**SUBMISSION TO THE REVIEW OF THE OPERATION OF THE NHFIC ACT 2018**

By **Stephen Knight**

1. **INTRODUCTION AND BACKGROUND**

In early 2017 I was appointed by the Government to chair the Affordable Housing Implementation Taskforce to evaluate a model for establishing a bond aggregator for the social and affordable housing sector. My background in capital markets was relevant to this appointment. I had worked in financial markets my entire career from 1980-2015, with a strong focus on debt capital markets and government finance. I worked for NSW Treasury Corporation (TCorp) from 1996-2015, and was Chief Executive Officer from 2005-2015. I joined the Advisory Board of the Australian Office of Financial Management (AOFM) in 2016, and have served on AOFM’s Audit Committee since 2017.

The taskforce was established in March 2017 (refer media release from Treasurer Morrison dated 10/3/17 “Turnbull Government establishes affordable housing taskforce”) comprising myself, Peta Winzar (CEO of Community Housing Industry Association) and John Fraser (Treasury Secretary) as the expert panel, overseeing the work of Treasury officers and other Government officials. Two other independent experts (Piers Williamson – CEO of The Housing Finance Corporation in the UK, and Matthew Quinn – former CEO of Stockland) subsequently joined the panel. The taskforce was to finalise its work and report back to the Government by July 2017.

The taskforce provided an interim briefing to Treasurer Morrison and Assistant Minister to the Treasurer Sukkar prior to the May 2017 Budget. By that stage we had formed clear views on the key parameters and settings for the bond aggregator, and were finalising some of the detailed work. In the 2017 Budget the Treasurer announced the establishment of NHFIC, including a bond aggregator and an investment fund, to commence operations by 1 July 2018.

The final report from the taskforce, including detailed analysis by EY, was completed in July/August 2017 and presented to the Government.

Following this I continued to assist Treasury officials through the establishment phase for NHFIC, including advice on aspects of the operating model and commercial arrangements. This process continued from mid-2017 up until the commencement of NHFIC’s operations on 1 July 2018.

In October 2018 I was approached by the Chair of NHFIC to chair NHFIC’s Bond Due Diligence and Issuance Committee, designed to oversee the establishment and ongoing management of NHFIC’s bond issuance program. I chaired the first committee meeting in November 2018 and have continued in this role to this day. In addition to overseeing each issuance for NHFIC, the Committee fulfils an important role in advising NHFIC Board on funding alternatives for key transactions (including substantial state based housing renewal/development projects), strategic development of a yield curve for NHFIC bonds, and interaction with joint lead managers and investors.

My involvement with NHFIC throughout the conceptual, establishment and development phases provides some important context to the operating framework for NHFIC and hopefully provides some useful input to the review process. As such my comments will be contained to the effectiveness of key aspects of the bond aggregator model, focusing on -

1. Effectiveness of NHFIC borrowing
2. Pricing relativities
3. Government Guarantee
4. **EFFECTIVENESS OF THE NHFIC BORROWING MODEL**

My first question during the taskforce process was to gain a clear understanding of the Government’s key policy objectives, as this would inform the preferred outcome. Basically, if the ONLY objective was to obtain the cheapest possible debt finance for CHPs, and assuming the Government was willing to provide a guarantee, then why bother establishing a separate entity to issue bonds? Better to have AOFM issue additional CGS and pass the funds through, as guaranteed agency debt will always trade above the more liquid sovereign debt in yield terms (estimated 50+bps at the time but this margin varies). The policy response from Treasury was clear – the taskforce was advised that this dynamic was well understood, but there were a number of key policy objectives at the time which I recall as follows –

1. Provide substantially cheaper and longer tenor debt funding for CHPs than they were able to achieve through bank finance
2. Encourage private sector investment in social and affordable housing through development of a new asset class
3. As part of a range of policy initiatives addressing the CHP sector, establish an entity that would apply a lender’s discipline to the sector and work with the CHPs to help them improve their balance sheets and facilitate new investments in housing stock

In terms of the cheaper alternative question (ie AOFM funding), (i) and (iii) could still be achieved by using CGS for debt funding, but (ii) could not. While the institutional investors who initially purchased NHFIC bonds are largely the same investors for CGS and state government bonds, the defining feature of the NHFIC bonds that will become increasingly important is their status as social bonds. An increasing number of funds and institutional investors are specifically allocating funds to ESG, social and green bond programs, and this will play well for NHFIC’s positioning into the future. It also goes a long way towards achieving the policy objective of attracting private sector investment into the asset class.

In terms of the outcomes that have been achieved for CHPs by borrowing through NHFIC, the savings have been significant (see details in NHFIC Social Bond Reports). The results have far exceeded the expected demand from the initial EY modelling, with nearly $1.2bn of funds raised in the first 3 bond issues between March 2019 and June 2020. Importantly the CHPs have been able to lock in certainty of funding, borrowing for tenors of 10-12 years (compared with 2-5 year bank funding). Demand for NHFIC funding continues to grow and assists in enabling new projects that will provide significant uplift in supply of housing stock.

NHFIC has established, over a relatively short period of time, a positive reputation with investors as a professional, periodic issuer. Investor interest continues to grow and each of the 3 bond issues to date has seen healthy bidding and improved pricing relative to comparator borrowers.

NHFIC’s ability to issue in the volume and tenors that it has achieved to date, is largely a function of the government guarantee. Another important feature of the NHFIC model is access to the Line of Credit. This enables NHFIC to build a critical mass of loans to CHPs over a period of months, then come to the market with a sizeable bond issue which achieves optimal investor participation and best pricing.

In terms of achieving an issuance structure and outcomes that would meet ALL THREE of the Government’s policy objectives as listed above, it is difficult to see how an alternative approach would have delivered better results than what has been achieved to date.

1. **PRICING RELATIVITIES**

The initial EY analysis assumed a 10 year guaranteed NHFIC bond would price around 0.8% (80bps) above CGS. This would be reduced to around 0.55% (55bps) if the bonds were repo eligible with the RBA and had High Quality Liquid Asset (HQLA) status.

When NHFIC prepared for its first bond issue it applied for repo eligibility and HQLA status to ensure optimal pricing and investor participation. Both were achieved. Initial market indications at that time for NHFIC as a first time issuer were around 50-55bps over CGS, and flat (or slightly over) the liquid AAA-rated semi-govt issuers of NSW TCorp and TCV. Following extensive investor engagement, NHFIC’s first bond issue in March 2019 ($315m) exceeded these expectations, issuing at 48bps over equivalent maturity CGS, and 2bps under NSW TCorp. NHFIC’s inaugural issue also priced tighter than its only true comparator being Export Finance Australia (as a Government-guaranteed agency issuer), though Export Finance does not have large lines of domestic bonds on issue.

The second issue in November 2019 ($315m) was tighter still, at 38bps over CGS and 11bps under NSW TCorp. The third issue in June 2020 ($562m) demonstrated further spread tightening. While the bond was a longer tenor than earlier issues at 12 years (which would normally result in a wider spread), the bond priced at 38bps over the equivalent maturity CGS, and 20bps under NSW TCorp.

It is a feature of debt capital markets that any new issuer will pay an illiquidity premium relative to the established, liquid benchmark bond issuers. This illiquidity premium will gradually reduce as the issuer continues to return to the market and build its bond lines, and potential investors become more familiar with the issuer and establish investment limits. While NHFIC has substantially less on issue than the sovereign or the large semi-govt issuers, it has quickly established itself as a periodic issuer and the spread tightening has been encouraging for both NHFIC and its investors.

The question will always be asked if NHFIC could/should have achieved cheaper funding. I believe this can only be answered having regard to the following –

1. Given the objective of establishing NHFIC as a long term regular borrower, credibility with investors (and intermediaries) is absolutely critical. Establishing a fair price for the initial (and subsequent) issuance that motivates investors to return is paramount. Issuers who try to force a more aggressive price that results in post-issue spread widening will end up with disenfranchised investors and a poor reputation, and investors will likely be wary in future issuances.
2. A great deal of analysis and market soundings are undertaken to determine where an issue is likely to price, and naturally there are many variables at play. The NHFIC team were well informed and connected with the market for each issue, so price transparency was high. Importantly, NHFIC established a fee structure for Joint Lead Managers (JLMs) at the outset that was extremely competitive and at the lower end of market for sovereign/agency issuers. Given all factors and pricing dynamics for each of the 3 issues, I believe the outcomes NHFIC achieved in each bond issue were optimal.
3. The trend of improving spread relativities and building the number of investors is very much a desired outcome. It provides validation for the investors who participated in the issues to date, and encouragement for future issuance.
4. In terms of where NHFIC could/should trade relative to CGS over the longer term, there is no simple answer. Encouragingly, all of NHFIC’s issuance to date has been achieved at a spread well inside the market (and EY) pricing estimates during the evaluation and establishment phase. NHFIC’s spread to CGS has continued to tighten and this bodes well for future issuance. The only way NHFIC could have achieved tighter pricing would be for AOFM to have issued CGS instead (as discussed above) which fails to achieve all the policy objectives.
5. **GOVERNMENT GUARANTEE**

As outlined above, issuing with a government guarantee (GG) was the logical option to enable substantial cost savings and tenor lengthening for CHP debt. As the EY analysis showed, issuing non-guaranteed bonds would have delivered negligible benefit in a cost sense for CHPs, and negligible opportunity to extend tenor of debt.

There are now 2 key questions –

1. For how much longer should NHFIC issue with a guarantee?
2. If/when NHFIC moves to non-guaranteed issuance, how should this occur?

Addressing the first question, I believe there should be 2 main considerations for Government being (1) Is continuing to utilise the GG providing the best policy outcomes for the sector? (2) Is there an absolute limit on the volume of lending to CHPs that the Government is unwilling to exceed?

From a pricing and debt outcomes perspective for CHPs I believe the answer to the first question is a clear yes. With regard to the second question that’s ultimately the Government’s call, though it is worth noting that the current liability cap for NHFIC of $3bn is very small in the context of the Government’s overall debt levels. Having regard to this I believe there is a sound case for the liability cap to be increased over the coming years to facilitate anticipated strong demand for NHFIC funding.

When the taskforce considered this issue of period of utilisation of the GG, my view was (and still is) that for NHFIC to achieve optimal success it would need to issue with a GG for at least 10 years. I remain concerned that any premature removal of the GG – notwithstanding all GG issued bonds will be grandfathered – will stall NHFIC’s momentum and result in sub-optimal outcomes for the CHP sector (particularly with regard to hindering significant projects that add to the supply of social housing). The counter-argument to this would be that we are in an environment of very low rates so the added margin should be able to be absorbed by CHPs. While this may be true, the greatest benefit of GG issuance is the capacity to issue the required volume in longer tenors (at very low yields) which is important for long tail housing projects. Non-guaranteed issuance would be more constrained towards the shorter end of the yield curve which increases refinancing risk and likely rules out a number of potential projects.

It is also worth noting that the initial work of the taskforce identified the opportunity for improvement in the regulatory framework for the CHP sector, recognising there were significant differences between state based regulatory arrangements. The taskforce noted this opportunity in its advice to Government and, while strictly outside the scope of the bond aggregator evaluation, we believed that improved outcomes in the sector would be the result of a range of policy measures (ie not solved alone by the establishment of a bond aggregator). This was also consistent with views expressed by the Treasurer at the time. It is important to note this because there is still work to be done to develop the regulatory framework for CHPs and this is likely to take some time. I believe this adds to the case for NHFIC continuing to issue with the GG for the foreseeable future in order to optimise the debt outcomes for CHPs.

Regarding the second question of (eventually) transitioning from GG to non-guaranteed issuance, I do believe that there will be a point in the future when this makes sense, but we are a long way from it. In terms of market conditions, the ideal environment to do so would be when credit markets are healthy and all credit spreads are tight. Therefore the cost of moving from GG to non-guaranteed issuance would be comparatively reduced. Also it would require well developed credit markets that enable NHFIC to issue significant volumes of non-guaranteed debt for longer tenors (10+ years) at a cost-effective yield, which is not the case at present.

1. **CONCLUSION**

The review of the NHFIC Act seeks to address a number of areas but I have focused my comments on NHFIC’s performance as a borrower in the debt capital markets. In doing so it is important to understand the path of NHFIC’s journey from feasibility study through to establishment and growth, having particular regard to the Government’s key policy objectives. In this context I believe NHFIC has achieved excellent outcomes as a bond issuer, enabling the provision of low cost (and long tenor) debt to CHPs far exceeding early expectations.

NHFIC is well placed to continue its contribution to substantially improved outcomes in the social and affordable housing sector, but to do so it needs to build on its early success. Access to low cost, long tenor debt will be critically important in the coming years, and I believe some of the key pillars of Government accommodation for NHFIC (being the Government Guarantee and Line of Credit) are fundamental to this ongoing success.