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Facilitating investment in affordable housing – towards an Australian model

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Abstract

This paper argues that sustainable and affordable finance provides a crucial pillar to support the provision of affordable housing in the long term. This finance can take on a variety of forms, comprising grants, public loans, commercial loans as well as shareholder equity. It can be facilitated by various forms of collateral, government guarantees, mortgage insurance and tax privileges, often involving a specialist financial intermediary. Importantly, how this pillar is constructed influences the scale, pace and quality of housing outcomes generated.

Unlike many other countries, Australia has not established a long term vehicle to channel institutional investment into housing, despite clearly inadequate public and private low cost supply, a situation that has been recognised by numerous reviews, such as the National Housing Strategy (1991-1992) and the Affordable Housing National Research Consortium (2001). The use of government bonds for this purpose has been a consistent feature of proposals by the research community (inc. Yates, 1994; Hall et al, 2001; Lawson and Milligan, 2007). This paper revisits the case for housing bond financing in Australia and supplements it with analysis of similar but well established bond financed schemes operating successfully in Austria and Switzerland. This analysis provides an exploratory basis for outlining necessary features of a bond financed model that would be appropriate for Australian conditions to support the sustainable growth of social housing and the broadening of affordable housing options for low and middle income households.

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Introduction

This paper concerns the financing of affordable housing in order to respond to what is now a well documented need in Australia. It explores the potential of a bond-based model, which channels low cost investment towards the non-profit housing sector and provides tax incentives to investors.

Recent research shows that of the 7.6 million households in Australia, just under 1.2 million (16 per cent of all households) paid 30 per cent or more of gross household income to meet their housing costs. Of these, 862,000 were lower-income households, defined as being in housing stress¹. A further 164,000 were moderate-income households (Yates and Milligan, 2007:19). In its first State of Supply report, the National Housing Supply Council (NHSC) showed there was a need for an additional 251,000 rental dwellings affordable and available for lower income households (Australian Government, 2009: 98).

In the last year, the Australian Government has made welcome moves to address this shortfall. Two substantial initiatives have been a \$6.4billion social housing stimulus package to increase the supply of social rental dwellings by 20,000 over three years, and a Commonwealth contribution of \$623million² towards the National Rental Affordability Scheme (NRAS), which when combined with state government outlays and private equity investment, aims to add 50,000 dwellings to the affordable

¹ Housing stress is defined by a household in the lowest 40 per cent of the income distribution having housing costs of at least 30 per cent of their household income. For detailed results and technical notes see Yates and Milligan (2007).

² For the first four years of its operation until the end of 2011-12.

rental stock over 4 years. These initiatives represent a significant turn-around in the funding of rental housing in Australia. However, their impact is unlikely to be adequate to meet the already considerable and rising need.³

This paper explores the proposition that what is missing in these initiatives is the establishment of a financial intermediary and funding instrument which builds on them and is designed to channel much more substantial levels of low cost investment towards social and affordable housing⁴. While overseas efforts in the field of private finance for affordable housing accelerated in the 1990s (Berry et al, 2004; Whitehead, 2003), Australian policy has continued to rely on government funding and sporadic innovative programs that, with the notable exception of the new initiatives, have only provided for low levels of activity and have not been robust for the longer term.

Inadequate funding strategies have persisted despite recommendations for change put forward by the research community and housing interest groups, and numerous proposals outlining alternative strategies, including tax credits and bond financed approaches. In their 2009 assessment of what is needed to enable emerging non-profit housing developers or similar organisations to make larger scale contributions to the provision of affordable housing in Australia, Milligan et al (2009:151) argued that growth in affordable housing necessarily required a long term investment path involving a substantial commitment of dedicated public funds coupled to forms of cost-effective private financing. A recurring feature of past proposals has been the use of long term, low risk and low interest bonds for this purpose. For a range of reasons, discussed in this paper, these proposals were not implemented. However, during the same period two countries did employ such models with a high degree of success, not only in terms of the volume of supply but also outcomes for tenants and positive impacts in the wider housing system (for example, containing house prices).

The next section of this paper begins with an overview of the current arrangements for funding social housing to provide general background information. This is followed by a summary of several of the unsuccessful previous proposals in Australia, focussing specifically on the rationale given for these proposals. The third section provides an overview of schemes that have been implemented in Austria and Switzerland. These schemes show how a financial intermediary and ‘fit for purpose’ funding instruments can be used successfully to channel substantial levels of low cost private investment funds into affordable housing. The paper concludes by drawing out the lessons from current policies, past proposals and this international experience to support its argument that there is a missing piece in current policies that could be remedied by adoption of a Housing Supply Bonds (HSB) model. This model is loosely based on key characteristics of past proposals and the Austrian and Swiss schemes described in this paper, and builds on policy and funding initiatives already in place in Australia.

Current arrangements for funding social housing⁵

To date, the financing of social and affordable housing in Australia can be categorised into three models, which have generated what is known as public housing, community housing and most recently

³ Steps have also been taken to assist new home purchasers accumulate a deposit, via a matched saving scheme for first home buyers. Individuals can divert up to 10% of their income into First Home Savings Accounts (FHSA). Interest on these accounts will be taxed at a favourable 15% by the Australian Tax Office. The Commonwealth will contribute 17% of annual contributions, to a maximum of \$850.00 per year. Other initiatives that have been introduced are less relevant for this paper.

⁴ In the Australian context, social housing refers to deeply subsidised public and community managed housing that is allocated predominantly to low income households and those with special needs. Affordable housing refers to a wider range of low cost housing options provided by non government agencies using diverse forms of government and private funding.

⁵ These arrangements do not cover funding arrangements under the new National Affordable Housing Agreement (NAHA) that commenced on 1 January 2009. See Milligan (2009) for an overview.

affordable rental housing. These models are outlined in the paragraphs below, followed by a review of the issues that they raise for developing more sustainable approaches to the supply of low rent housing.

Public housing funding has evolved since 1945 from a combination of discounted Commonwealth and state matching loans that were later replaced by grants because of the insufficient capacity of state housing authorities to service debt. Alongside, there has been a major shift in rent policy from historic cost rents to market rents accompanied by income related rebates. Shifts in demand towards smaller, lower income households and allocation policies that have increasingly targetted those with high or complex needs have reduced rental income and increased operating costs, and providers have had to rely on annual grant funds to meet deepening operating shortfalls. However, declining grant levels have left little or no capacity for growth (Hall and Berry, 2007), and even resulted in significant sales in some states. By 2008, there were around 351,000 units of public housing remaining in Australia, less than 5% of all dwellings (AIHW, 2009a and 2009b).

Community housing has been funded by a variety of programs as outlined in a recent review (Jones et al, 2008). Implementation of these programs has varied across states and territories. For example, Victoria and South Australia had debt-financed schemes backed by government subsidies in the 1980s but these have not been expanded. Other populous states (NSW and Queensland) have relied on grants to fund supply, supplemented by head leasing of private housing. Some community housing providers have restructured their rent setting policy to draw in Commonwealth Rent Assistance (CRA), which it is paid directly to many of their tenants⁶, with the aim of generating additional cash flows to leverage and service debt finance. However, the portfolios of most providers are too small to generate significant surpluses. These fragmented and low-level funding arrangements have generated approximately 36,000 dwellings, most of which, while managed in the non-profit sector, are owned by state housing authorities (AIHW, 2009c)⁷.

Affordable rental housing has been funded, until recently, mainly by state and local government initiatives that have been designed to demonstrate new models. The small-scale and experimental nature of these schemes has produced about 7,000 additional dwellings (Milligan et al, 2009; 2004). Prospectively, much more affordable rental housing will be delivered through the National Rental Affordability Scheme (NRAS). This scheme offers financial incentives to encourage private investors, developers and non-profit organisations to construct additional dwellings for rent. Specifically, it offers a \$6,000 Commonwealth refundable tax offset (or grant to registered charities) plus a \$2,000 state grant (or equivalent) per dwelling, indexed, for ten years. Dwellings must be allocated to eligible low and moderate income households at rents no higher than 80 per cent of the local market level for 10 years. There are no restrictions on the use of the dwellings produced after the expiry of the 10-year tax credit period. NRAS guidelines encourage private developers and investors participating in the scheme to use regulated non-profit housing organisations as tenancy managers. This strategy aims to promote the expansion of non-profits and to ensure good tenant outcomes. The target output for the initial funding allocation is 50,000 dwellings⁸. There have been indications from the national government that the scheme will be expanded by a further 50,000 incentives, if it is successful.

⁶ Tenants (except tenants of state government housing authorities) who receive social security payments are eligible for this additional cash payment, if their rent exceeds a floor amount. A maximum payment, which is uniform across Australia, applies also.

⁷ There is also an Indigenous community housing sector and some community managed housing provided by other non government organisations such as disability and welfare groups and aged care providers. These groups in total are estimated to manage /own a similar number of dwellings to the mainstream community housing sector.

⁸ <http://www.fahcsia.gov.au/sa/housing/proserv/affordability/nras/Pages/default.aspx>

Past approaches to funding housing using non-profit organisations have been insufficient to generate a strong and sustainable third sector in Australia. Consequently, while there is clear potential to expand the contribution of non-profit organisations, especially through appropriate funding, regulation and capacity building, this sector remains small and under utilised (Milligan et al, 2009). In the past decade, considerable growth in community housing was insufficient to offset the decline in public housing and thus the absolute size of the social housing sector in Australia declined (Australian Government, 2009:135).

Attracting large scale institutional investment towards affordable rental housing has been an important goal for a non-profit housing sector with ambitions to emerge from under the control of state housing authorities. In principle, NRAS has the potential to attract larger volumes of private investment that could be channelled to this sector. While the infancy of that scheme makes it premature to assess its impacts, it is not designed presently to secure a long-term stock of affordable dwellings. Thus it runs counter to the mission of many non-profit organisations to provide *and* preserve affordable housing. There have also been teething problems with the Australian Tax Office (ATO) challenging whether the scheme's provisions to house a range of low to moderate income households meet their rules for alleviating poverty that govern the charitable status of these organisations, which in turn contributes to their cost effectiveness.

The shortage of affordable housing in Australia⁹ has meant that most low income households rely on a volatile private rental market with potential for sizeable rent rises when conditions are tight (as is the case in the current economic environment) to meet their need for housing. However, there is longitudinal evidence to show that increases in the stock of private rental dwellings occur mainly at the top end of the market and that the stock of low cost rental dwellings has declined steadily (Yates and Wulff, 2005; 2000 and Australian Government, 2009). Historically, the private rental sector in Australia has been dominated by individual 'mums and dads' investors holding small portfolios (one or two dwellings typically). They are motivated by a variety of factors but especially expectations of capital gain (Seelig et al, 2009). When coupled to a strong first home buyer market, this has resulted in security for long term tenants in the private rental sector being weak.

This situation suggests that market shortages of affordable housing have structural causes and, therefore, calls for policies that can promote sustainable provision of housing affordable by lower income households. Given public funding constraints, such policies must rely in part on stimulating an expanding supply of low cost finance that is fit for purpose and tap into major innovations in financial markets that have occurred over the past two decades. Some suggestions along these lines are presented in the following sections of this paper.

The new model of funding under the National Affordable Housing Agreement (NAHA) provides funding that should be adequate to ensure retention of the existing stock of public housing but does not provide funds for growth beyond two years (Milligan, 2009). Thus suggestions for expansion of the supply of funds to seed growth in an affordable housing sector will need to build on the important new NRAS initiative for the foreseeable future.

NRAS has considerable strengths in that it has committed a considerable and predictable volume of Commonwealth and State funds to the supply of additional affordable housing over a 10-year period. As an on-going recurrent subsidy, the funds available through NRAS provide affordable housing providers with the capacity to service significant debt burdens for this period. The scheme has also served to indicate to the private sector the potential for investment in the affordable rental sector and

⁹ In what follows, the term affordable housing will be used generically, to encompass public and community (social) rental housing as well as any other form of subsidised rental housing.

has helped to educate them both about the opportunities for, and benefits of, doing so. Early funding rounds have attracted a considerable number of applications from a diverse range of would-be providers.

There are, however, a number of weaknesses of NRAS, as it is designed or operating currently. First, the flat rate subsidy is likely to be inadequate to ensure that affordable housing projects in high cost areas are viable on an on-going basis. Rather than being satisfied on the basis of the rental income alone, investors in such areas are likely to look to returns from capital growth (and, consequently, to the sale of dwellings) at the end of the designated 10-year period. Thus, in high cost areas, the current scheme is unlikely to contribute to development of a sustainable affordable housing sector. Second, the prevailing subsidy structure is unlikely to be adequate to generate housing that is affordable for special needs households or households on low and very low incomes because of their more limited capacity to contribute to rents and the current design of CRA. Such households will need additional ('top-up') recurrent subsidies. Finally, as with any new financial initiative at present, the current economic climate raises considerable uncertainties about the capacity of a scheme to attract private investors.

Progress towards affordable housing financing using housing bonds

Identifying ways of achieving sustainable private investment in the provision of additional affordable housing has been an explicit concern of past Australian governments but not acted on (COAG, 2003; HPLGM, 2005). The current national government has committed itself to increasing the supply of social housing under the new National Affordability Housing Agreement (COAG, 2009; Plibersek, 2009) and state governments will report to the Coalition of Australian Governments (COAG) by the end of 2009 on reforms to enable the leveraging of government capital investment to enhance supply¹⁰.

In this context, it is pertinent to revisit proposals by the research community concerning the use of long term investment bonds as a vehicle for investment in social housing (inc. Yates, 1994; Hall et al, 2001; Lawson and Milligan, 2007). Bonds are a proven mechanism for raising private capital, used by both the public and private sectors. Government secured bonds typically offer investors low risk, low interest, fixed income securities. Additional incentives, such as various tax concessions, can be used to entice investors. Governments throughout the world use bonds to generate funds for a particular purpose. Austria and the United States provide two examples where they have been used for housing supply targets. The proposals of Australian housing researchers have included the 'equity bonds' model, developed for the National Housing Strategy more than a decade ago (Yates, 1994) and the 'Consortium Model' involving sale of wholesale bonds, developed by the Affordable Housing National Research Consortium (Hall et al, 2001).

The 'Equity Bonds Model' proposed the establishment of a single independent corporation or trust to issue standardised equity bonds indexed to changes in house prices (Yates 1994:192). Finance raised would be used by non-profit organisations to provide dwellings at market rents to low income renters, who would also be assisted by an adequate and secure rent allowance. This proposal aimed to provide a tradeable bond linked to actual price movements in the housing portfolio and suitable for large-scale investors. The bonds were to provide investors in social rental housing with the same return on their equity as was available (on average) to investors in tax-advantaged, owner-occupied housing. The proposal to establish an independent corporation was a response to the inefficiencies that arose from the complex and costly administrative structures that had been used previously to raise off-budget finance for social housing in Australia. Not least of these had been the need to establish a new trust or company for every financing deal and to obtain a tax ruling from the Australian Tax Office on how the

¹⁰ http://www.coag.gov.au/coag_meeting_outcomes/2009-02-05/index.cfm#social

returns would be treated. As such, a special purpose corporation would address the uncertainties about tax rulings that plagued past financing initiatives (available only on an ad hoc basis after the proposal has been fully developed). The possibility that the proposed structure would be denied a tax exemption previously granted added to development costs for specific proposals and also reduced the value of information derived from schemes that had been successful in the past. A single corporation also increases the possibility that there is adequate financial and legal expertise available to ensure financing arrangements are effective. An additional proposal that the government guaranteed continuation of existing rental assistance schemes as a means of guaranteeing the rental return on investment provided a source of public-private risk sharing and a form of credit enhancement that would help to reduce the costs of raising finance capital.

A number of factors might explain why this proposal was not successful. At the time it was proposed, house price derivatives did not exist and there was no suitable house price index to which equity bonds could be linked, although work was underway to develop such an index. Indexes now exist. Responsibility for different aspects of the proposal resided in different government departments or instrumentalities. The (then) Commonwealth Department of Health, Housing and Community Services was responsible for housing policy but responsibility for procuring and delivering social housing lay with the State Housing Authorities. Treasury was responsible for developing tax policy but the Australian Tax Office has responsibility for implementing this. The proposal, therefore, required a significant degree of coordination both within and across different levels of government. A third factor arose from the fact that the institutional investors who were the target for the proposed equity bonds were adamant that they did not want to be involved with the day-to-day management of social housing. Public sector management of housing developed with private sector funds was seen as insufficiently independent and the management capacity in the existing (then marginal) community sector was inadequate at the time and there was no regulatory framework that could provide investors with the comfort that proposed managers were accredited and therefore, competent. Removal of, or reduction in, such capacity constraints and management risks is well advanced (Milligan et al, 2009).

Although equity bonds were not introduced to finance social housing, within a year or two of the proposal being floated, infrastructure bonds (with very similar characteristics) were introduced to finance roads. This suggests that many of the above constraints can be addressed and raises the question as to whether the real constraint, in fact, was a lack of political commitment to ensuring that sufficient affordable housing is available for lower income renters.

The so-called ‘Consortium Model’ was proposed as a debt instrument involving the sale of fixed interest state government bonds to institutional investors with a 20-year term at market rates, with the aim of tapping into burgeoning superannuation funds. Funds raised would be used by state housing authorities (or allocated to other regulated providers) to acquire dwellings, which would be rented to low to moderate income tenants at rents set to 25 per cent of income. The Commonwealth Government would provide outlay subsidies to housing providers for the difference between rents and the full cost of provision, including the cost of loan funds. Regular bond issues would be limited by the amount of funding made available by the Commonwealth. Properties would be turned over after 20 years to retire the debt, or new bonds could be issued (Allen Consulting Group, 2001; Berry, 2003, 2002; Hall et al., 2001).

The main policy advantage of the consortium model is the degree of leverage achieved; initial modelling suggested that for every dollar of government subsidy, \$4.50 of housing would be provided. From the Commonwealth Government’s point of view, a major advantage is that its financial exposure is capped at the agreed upfront subsidy level for each tranche of support. Institutional investors can satisfy their requirements for scale, liquidity and risk adjusted returns by purchasing (state) government bonds in the normal way, while avoiding any reputation risk associated with financing social housing.

Most of the financial and operating risks would be borne by and must be managed by state government treasuries and public housing agencies.

However, this also points to a major disadvantage of the model: viz. the unwillingness of state governments to assume these risks or endanger their credit ratings by expanding public borrowings. Constraints imposed by the Australian Loan Council also reduced the attractiveness of this approach; applying public borrowing to social housing reduced the capacity of governments to apply loan funds to other priority areas of social and economic infrastructure. Another disadvantage of the model was the need to sell off the stock to redeem debt and thereby manage re-housing of sitting tenants. The Consortium Model assumes dwellings required to house social housing tenants are initially purchased from the proceeds of a bond issuance, and that as time goes on the proceeds of sales of the dwellings is used to repatriate the principal owed on the bonds and to provide for any operational shortfalls (Hall et al, 2001:26). This could be avoided by the Commonwealth Government committing a new round of funding to support a replacement round of state bonds. Alternatively, either or both levels of government could replace the loan funding with government equity.

These disadvantages largely explain why the model was not taken up earlier this decade. However, as with equity bonds, inter-government and within-government bureaucratic factors were also obstacles. For example, central agencies at both levels were generally not convinced that declining housing affordability represented a long term structural problem or that expanding the supply of affordable housing provision was a high priority (in preference to providing rent assistance, for example. In the current environment, the impact of the global financial crisis on house prices in many countries (though apparently not Australia) is likely to mean that, at least in the immediate future, institutional investors will be wary of investments that involve house price risk. While the Consortium Model avoids this, it replaces it with a policy and political risk to the sustainable supply of affordable housing.

The perception that affordable housing supply was not a political issue had altered by the time the new Labor government came to power and, in response, NRAS was introduced in 2008. By then, the expectation that some kind of private financing instrument should be established had grown, particularly through advocacy from research consortia and stakeholder forums. Electoral politics also played a role. Housing affordability for those on a moderate income and first home owners was an important issue during the 2007 election period and the alternative government was looking to differentiate itself in this area (Rudd et al, 2007). Once the government changed, advocates and policy makers attempted to emulate the US low income housing tax credits model via the NRAS scheme. In discussions, private finance for social housing was positioned (correctly) as a missing lever. However governments, through COAG, are yet to deliver a sustainable social housing funding model (Milligan 2009). While this shortcoming may be masked at present by the economic stimulus funding for social housing, it will become clear in a few years if more is not done to facilitate incorporation of private finance into the funding of affordable housing.

Illustrations of bond financed affordable housing systems

Given the issues raised above and the current interest in models which can use public funds to lever private investment, this section describes how bonds are used to support the growth of social housing in Austria and Switzerland. The concluding section discusses the possible relevance of these approaches in the Australian context and suggests what changes might be required to address the missing link in current policies.

The Austrian ‘Housing Construction Convertible Bond’ model

The Austrian bonds model is relatively straightforward. It does not rely on derivatives nor does it require the turn over of social housing stock. Commercial finance is simply raised via the sale of bonds to low risk investors, promoted via tax incentives and secured by public loans and grants. These are used to fund a well regulated and broadly accessible social housing sector. Delivery is via a mix of regulated limited profit housing companies and private providers.

In principle, affordability in the Austrian system is promoted by cost efficient, limited profit housing providers assisted by ‘bricks and mortar’ subsidies in the form of discounted land, public loans and grants and tax relief. Initial rents are based on a rental cost per square metre, which can be increased each year with the consumer price index (CPI). Rent revenues are intended to be sufficient to repay the annuity of the capital loan, as well as the interest on the public loan (Neuwirth, 2004:1). Typically rents are fixed annually and balanced at the end of the year, with tenants either receiving a return or making additional payments to cover financing and operating costs. Where a tenant's income falls below that needed to pay for decent housing, they can draw upon rent assistance, which is provided by regional governments.

In summary, Austrian social housing is financed via capital market loans (30 to 50 per cent); public loans (30 to 40 per cent); equity of the developer (around 10 per cent, mostly land); additional subsidies and sometimes the equity of future tenants (0 to 10 per cent) (Amann and Mundt 2006; Lawson and Nieboer, 2009). Private mortgage finance, comprising up to 50 percent, is largely raised through the sale of bonds via private Housing Banks.

In 1993 the Austrian Government passed the Housing Construction Subsidy Act to create a special circuit of capital involving the sale of bonds via Housing Banks in order to channel investment into new affordable housing. The Austrian Tax Office offers progressive incentives for purchasers of Housing Construction Convertible Bonds (HCCB) and requires that any funds raised by Housing Banks through the sale of bonds have to be used to finance approved limited profit housing projects by registered social landlords.

This national legislation enabled several major banks to create subsidiaries, called Housing Banks, with preferential underwriting criteria (first-lien loans with 62 per cent maximum loan to valuation ratio similar to the classic mortgage loan, whereby only 4 per cent of the risk exposure had to be covered by asset holdings instead of the usual 8 per cent according to the Basel accord). With that allowance, the Housing Banks could operate with lower transaction costs (of around 65 basis points).

Purchasers of HCC Bond coupons are required to hold them for a minimum of 10 years. In return, they receive tax relief on the first 4 per cent of returns (Ball, 2005). In Austria returns on bonds are subject to a withholding tax of 25 per cent. This is deducted from the bond coupon upon disbursement to institutional and individual bondholders alike. However, HCC bonds are one of a specific list of expenses that are progressively tax deductible for low to upper middle-income earners, in keeping with the aims of Austrian tax policy to prevent regressive tax effects. After 10 years, the initial expense of the bonds can also be deducted from taxable income at year 11.

Today, bond purchasers are typically long term investors seeking a secure, low risk investment such as insurance companies, pension funds and municipalities (Amann and Mundt 2006; Czerny et al, 2007). It is also claimed that the presence of the HCCB facility has not only had a moderating effect on the general mortgage interest rate level (Deutsch, 2007 personal communication) but for every €1 of foregone tax revenue, €19 of commercial investment has been committed to affordable housing production (Housing Bank Austria, 2009).

HCCBs have been very successful in raising the level of investment in affordable housing, although the recent provision of a guarantee on savings deposits in response to the global financial crisis has diminished purchaser demand in the current economic climate (Housing Bank Austria, 2009; Amann, 2009). Housing banks have been able to assist the financing of new housing and refurbishment, generating approximately € 1.5 billion annually. Loans issued under bond issues cover approximately 45 percent of total construction costs, with the balance met by housing subsidies and provider contributions. Since 2000, Housing Banks have registered a sharp rise in demand for tax-free bonds. By the end of 2006, the total volume of bonds had reached approximately € 11 billion, of which € 9-10 billion had been directed toward the financing of the construction of more than 100,000 dwellings by 2006 (Czerny et al, 2007:28). Figure A.1 in the Appendix places this bonds model within the institutional context of the Austrian housing system. For more detail see Milligan et al, 2009, section 5.3 and Bauer, 2004).

The guaranteed co-operative Swiss housing bond model

The Swiss government offers modest but strategic support to assist the social housing sector to access small loans and additional private funds (Lawson, 2009; FOH, 2006). Small low-interest loans are competitively allocated from a revolving fund (managed by the sector) that contributes around 5 per cent of total project costs. The federal government secures all loans released by a Bond Issuing Cooperative for Non-Profit Builders (Hauri, 2004). Funds generated in this way contribute up to 70 percent of the cost of the total project. The remaining amount is financed by commercial loans and owners' equity. Finally, the federal government can provide collateral security to specialised mortgage guarantee cooperatives that reduces second mortgage interest rates (although its impact is marginal).

The Swiss Bond Issuing Cooperative (BIC) (*Emissionzentrale für Gemeinnützige Wohnbauträger*, EGW) was established in 1990 to raise funds for non-profit housing entities that have formed a cooperative. It was founded during a time when interest on loans was high and there were risks associated with national adjustments to European financing costs. In 1991, the first bond of 85.1 million Swiss francs (CHF) was issued for a running period of 10 years. At that time, the market conditions for bonds were favourable compared with bank loans of the same maturity. Since that time, BIC has issued 3,048 million CHF in a series of 37 bonds (public issues or private placements). The BIC has played a leading role in financing small non-profit housing projects, when commercial rates were high. It has about 350 members and has helped to finance approximately 877 projects to supply 30,000 non-profit dwellings. Recent interest rates have made BIC financed loans less competitive. However, the bond vehicle remains on call for when these conditions reverse (Gurtner, 2009).

Key players in the establishment of BIC were the umbrella organisations in the sector (SVW, SWE and VLB) and the Federal Office of Housing (FOH). Currently, the FOH issues 8-15 year bonds, which are covered by a state guarantee, with the funds raised able to provide loans to members with a fixed interest rate over a fixed term (Hauri, 2004). While some larger non-profit entities are financially strong, the BIC pool allows smaller non-profit builders to join together, improving their access to finance on more favourable terms.

Institutional investors, such as pension funds and insurance companies, are attracted to BIC bonds by the state guarantee and high credit rating (AAA). As recent requests show, the level of demand for the Swiss housing bonds is very high. In 2006 and 2007 the BIC raised 200 million CHF annually. A flow chart is provided in Figure A.2 in the Appendix. The following paragraphs describe the BIC application process (mimeo EGW, 2008; Hauri, 2004):

1. Requests can be submitted for a new project or to refinance a mortgage. Applicants must have a non-profit status, BIC membership and undertake appropriate activities according to the Charter and Federal Office of Housing standards. They must also be financially sustainable entities with a viable and suitable project (assessed against cost limits, quality requirements and location attributes) and be able to offer assurances with respect to lending limits and available mortgage deeds.
2. All requests are pooled by the BIC. When the pool is of sufficient size and market conditions advantageous, the BIC will issue a new bond. It then negotiates with a lead bank the conditions of issuance and applies for the State Guarantee to cover the entire extent of the bond.
3. The issuance can be as a public bond or a private placement. A private placement will be done for smaller pools (20-50 million CHF). In these cases, one investor, such as a pension fund or an insurance company, subscribes to the entire bond. Where the pool is more than 50 million CHF, the bond is divided into denominations of 5,000 and placed by a consortium of banks. A bond pool of 100 million CHF could serve around 40-60 non-profit organisations. All the bonds are listed on the stock exchange for trading.
4. After subscription, funds raised from the sales of bonds are allocated to non-profit housing entities according to their requests to be paid back in full at a fixed rate and defined term. On maturity, BIC organises conversion of the bond and seeks ongoing participation of investors (Hauri, 2004; FOH, 2006).

Overview

A number of key characteristics of these two successful approaches to institutionalising the raising of private investment to fund affordable housing can be singled out. The first is the establishment of financial intermediaries (such as the Housing Banks in Austria or the Bond Issuing Cooperative in Switzerland). The second is the development of a specific and standardised financial instrument (such as a bond) to raise funds. These bonds have been subsidised by the tax system and have additional credit enhancements (provided by preferential underwriting or guarantees) to increase their attractiveness to investors. A third is that bond holders are additionally protected by regulations requiring registration of housing providers. These delivery agents must comply with legislated requirements and regulatory codes. Finally, packaging (or pooling) of the various forms of assistance (such as direct public grants and in-kind support) is also facilitated.

These characteristics are consistent with the characteristics identified in studies of similarly successful attempts to raise private finance for social or affordable housing in other countries as being critical to the success of the approaches employed. Examples can be found in Berry et al. (2004, 2006), which draws conclusions from comparing the UK and Australian systems of affordable housing provision; in Oxley (2008), which draws conclusions from a range of European countries; and in Swack (2006) which drawn on US experience.

Progressing a bond financing scheme for Australia via a ‘Housing Supply Bonds (HSB)’ model

Before setting out a framework for a bond financing scheme for Australia, a number of additional essential conditions can be added to the key characteristics identified at the conclusion of the previous section. Those identified in previous research (Berry et al, 2006; Milligan, 2005) include:

1. Institutional and subsidy arrangements to attract private investment on a scale that is necessary to make a difference;
2. A resolute and consistent national framework for using the planning system to promote affordable housing, by capturing a share of development gain and redirecting it towards affordable housing, providing access to suitable sites for affordable housing development and promoting social inclusion, environmental sustainability, urban regeneration and affordable housing outcomes;
3. A regulatory framework for social housing organisations which gives high levels of confidence and assurance to all stakeholders, including institutional investors;
4. Rents that cover the cost of operating and financing decent housing, breaking the nexus between rents received on affordable housing and the incomes of resident households;
5. Adequate demand side subsidies to address the gap between incomes and the cost of decent housing; and
6. Management of assets by social housing providers in a manner that enhances their value and enables further leverage of private funding.

Any new proposal must also learn from the advantages and disadvantages associated with previous proposals for Australia. These suggest that, in terms of its financing aspects, it must recognise the constraints imposed by volatile housing markets; it needs to address the trade-offs between the extent of leverage and the amount of subsidy needed to fund housing affordable for specific household groups; and it needs to establish consistent and predictable privileged tax status (rather than having to rely on frequent rulings). In terms of its production and delivery aspects it must only involve housing providers that are well regulated through a nationally consistent regulatory framework and it must separate out financing and management roles so that investors are not required to be directly involved in housing management. To ensure sustainability and preservation of affordable housing over time, it must not require stock to be periodically sold to redeem debt. Finally, it must gain cross jurisdiction and interdepartmental support in each sphere of government, not endanger credit ratings of governments and not reduce the capacity of governments to loan funds for other purposes.

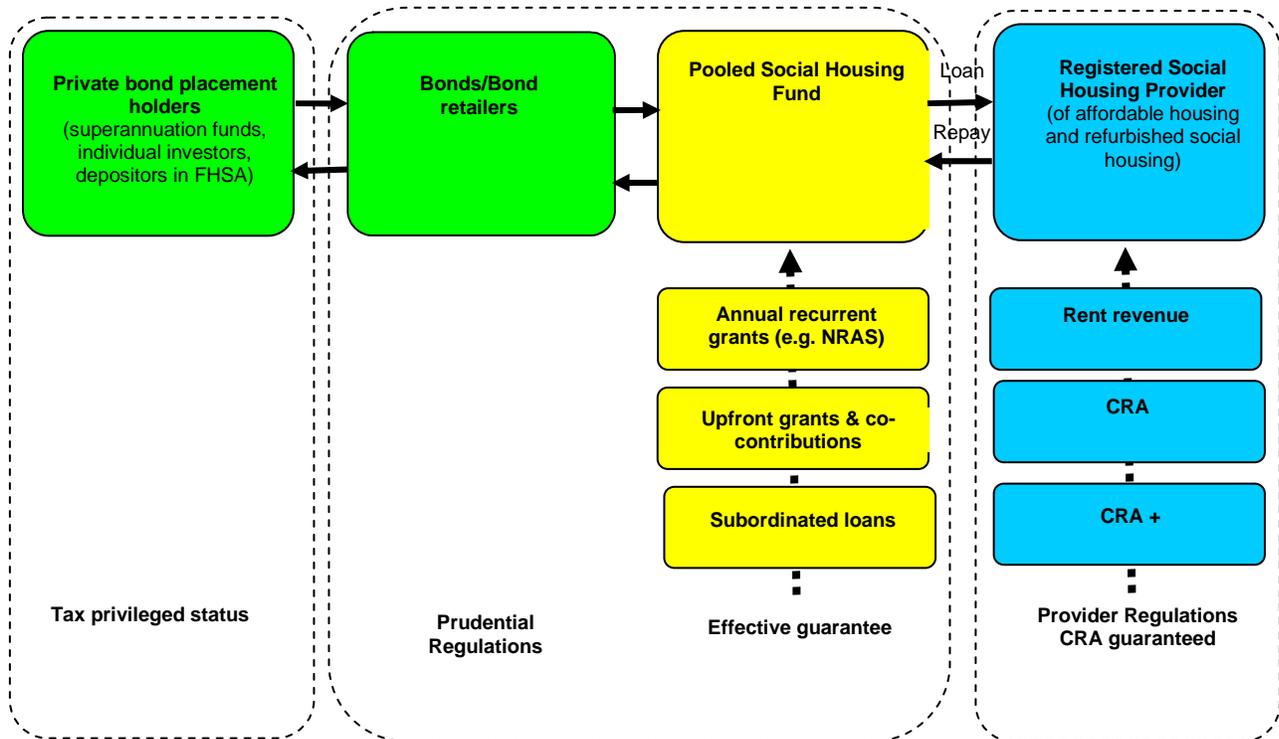
The Austrian and Swiss models of housing construction bonds provide a large scale, well funded and a small scale, limited public loans illustration, respectively of how the sale of bonds can make a scaleable and cost effective contribution to the provision of affordable rental housing. The operation of the HCCB model demonstrates that private banks can deliver the bonds; that tax incentives can encourage investors to purchase bonds; and that these can be progressive to attract ‘granny’ investors. Further, a public guarantee need not be provided where sufficient grant and loan programs comprise an adequate proportion of the financing package and are subordinate to the commercial loan, as in Austria. In Switzerland a guarantee is indeed required, due the low proportion of public loans (5%). However, the bonds do not have a tax privileged status. The regulations limiting the cost of commercial funds for affordable housing (less than 30 basis point above the Eurobor rate) has moderated the cost of finance across the wider mortgage market. The BIC model demonstrates the value of co-operation between social housing providers and government offering a suitable guarantee.

This third section of the paper builds on these requirements and learning from the successful experience in Switzerland and Austria, to outline the basic elements of a bond financing scheme for Australian conditions. For expediency, this is called a ‘Housing Supply Bonds (HSB) model’. This HSB model introduces financial intermediaries and standardised financial instruments (in the form of tax privileged bonds) into the existing NRAS model as a means of institutionalising the role of private investment and hence leveraging available public funds. By introducing what has been described as a missing link in the current model, it represents a logical development of the NRAS model.

The HSB model is based on a rent model to cover finance and operating costs, accessible to a wider range of households than social housing currently and accompanied by adequate demand side assistance coupled to social security payments, when and where this is required by different households. Options for retailing the bond instrument include a government financial intermediary, a co-operative buying group of social housing providers or one or more banking institutions with expertise in the sector. The bond obligations would be backed by well managed rent accounts and secured by grant funding, subordinate public loans and the like. In the Australian policy context, Commonwealth Rent Assistance will be an essential component of this funding arrangement and therefore needs to be guaranteed for the life of the loan for eligible participants. Interest on the bond would be tax privileged to attract superannuation savings and self funded retirees seeking low risk, low return socially responsible investments. Various forms of credit enhancement or additional subsidies could be applied to decrease costs further.

The bond instrument could make use of a special circuit of finance created by the First Home Savings Accounts as it develops, or special deposit accounts, as successfully implemented in France via the Caisse de Dépôt and described in Milligan et al (2009) and by Shaeffer (2003, 2008).

Figure 1: The Housing Supply Bonds model



The above model offers a stepping stone to be further developed using detailed research to determine the precise terms and conditions for such a bond financing system that is appropriate to the Australian financial and policy environment. A number of key issues will need to be addressed. First and foremost, investment requires a financially (and politically) stable delivery system, which is capable of ensuring that subsidised affordable dwellings are retained in the affordable housing sector and which can produce and operate housing services accessible to a *broad range of tenants* including those who have high needs and/or low incomes.

Secondly, investors need to be reassured that rental returns will generate sufficient revenue to cover financing costs and maintain asset values. In Austria, for example, the viability of social housing providers is secured by long term (12 year) funding agreements between the national and nine regional governments, providing grants and loans for projects applying cost rents (covering financing and operating costs) to a range of household incomes. As indicated above, CRA is an essential component of this funding arrangement and needs to be guaranteed for the life of the loan for eligible participants. Supplementation by what has been called 'CRA plus' (Burke 2006) will be needed in high cost areas where operating costs are likely to be higher and for high needs and low income households with lower capacity to pay.

Thirdly, investment should be long term and not speculative, seeking low risk, modest returns. The most likely source of investment is the Australian superannuation funds. With the introduction of compulsory contributions in 1992, there has been a growing pool of retirement savings that could be diverted to safe, secure and socially beneficial investments in Australia. Housing bonds could channel a small proportion of these funds towards the social housing sector and offer a modest and low risk return.

Fourthly, affordable housing must be recognised as a *special form of investment* for an under-developed sector. Towards this end there is a need for governments at state and federal levels to re-prioritise affordable housing as a 'case suitable for treatment'. This could involve a special tax privileged funding instrument to channel funds towards approved, part publicly funded housing projects. This will require action through COAG, facilitation by the Department of Families, Housing, Community Services and Indigenous Affairs (FaHCSIA) and co-ordinated agreement by Treasury and the ATO.

Fifthly, given the small scale of community housing in Australia, as in Switzerland, *funding should be pooled* to improve economies of scale and provide greater liquidity. This is more likely to be achieved using a standardised instrument offered by a centralised financial intermediary, with specialist expertise in the sector. The national government should provide the right incentives to steer investment into affordable housing construction, in partnership with the financial sector. To do so, they will need to devise appropriate prudential norms for any financial intermediary, adequate tax incentives for bond purchasers relative to other investment products and permit the subordination of public loans or provision of public guarantees to primary bond financed loans. Careful work is required to accurately assess which incentives would be the most efficient and effective in Australia.

Another important factor concerns the *regulatory framework*. Both overseas examples involved social landlords that are regulated to safeguard stakeholder investment and ensure fulfilment of their social task. This arrangement improves the credit worthiness and importantly, the financial rating of the sector. Considerable efforts have been made in Australia towards such a framework drawing on best practice overseas (Milligan et al, 2009). Another barrier is that most non-profit providers currently lack balance sheets to secure private loans, have an insufficiently diverse client base and are too small to generate revenue surpluses to service much debt. Emerging efforts to strengthen balance sheets (for

example by transferring government owned assets) and increase revenues (by capturing CRA) may be practical ways to address this issue in the Australian policy context.

Whilst it is not the focus on the paper, more effective and nationally consistent planning and land banking mechanisms also need to be engaged to ensure access to suitable development sites and to promote more equitable access to employment and community resources. Again, there are ample illustrations abroad to demonstrate how this can be done to achieve housing policy goals (see, for example, Gurran et al, 2008).

Conclusions

This paper has argued that sustainable and affordable finance is a crucial pillar to support the provision of affordable housing in the long term. It has revisited the case for housing bond financing in Australia. Whilst proposed bond schemes have not been implemented here, variations of bond financing have been introduced successfully in Austria and Switzerland. Their experience demonstrates the value of a well regulated sector of limited profit providers, sustained provision of public grants and loans and a long term, low risk tax privileged investment instrument to channel funds towards approved housing developments. Necessary steps towards an Australian model are outlined in this paper in order to attract additional funds to social housing provision and revive the housing choices of many Australians facing housing stress who deserve better outcomes from our housing system.

The paper explores the possibility of a Housing Supply Bonds model, developed as a logical extension of NRAS. It sees NRAS not as an end in itself but as a critical contributor to an integrated system of finance for affordable housing. Many of the components of the framework that underpin the proposed HSB model are already in place or are in the process of being developed. A delivery mechanism already exists and capacity is being expanded rapidly. Regulatory frameworks are in place in most states and adoption of a nationally consistent approach is being discussed. Recent initiatives have shown how both direct and indirect fiscal mechanisms (such as CRA and tax concessions) can be used to provide on-going support that contributes to the viability of affordable rental housing provision. In addition to the need to have a mechanism to raise private finance, what is missing from the current approach to funding affordable housing is a mechanism for collecting, coordinating and distributing the totality of funds available in a cost-effective way. This would include pooling co-contributions from state and local governments, from non-profit organisations and from whatever philanthropic sources might be available.

The proposed HSB model represents a further move towards providing these missing links and to solving the problems that have emerged from the Australian system of affordable housing provision. It highlights the need for policy makers to continue to develop the financial institutions and delivery mechanisms required to supply an adequate level of socially inclusive, affordable and quality housing options for the next generation of Australian households.

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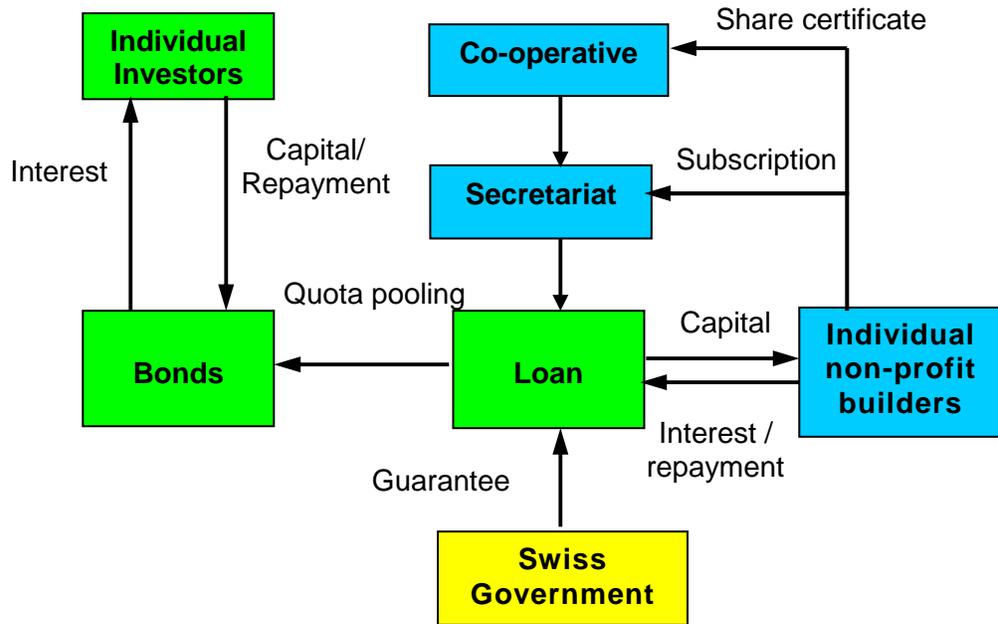
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Figure A.2: Swiss Bond Issuing Cooperative



Source: Federal Office of Housing (FOH) (2006)