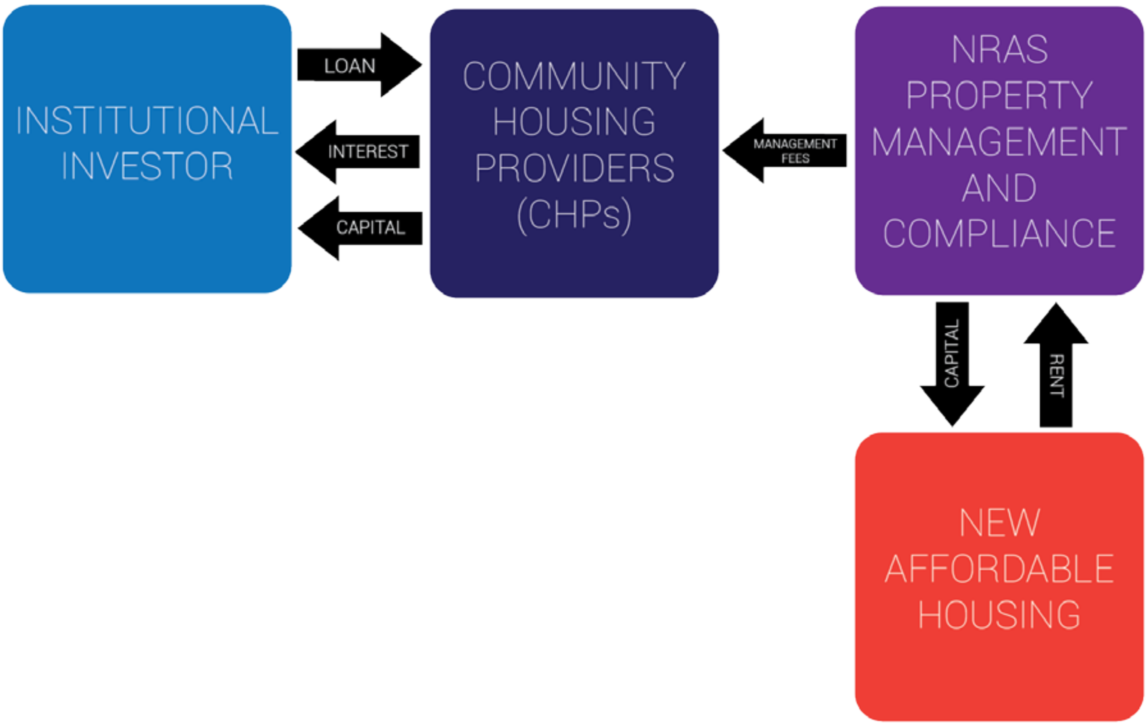
(i) The institutional investors, for example a superannuation fund

(ii) The Community Housing Providers (CHPs) who receive the loan and pay interest and capital

(iii) The property manager (often the CHP) undertaking property management and compliance

(iv) The tenant who pays rent including NRAS or other subsidy

Figure 9 – Social impact debt model



5.4.3 Objectives delivered

- New cash flow to invest in additional affordable housing.

5.4.4 Overcoming barriers to entry

Scale: While this model can be scaled up it is not as scalable as other models (e.g. the bond aggregator model). It also has a limited life expectancy because NRAS has been closed down. It would be necessary to find another viable income stream if this model is to become more mainstream.

Risk/return: The model should provide returns consistent with returns earned from other commercial entities with similar risk characteristics including, in particular, credit risk and vacancy risk. The guaranteed NRAS income stream does, however, lower the risk.

Liquidity: This model lacks liquidity. It may be possible to sell some of the underlying affordable housing assets however this would undermine the revenue stream supporting the model and creating an impact on cash flow supporting the development of new affordable housing.

Diversification: Providing a new model to access housing assets will contribute somewhat to diversification of investment strategies but price movement of housing assets is likely to be somewhat correlated with price movement for affordable housing.

Investor awareness: Social impact investing has existed for some years but would not be considered a mainstream investment.

Guarantees: The Government does guarantee NRAS cash flows however, since it is no longer accepting new applications, this guarantee is winding down.

5.5 Conclusion and Recommendations

Institutional investors, particularly the Industry SuperFund sector, would invest to build and develop affordable housing, provided the risk-adjusted return on investment is appropriate.

Since affordable housing by definition offers sub-market rental income, and affordable housing public policy seeks to overcome market failures, there is a necessity of government intervention to deliver policy and social goals.

In this submission, we have suggested roles that government can play to facilitate institutional investment in affordable housing, one principally focused on debt instruments and one principally focused on equity.

The core of the debt model, which builds upon the AHURI proposal, is a government aggregator, which assists with underwriting, operations and collections, and addressing collective action problems. The debt instruments issued by this entity would receive government credit support to help bridge the risk-return gap.

The core of the equity model is the combination of densification and government coordination to enable a rolling series of equity investment in developments.

ISA recommends the Affordable Housing Working Group work together with industry and other stakeholders to evaluate the potential of these models.