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Response to the Consultation Paper

'National Housing and Finance Investment Corporation – Draft Investment Mandate'

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Submission on the Investment Mandate

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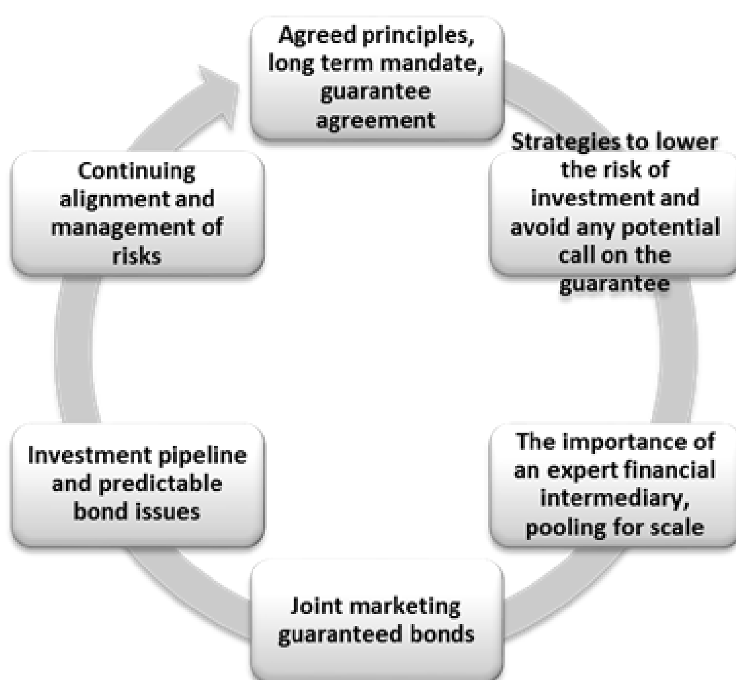
This submission concerns the proposed draft Investment Mandate for the Australian Housing Bond Aggregator, as part of the National Housing Finance and Investment Corporation and draws on relevant research and international experience. In particular it makes recommendations regarding eligible organisations receiving AHBA financing, the mechanism to build up a reserve fund as well as assess and report on guarantee liabilities. It builds on highly relevant international and national AHURI research and draws attention to the following sections of the following reports:

Report/Section	Lawson 2013 The Use of Guarantees in Affordable Housing Investment – a selective international review, AHURI, RMIT
2.3	Design elements of the guarantee
2.5	Accounting norms and practices when using guarantees
3	Different types of guarantees used for social and affordable housing
4	Discussion and comparison
5	Principles
Report/section	Lawson, Berry, Hamilton, Pawson, 2014 Enhancing investment in affordable housing via a financial intermediary and guarantee, AHURI, RMIT
5	Building on Australian Policy and Practice in the use of Guarantees
5.5	Key issues in developing a Social Housing Guarantee for Australia
6.3.1	Model – Affordable Housing Finance Corporation, specifically p.86-88
7.1	Building on research evidence
7.2	Applying key principles

The overarching approach to the process of financial intermediation, as applied to housing bonds with a guarantee (from Lawson et al, 2014: 54), follows the logic outlined below.



Specific Comments on the clauses of the draft AHBA Mandate

Clause 4 Definition

Favourable financing should be accessible to any registered and regulated provider which is operating for the primary purpose of providing affordable housing and supported housing services and regulated to do.
Sometimes, registered providers develop a range of housing services for both rental and ownership. They also establish companies to pursue for profit activities, cross subsidising profits for investment in social housing (Randolph, et al, 2018). These strategies have become necessary in the absence of sufficient balance sheets, a capital investment program or suite of subsidies to do so. Such subsidies, to address the funding gap have been recommended by the Affordable Housing Working Group (Commonwealth Government, 2017).
For profit developments are ring fenced from not for profit activities by housing associations and cross subsidy has become a common strategy.
Recently for profit providers have entered the market for affordable housing, attracted by tax incentives and the potential for availability payments.
Care needs to be taken by the AHBA that it is not supporting risky speculative projects and those with the primary goal of extracting surpluses for external shareholders. Such activities should not be subsidised by government and could also pose an unacceptable risk to the government guarantee.

First and foremost, the financing from AHBA should be primarily directed towards developments which provide below market rent and affordable home ownership profits on a not for profit basis but not exclude innovative mixed tenure or mixed income projects. Care should be taken to ensure that the favourable financing supports the not for profit entity rather than the for profit entity. To ensure public policy compliance, the subject property should comply with any affordability, ecology and sustainability conditions for housing assistance which under the NHHA should be clearly outlined in national or state housing strategies.

Thus, favourable financing should not be provided to developments where the majority of units are intended for commercial purposes via market rent or market sale and for which the primary goal is shareholder dividends. This requirement may need to become more precisely defined even in legislation, as has long been the case in many other European social housing systems.

Clause 10 Commercial approach

The comment below should be considered with the preceding.

Although it is understood that the AHBA must protect investors and the government guarantee, this clause should refer to financial feasibility rather than commercial. It needs to be clear and understood by all stakeholders that not for profit housing providers should not be driven to provide housing on a commercial basis this is contrary to their mission and charitable status.

Not for profit housing providers do not strive for investor yields and company profits in the standard commercial market sense, rather they aim for financial feasibility and sustainability, covering costs and accumulating sufficient surpluses to maintain and eventually contribute equity to expand their affordable housing portfolios and support services.

Their low operating margins, rent revenue constraints but access to conditional subsidies necessarily requires a different business model than commercial providers. To date this has not been well defined in Australia – but has been in many other countries.

Housing associations can also be exposed to fewer risks than a more speculative commercial asset strategy. They are funded by commonwealth assistance and other government subsidies. They do not have to pay out dividends to unit holders or charge commercial management fees, as in REITS, which can erode cash reserves and risk buffers.

Clause 11 Reserve funds

As proposed in the implementation steps in the AHURI research on the intermediary and guarantee (Lawson, Berry, Hamilton and Pawson, 2014) the AHBA should establish internal procedures for creating borrower-specific and general reserve funds to reduce the likelihood of the guarantee being called on.

The probability of the government guarantee being invoked in this model will be reduced via:

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 borrowers.
4. The monitoring and step-in powers over borrowers exercised through the National Regulatory System.
5. The reserve funds held and accumulated by management to maintain continuity of payments to bond holders.

In the AHBA model, the investors' interests are protected by the government guarantee – but the guarantee is protected by practices 1-4 above and the reserve funds.

From the government's viewpoint, the guarantee is a final backstop to be drawn upon only if:

1. a borrower defaults after other procedures and processes fail, and
2. the reserves held by management are insufficient to meet loan payments when due.

As outlined in the AHURI report (Lawson et al, 2014), and drawing on the UK and Swiss experience, there are two reserve funds that can 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. 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. Such a reserve was used by the UK's THFC to convince HM Treasury of the very low risk of the guarantee to government.

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 management as a general reserve to cover unexpected contingencies ('unknown unknowns'). This is not returned to borrowers and accumulates as a further fund from

which to manage possible but unforeseeable default threats. 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 Cooperative and negated any need to rely on government support.

The role of these reserve funds 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 management to step-in in this manner; these details should be harmonised with the procedures laid down in the National Regulatory System for Tier 1 non-profit housing providers.

As in the Netherlands and Switzerland (Lawson, 2013), a guarantee fee can also be used to build up a reserve fund proportional to the obligations guaranteed. It can also be conceived as the government guarantee's second line of defence against being called upon. In Switzerland, the fee is used to cover interest payments for a maximum of one year and is, of course, in addition to any issuance fee.

Alternatively, governments can act as an insurer, by pricing the risk and charging fees; thereby accumulating a fund. Otherwise they must account for this risk in their budgets, as contingent liability and set aside an acceptable proportion of the guarantee obligations.

If they intend to regularly support organisations to meet their repayment obligations, the government is in effect taking responsibility for them and they should be accounted as such in the government budgets.

The creation of a reserve fund by AHBA would enable payments to be made to investors holding defaulting debt, thus avoiding any call on the government guarantee and a threat to the value of this guarantee.

This fund could be fully funded by government or co-funded with, for example, the non-profit housing provider sector. The balance of provider versus government contributions to the fund could evolve with the former increasing relative to the latter as the rental sector matured. A final government guarantee could stand behind the reserve fund that would be called upon only in the event that the fund was exhausted before investor entitlements were met. This two-part structure has the benefit of allowing time for restructuring the debt of defaulting providers—for example, by merging at-risk providers with stronger ones. It may also reduce the cost to government of credit enhancement.

Other forms of back-stop guarantee options could be a government commitment to purchase unsold dwellings at agreed market value upon default or in the event that a newly-developed housing project fails to be taken up fully by private investors.

Specific conditions can be placed on guarantee structures with respect to timing, financial limits, reporting and monitoring, and cascading by level of risk reduction. In the latter context, specific debt instruments can be engineered with different levels of support, enabling the different tranches to be targeted at different investor/stakeholders; the deepest enhancement would be attached to low risk-return instruments sold to the superannuation funds.

Clause 16 Eligibility for loans

Favourable financing, conditional subsidies and regulation should reinforce each other to deliver effective, efficient and equitable housing outcomes towards a national and local strategy.

AHBA loans will provide long term finance for turn-key projects which have already been developed. They have already received planning permission, development finance and are either tenanted or about to be occupied.

Given that subsidised social housing necessarily involves subsidy and planning permission, it is likely they have received some form of subsidy, such as land, development permission, developer contributions, capital investment grants or subordinated public co-financing. This is also the subject of the recommendation made by the Commonwealth's AHWG (2017).

In a well-functioning social housing finance system, registered providers of social housing will have already gone through numerous local and state level processes of selection and possibly competition for these subsidies in order for the housing to be developed.Their access to long term AHBA financing should complement and reinforce these conditions but not add excessively to any delay by doubling up on selection for loan finance.

It should be sufficient that these turn-key projects are managed by registered not for profit private or public providers for the mission of affordable rental and shared ownership housing and that the subject properties fulfil this mission.

Of course, these assets can change their use, be rented at market rates and sold to the highest bidder. The AHBA will need to be confident there is a mechanism which ensures ongoing eligibility. This is where the National Regulatory System important and perhaps even legislation on the use of subsidies. See also below for how this works in Finland and Austria.

Clause 34 Guaranteed liabilities

An appropriately designed guarantee mechanism could unlock much larger volumes of investment on more favourable terms, with very little impact on the public budget. To do so, the guarantee must respond to the local housing and treasury policy climate as well as borrower capacity and investment conditions.

First and foremost, the AHBA would need to focus on the cash flow of housing associations and apply various stress tests to inform their judgment on AHBA guarantee liabilities and any likely calls on the guarantee.

A sustainable and sound business model is the strongest line of defence protecting any government guarantee, growing supply capacity amongst providers and easing access to lower cost larger volumes of investment.

The AHBA would need to consider cash flows, rent indexing policy and subsidies and the capacity of housing association revenues to cover their operating, maintenance and finance costs. Indicators such as debt service cover ratios and interest cover ratios are vital.

Plans and policies change over time and the AHBA would need to be regularly informed about housing association solvency, strategies for project development and regeneration relative to actual performance, as well as existing stock management practice and capital adequacy.

Cash flows are also impacted on by a number policy settings including the rent regime, rent assistance settings, service payments and importantly any other form of subsidy including that from a capital investment program providing grants, tax incentives or interest subsidies. Thus they are subject to political risk, which will also inevitably impact on provider's capacity to borrow from the AHBA.

Also important are the market conditions affecting investors. Market conditions amongst investors and borrowers are decisive for the rise and fall of actual loan terms and conditions. Bonds will vary in cost and tenor depending on the market appetite, where the longer the bonds maturity the higher the interest rate and hence the cost of borrowing. Duration, above- or under-par issuances and volumes are determined by the situation in the capital market and the needs of the borrower. The interest rate depends on the going SWAP rate for bonds and the going rates for borrowers with the highest credit rating (AAA).

For these reasons the investment market conditions and borrowing capacity of housing associations need to be assessed regularly by the AHBA and for over a reasonable period, such as three years.

This would inform the setting of a liability cap for guarantees. For details on how this works in Switzerland see below. The Guarantee agreement defining overall volume cap (and hence contingent liability) for government, will also provide a pipeline and give certainty to investors.

Relevant International Experience

Much has already been written about the THFC in the UK, and much has been shared by senior staff of this organisation with Australian policy makers. This has been of great assistance.

It is also highly relevant to consider the experience of Austria, Finland and Switzerland, which also utilise financial intermediation with a government guarantee to reduce the cost and lengthen the terms of finance for social housing. Their established and successful experience is particularly relevant for both the investment mandate of the AHBA and the long term development of the social housing sector in Australia.

The key message from these is that access to favourable financing via intermediation is linked to their use of conditional subsidies. Further, transparency and compliance is ensured via effective project monitoring and communication with fit for purpose auditing and regulatory systems. Together favourable financing, conditional subsidies and compliance reinforce each other to deliver effective, efficient and equitable housing outcomes in line with national and local housing strategy.

In these three countries, government efforts to reduce the cost and improve the tenor of private financing for social housing have been directed towards those providers which focus on the construction and management of affordable rental dwellings broadly targeted and sometimes used to promote use of green technologies or have simply to bolster broad based housing supply.

Furthermore, access to explicit and implicit subsidies, in the form of grants, interest rate subsidies tax incentives and guarantees, is only given to providers which operate a transparent and accountable business model in which the costs involved and use of accumulated surpluses are well defined,

transparent and can be monitored by subsidy providers. In each country this model is defined in Act of parliament.

In this way subsidies and favourable financing won't flow towards inflating costs, including management fees or be unreasonably extracted by any shareholders.

Austria

Since 1994 finance raised by Austria's six Housing Banks issuing tax privileged retail Housing Construction Convertible Bonds HCCB has to be invested in *subsidized* housing projects - but these may be provided by housing associations or commercial providers.

However, recipients of favourable financing must practice a business model which re-circulates any surplus towards the mission of affordable rental supply, and this model does not tend to attract for profit providers, such as REITS who of course thrive on management fees, deliver dividends to shareholders and tend not to build for a social purpose. Hence, the longer term lower cost financing goes mostly towards the limited profit housing sector and not the commercial sector. In this way any related subsidy program providing grants, interest rates subsidies, guarantees and public loans is efficiently extended via the intermediary providing lowest cost private financing. As these subsidies rise and fall, favourable financing has remained important in steering housing outcomes.

Austria's housing promotion law requires that any housing project receiving a subsidy has to operate as a cost capped cost rental limited profit scheme that recirculates limited surpluses towards maintenance, replacement and new production of affordable rental dwellings. Most housing projects receiving grants or interest subsidies are co-financed by longer term lower cost HCCB backed loans. By the end of 2012, the volume of outstanding loans backed by HCCBs was around € 14 bn (Amann, 2016).

In Austria social housing provision is regulated by both the LPH Act and Housing Promotion Act which govern the business model of HAs and the permitted use of subsidies (see Deutsch and Lawson, 2013). LPHA are audited annually under a fit for purpose accounting system, compliant with these Acts.

Recently, the Austrian government legislated to establish a new financial institution to issue bonds, for the first time with a government guarantee, and channel even lower cost fixed rate funding towards limited profit housing associations and commercial providers that employ a defined limited profit business model.

The new not for profit credit institution is called the Federal Housing Construction Investment Bank (Wohnbauinvestitionsbank, WBIB) and will channel long term lower cost EIB (European Investment Bank) investment towards affordable rental housing. It is part of an investment package to foster job and economic growth via stimulating housing supply (so-called Wohnbauoffensive) and aims to create 30,000 additional affordable housing units over the next 5 to 7 years. The total investment should amount to almost € 6 billion and the government expects an economic impulse of 0.4% additional GDP growth per year (BMWFW, 2015). Austria claims that "Through WBIB, new ground is broken insofar as European funding is used for residential construction in a budget-friendly and Maastricht-neutral way." (BMWFW, 2016)

WBIB legislation was passed in January 2016, with a preamble highlighting housing supply and affordability. The target for WBIB funds will be new construction of affordable rental housing (90%) developed under cost capped cost rent business model as defined in the Limited Profit Housing Act.

This rental housing can also be purchased by sitting tenants after 10 years if desired by tenant. Also LPHAs can obtain cheaper long term loans for energy efficient housing retrofitting and renovations (10% of funding allocation) (see Lawson, 2017 advice to Treasury). WBIB is subject to Financial Markets Authority and Auditor General. Local government which disperses the subsidies is subject to Regional government audits of dispersal and use of funds.

The government guarantee is provided by the Ministry of Finance to the EIB, in the event that the WBIB cannot repay the funds provided by the EIB. The collateral for the guarantee are the mortgages on the properties financed by the WBIB which are registered on the national land registry. It is a deficiency guarantee which is capped at €500 million. The figure is loosely derived from the WBIB's 25% contribution towards the cost of financing 30,000 dwellings estimated at €6 billion. The actual volume of guarantee loans provided by WBIB will be reported to Austria's parliament via a government Advisory Council monitoring implementation of the WBIB. The actual amount that will be borrowed from the WBIB will depend on the development opportunities and capacities of the LPHA. These are promoted by Austria's housing subsidy programs and planning systems and refined by state governments, with projects approved local governments.

The Guarantee will be paid for (like an insurance premium) by borrowers, on top of the loan interest rate. It is expected to be 0.034% on top of the loan interest to be paid on a quarterly basis to the Ministry of Finance by the WBIB. This premium was required in order to confirm with market practices and European Commission policies on state aid and competition.

Finland

The same conditionality and governance regime applies in Finland since the 1990s, integrating favourable private investment raised by a public intermediary, public subsidies and effective regulation. The sliding scale of subsidies for different housing and support needs is interesting for Australia's efforts in addressing the funding feasibility gap (ARA, 2017, Averio, 2015, AHWG, 2017, Hamilton, 2016).

In the Finnish model, outlined in the figure below provides favourable financing from a publicly owned financial intermediary called Munifin and interest rate subsidies and guarantees provided by the national government can only be used by housing providers that are regulated by the Finnish limited profit housing Act. This regulator enforces cost capped cost rent for all providers receiving subsidies.

Finland uses a straight forward approach balancing conditional public investment of variable grants with lowest cost publicly raised and guaranteed bonds and well-targeted housing allowances and regulation on providers to provide a continuum of housing services for Finnish households.

Of central importance is the specialist role of Finland Housing Finance and Development Centre (ARA) which monitors needs and procurement costs, regulates providers, approves their financing costs and provides subsidies. It offers a sliding scale of grants – 10% to 50% depending on complexity of needs to be addressed.

ARA's public loans, interest subsidies and grants are financed from an off-budget fund called the Housing Fund of Finland. The off-budget fund receives cash from interest payments and amortization of existing state housing loans and additionally from external funding. It is a kind of future fund for housing. It is substantially larger, more effective and transparent version of proposed Growth Funds in NSW and Victoria which could be used to complement an established ABHA.

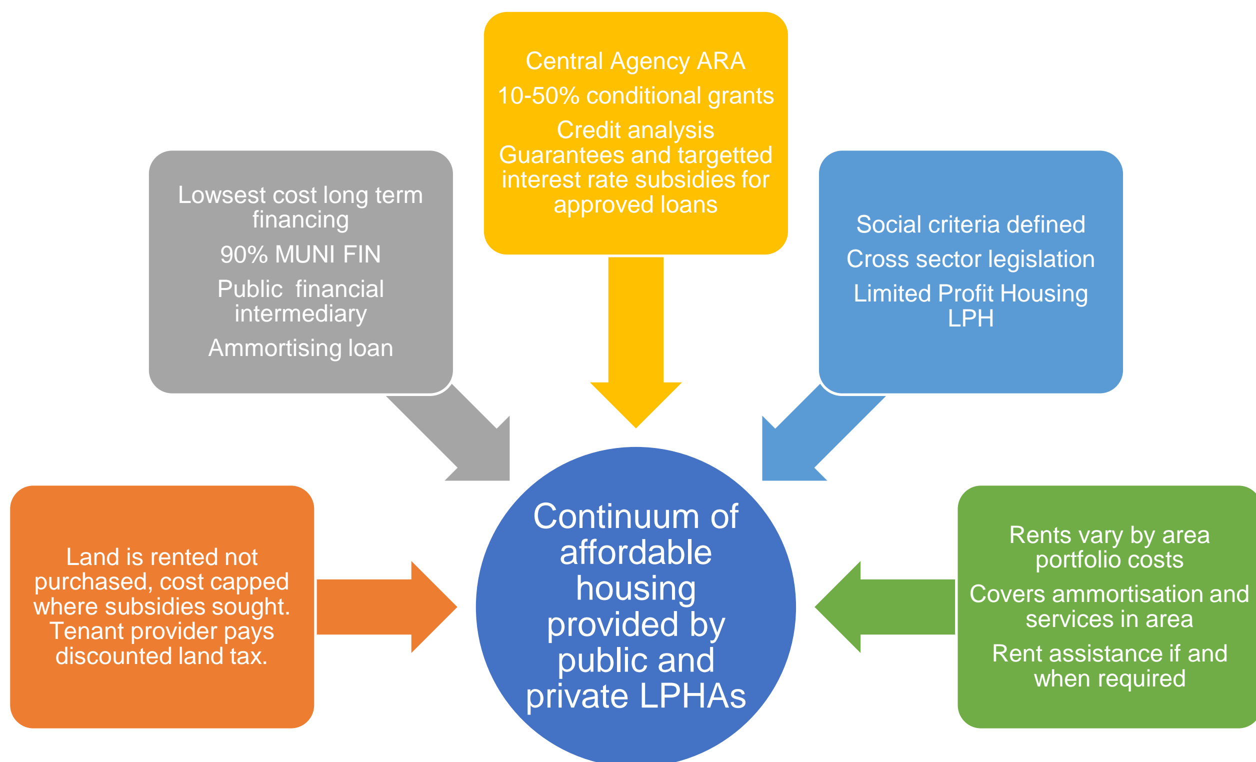
The Guarantee and Interest subsidy is only provided on approved loans within the interest rate cap.

Private debt is raised from the debt capital markets via the Municipal Finance Corporation. This is Finland's pubic infrastructure bank which finances both social housing and infrastructure.

Clarity of regulation of providers public and not profit under Limited Profit Law. After costs and maintenance, surpluses must be reinvested new supply. It also relies on land being long term leased rather than up front owned, which is interesting as a solution in Australia, where up front purchase is prohibitive and governments or private investors want to retain an equity stake in housing projects.

Together ARA and Munifin together constitute one of the most effective social housing systems in Europe in terms of preventing and reducing homelessness and providing a continuum of housing options for households neglected by the free market, as outlined in Figure 2 below. See also Averio (2015).

Figure 2 Finland's social housing system with intermediary and guarantee



Switzerland

There is much to learn from the EGW in Switzerland which is detailed in Lawson (2013). Australian policy makers have also benefited from advice by the Chair of the EGW, Dr Peter Gurtner, former head of the Federal Office of Housing and his involvement in Australia's National Housing conference in Adelaide.

With regards to the guarantee cap, in accordance with the Housing Bill the Parliament periodically sets a credit line for the Bond Issuing Co-operative (EGW) guarantees.

This amount only figures in the annex to the annual budget and state accounts. Whenever a guarantee is granted for a new series of bonds, the margin for further guarantees shrinks. The annex therefore shows the total of the credit line, the part of it already used as well as the potential for further obligations.

Once exhausted a new credit line must be opened by the Parliament. As with all Swiss Federal Government initiatives, the EGW is subject to five yearly efficiency reviews (SECO 2010). On the basis of continuing favourable performance, the Swiss Parliament extended EGW's credit facility in 2010 to allow new bonds issues by another 1.4 billion CHFs (with a vote of 109 to 64). The Minister of Economy, the Swiss Union of Cities and the Association of Swiss municipalities were important drivers for the renewed credit cap. For more detail on the Swiss model see Lawson (2013).

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