



Australian Housing
and Urban Research Institute

**New approaches to expanding the supply of
affordable housing in Australia: an increasing role
for the private sector
Positioning Paper**

prepared by the

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Executive Summary

Since the mid-1980s real expenditure on social (public and community) housing has fallen. Housing assistance to the two main tenure groups – owner occupation and private renting – has continued to increase, in the form of income and capital gains tax subsidies to home owners and rent assistance to eligible private tenants. Private investors provide housing capital in the form of dwellings owned by private (largely individual) landlords and mortgage finance to owner occupiers. By and large, the tenure division of the total dwelling stock has been constant since the 1960s, though we may be beginning to see the slow decline of home ownership from its post-War high level of around 70 per cent.

Although the total dwelling stock continues to grow in absolute terms, tracking moderate population growth – albeit in a highly cyclical and uneven geographic fashion – increasing problems are apparent in matching housing opportunities and needs among the less affluent sections of the population, particularly those who are not well placed in the changing labour market. The demand for *affordable* housing is outstripping its supply in some areas and sub-regions.

The capacity of governments to deal directly with housing affordability problems has been severely limited by fiscal constraints on public borrowing and investment. Following the National Housing Strategy of the late-1980s, early 1990s, governments have attempted to attack affordability problems through a number of supply-side and demand-side measures, including: rent assistance, encouragement of more efficient land sub-division and building regulations, and greater private investment in housing provision. It is this latter emphasis on the potential contribution of private investment to increasing the supply of affordable housing that forms the focus for this project.

This positioning paper proposes a number of *key research questions* concerning the potential for (and barriers to) greater private investment in the provision of affordable housing. These questions are:

- What are the options for private sector finance of affordable housing?
- What are the main barriers preventing greater private investment in affordable housing in Australia?
- What policy approaches could be utilised to overcome those barriers in order to stimulate private investment in this sector?
- What are the implications for government housing assistance and asset management policies if barriers can be reduced?
- In the case of institutional investors, how might rental housing be turned into a new asset class?

The paper reviews the public policy context in which these concerns are being expressed and reviews a range of recent research findings on the nature and impacts of housing investment in Australia and several other countries where governments have attempted to attract more private investment into the housing system. Key outcomes from this review include the observations that:

- There has been a strong trend in Western societies towards greater reliance on market processes in achieving housing outcomes. This has been reflected in government attempts to cap or reduce the level of housing subsidies, and to target assistance more closely to households in need.
- At the same time, increasing inequality and insecurity, generated by changes in the wider economy, have impacted negatively on housing markets. The functional fit between labour and housing markets – forged in Australia through the operation of centralised institutions like the arbitration system – appears to be breaking down. Consequently, problems of housing affordability have increased through the 1990s, in spite of strong general economic growth.
- In Australia institutional investors have been loath to invest, in equity terms, in rental housing, in any part of the market. This follows from the existence of multiple barriers that prevent returns from being high enough, given the risks, to meet normal investment benchmarks. The basic barrier is the fact that net returns are too low given perceived risks in this sector. Other barriers include: illiquidity; lack of scale; high management costs; inadequate market information on asset performance and lack of a track record for this investment type.
- In Australia, specific joint venture projects have been attempted by housing agencies and larger investors but these have been on a small-scale and one-off basis.
- The development of a secondary mortgage market for owner occupation has attracted a growing volume of funds into that sector. However, this flow of funding has increasingly been directed to refinancing existing home purchasers, rather than new and first home buyers, and has underpinned a general explosion in consumer expenditure and debt.
- The rapid growth in the demand for private rental housing at all levels has only partially been met by increasing supply. The stock of medium rent and high rent dwellings has increased over the past decade or two but the stock of low rent dwellings has declined. As a result, housing affordability has declined significantly for private tenants in the bottom two income quintiles.
- The growth of a compulsory national system of savings in Australia (through the superannuation guarantee legislation of the early 1990s) has generated a large potential supply of funds for housing and other infrastructural purposes. However, accessing this growing pool will depend on developing acceptable investment products – i.e. instruments that deliver appropriate risk-adjusted rates of return to the funds.
- Recent changes in taxation, including changes in the capital gains tax regime and introduction of the GST, alter the picture somewhat with respect to investment returns on assets like rental housing.
- Research carried out for government and community sector agencies has consistently pointed to the need for government to bridge the gap between required and actual rates of returns facing investors given current market conditions and policy settings. The range of possible policy approaches to achieve this goal is large. Governments must decide on (a) what form of support to provide, (b) how to deliver that support, and (c) what form of private finance is to be sought. Ideally the policy approach adopted should generate maximum private investment for affordable housing provision, while minimising the total net cost to government.

The paper finishes by outlining the methods to be used to answer the five research questions posed.

The study will be based on a selective literature review of Australian and international research into investment in the provision of affordable housing, focused on how governments can reduce effective barriers and encourage private sector involvement. Interviews will be held with key actors in the social housing agencies and the financial sector. Secondary data concerning housing needs, current policy settings and economic conditions will be accessed. Assistance will be sought from the project user group to identify key interviewees and data sources.

Depending on data and interviewee availability, an early findings paper will be presented in early August and the final report and summary of findings in late September 2001.

Chapter 1

Introduction

1.1 Background

Since the mid-1980s real expenditure on social (public and community) housing has fallen. Housing assistance to the two main tenure groups – owner occupation and private renting – has continued to increase, in the form of income and capital gains tax subsidies to home owners and rent assistance to private tenants. Private investors provide housing capital in the form of dwellings owned by private (largely individual) landlords and mortgage finance to owner occupiers. By and large, the tenure division of the total dwelling stock has been constant since the 1960s, though we may be beginning to see the slow decline of home ownership from its post-War high level of around 70 per cent (Yates, 1999).

Although the total dwelling stock continues to grow in absolute terms, tracking moderate population growth – albeit in a highly cyclical and uneven geographic fashion – increasing problems are apparent in matching housing opportunities and needs among the less affluent sections of the population, particularly those who are not well placed in the changing labour market. The demand for *affordable* housing is outstripping its supply in some areas and sub-regions (Hall, 1997).

The capacity of governments to deal directly with housing affordability problems has been severely limited by fiscal constraints on public borrowing and investment. Following the National Housing Strategy (NHS) of the late-1980s, early 1990s, governments have attempted to attack affordability problems through a number of supply-side and demand-side measures, including: rent assistance, encouragement of more efficient land sub-division and building regulations, and greater private investment in housing provision. This latter emphasis on the potential contribution of private investment to increasing the supply of affordable housing forms the focus for this project¹.

A number of state government authorities have established programs to encourage or facilitate greater private sector provision of affordable housing. For example:

- In N.S.W. the Housing Minister has established an Affordable Housing Advisory Group which has proposed a program of seeding grants to demonstrate the viability of private sector collaboration in the delivery of affordable housing outcomes. The Department of Urban Affairs and Planning is also developing a new state environmental planning policy that will enshrine “inclusionary zoning” provisions allowing planning authorities to require the inclusion of affordable housing units in new housing developments.
- In Queensland the Department of Housing has established an Affordable Housing Unit responsible for developing a strategic program aimed at increasing the supply of affordable housing in the state. This strategy includes cooperation with the private sector, local government and community sector organisations (Queensland Housing, 2000).

¹ Following the NHS, “affordable housing” refers to housing that can be accessed by households in the bottom two income quintiles by paying no more than 30 per cent (or 25 per cent in the case of a more stringent benchmark) of their household incomes in rent or mortgage repayments. Housing costs in excess of 30 per cent are likely to impose significant financial and social hardships on low to moderate income earners.

- In Victoria the Bracks Labor government has committed to injecting an extra \$90 million into leveraging private and community sector investment into expanding the stock of affordable housing, during its current term of office.

This project will track and review these policy initiatives, along with other relevant approaches designed to attack the intensifying affordability problem. The emphasis will be on the ways the housing authorities can develop successful partnerships and leverage arrangements with private investors and other actors, in the light of existing and alternative policy settings.

1.2 Research Aims

The following five research questions will be addressed in this project.

1. *What are the options for private sector finance of affordable housing?* This question will identify the range of ways in which private investors are or could be involved in the provision of affordable housing in countries like Australia. The aims, requirements and motivations of the key players will be described in each case. The analysis will be supplemented by drawing selectively on past examples of private sector involvement in housing provision in Australia and internationally.
2. *What are the main barriers and inducements currently facing key players who are or could be involved in affordable housing provision?* The current pattern of housing investment in Australia will be described, highlighting the dominance of small individual investors in the rental sector compared to the deep market for (debt) investment (see technical appendix) in the owner occupation sector. The barriers to greater investment, especially in affordable home ownership and rental housing in general will be detailed.
3. *What policy instruments would be necessary to reduce current barriers and/or improve current inducements to effectively attract (significantly) more private investment into affordable housing provision?* Market failure at the bottom end of the rental market and increasing problems of access to home ownership constrain the capacity of the system to deliver satisfactory outcomes for lower income households; this has a pronounced geographical or locational dimension, feeding into broader patterns of social dislocation and exclusion. Housing subsidies and other policy interventions play a central role in breaking the vicious circle of poor housing-limited economic opportunities and their potential role in stimulating the flow of private investment into expanding the supply of affordable housing will be addressed.
4. *What are the main implications for government housing assistance and asset maintenance of greater private sector involvement in housing provision – if the current barriers identified can be reduced?* A number of approaches will be drawn from the earlier analysis and their implications for policy traced. Attention will focus on the impacts of alternative approaches on the level of housing assistance required and the implications for public housing asset maintenance strategies.
5. *In the case of institutional investment, what model or models could support the development of rental housing as a new asset class?* This question identifies the factors that would need to be addressed in order to establish rental housing as a distinct asset class suitable for large-scale investment by institutional investors. Appropriate investment vehicles would need to be developed and trialled. Both debt and equity models (see technical appendix) will be analysed in this context.

1.3 Structure of report

Chapter 2 of this positioning paper will discuss the current policy context, both in general background terms and then more specifically focus on some of the recent attempts by government to encourage private sector involvement in this area. Attention will focus on the trends and debates around the Commonwealth State Housing Agreement, taxation reform and competition policy, and financial deregulation.

Chapter 3 provides a selective literature review, drawing out examples of the different approaches to stimulating private sector involvement in affordable housing provision and reviewing the key issues, constraints and opportunities characterising this field. Current patterns of housing investment will be identified. Both Australian and international references will be covered.

Chapter 4 outlines the methodology proposed for this project. Primary data generated through key person interviews, analysis of documentary and secondary data and scenario analysis will inform the study.

Chapter 5 will provide a brief conclusion , highlighting the key issues and directions for the project. An executive summary of the paper will be added.

It is expected that an early findings paper will be presented in early August and the final report and summary of findings in late September 2001.

Chapter 2

National Policy Context

Current debates on housing policy in Australia are occurring in the context of both broader economic, demographic and social developments, and the peculiar history of housing and housing policy traditions in this country (on the latter, see Dalton, 1999). In the broad context the key factors include:

- Increasing deregulation and 'globalisation' of the national economy;
- Aging of the population and the rapid growth of smaller households;
- Increasing economic (i.e. 'vertical') inequality, expressed geographically; that is, polarisation between high and low income earners is increasing in general, but is particularly marked in some regions – especially those undergoing pronounced economic decline.
- Increasingly 'flexible' but segmented labour markets; i.e. labour markets unhindered by government or trade union rules, and the appearance of distinct types of jobs differentiated according to whether they have particular characteristics or not – such as guaranteed hours, time or piece rates, high or low wage levels, promotion prospects, redundancy provisions, etc.
- including the growth of both high income, knowledge intensive jobs and low paid, insecure and casual employment;
- The growth of dual income households, and the increasing economic participation of women in the paid workforce;
- A deregulated and rapidly growing capital market (see technical appendix), increasingly integrated on a global scale;
- Continued growth of the service sector in comparison to the primary and secondary sectors of the economy; i.e. the growth of a whole range of consumer and producer services – both in output and employment terms – in relation to the agricultural, natural resources and manufacturing sectors of the national economy.

In terms of the rather unique history of Australia's housing system over the past hundred years, the following key points stand out:

- Australia has – by comparison to most of the other advanced industrial societies – a very heavy emphasis on the market. More than 95 per cent of households have always accessed their housing through the markets for rental housing or owner occupation. Social housing has played a (numerically) minor role and was late on the scene when compared to, say, Great Britain;
- Australia already had a high rate of owner occupation by the end of the Nineteenth Century; this rate climbed further in the two decades after World War II;
- Australia has (and has always had) a significant and buoyant private rental sector, dominated by small individual landlord-investors owning one or two rental dwellings;
- The majority of Australians enjoy high housing standards;

- The housing stock is predominantly comprised of fully detached dwellings located in low density settlements;
- Policy responsibility for housing has been split between the Commonwealth and State and Territory governments, with local government playing a minor and indirect role.

The strong and persisting imprint of the market on housing provision in Australia has been dependent for much of the Twentieth Century on the institutional framework ushered in soon after Federation and resulting in what has been termed 'the social settlement' between Capital and Labour. In particular, the centralised system of wage fixation matched minimum award wages across the economy to movements in the cost of living for families. Housing costs were explicitly included in this calculation, more or less ensuring that households with a full-time employed member would be able to afford at least basic housing through the private rental market and many would be able to move from renting into home ownership. The development of a protected circuit of housing finance facilitated this typical pattern of housing careers. That is, close government regulation of the financial sector required the savings banks, credit unions and insurance companies to invest in limited areas of activity, notably the purchase of government bonds and home mortgage lending at lower than general market interest rates. In the case of owner occupation, this created a trapped pool of mortgage finance that did not reflect or respond fully to movements in economic conditions elsewhere in the economy. Permanent and secure employment led to adequate and secure housing for upwards of 90 per cent of the population, except in times of serious economic downturn (as in the 1930s) or Wartime privations (Berry, 1999; Dalton, 1999).

This functional fit between labour and housing markets has begun to unravel over the past twenty years. Employment security has declined for many workers across the economy, along with the proportion of full-time middle-income jobs, especially for men. Labour economists like Bob Gregory (1992) point to the phenomenon of 'the disappearing middle,' and the growth of low waged, part-time and casual jobs in the service sector. Campbell (1997) stresses the increasingly *precarious* nature of such employment, especially in terms of continuity of income over time. To gain and maintain access to both owner occupation and rental housing, households require adequate levels of income and a reasonably stable and predictable flow of income. Increasingly, labour markets are not meeting this dual condition for some workers. At the same time, in the wake of far-reaching deregulation of financial markets, the protected circuit of mortgage finance has broken down; mortgage borrowers now compete with other borrowers and pay full market interest rates on their loans. There is, therefore, an increasing disjuncture between housing and labour markets, which is undercutting the capacity of the market to deliver affordable and appropriate housing to an increasing number of households. Put another way, housing affordability problems are increasing – with implications for a range of social problems like homelessness, ill health and declining access to employment. Inadequate housing appears to be one of the interacting factors leading to the threat of 'social exclusion', and marginalisation of people from the mainstream economic and social institutions of society (Berry, 2000). Housing policy has changed too, with the Commonwealth withdrawing to focus on the delivery of income support through the social security system while progressively reducing its real contribution to public housing. Over the past decade most of the States and Territories have also wound back their direct housing operations, seeking to consolidate and reduce debt in the public sector and phase down home lending programs (discussions with housing officials).

A key question arising is: can the emerging crisis in housing affordability be adequately addressed by relying solely on traditional government policies in the housing assistance field – or will part of the solution be to attract more private sector investment into the provision of

affordable housing? If the solution involves a greater reliance on private sector involvement, how can this be engineered? This latter question is the focus for this project.

The next section outlines the current state of, and recent developments in, housing policy in Australia. The following sections of the chapter look at the impacts of the changing taxation environment and continuing economic restructuring on the policy outlook.

2.1 Housing Policy

Commonwealth housing policy has focused on facilitating access to the three main tenures, as follows:

- *Owner occupation*: through provision of both direct outlay subsidies like the first home owners grant, and indirectly through taxation revenue foregone. Owner occupiers pay tax on neither capital gains on their dwellings nor on the imputed rental income (see technical appendix) they enjoy. The total value of this tax benefit is greater than all other housing subsidies put together (Flood and Yates, 1987). Direct regulatory controls over the lending patterns of banks and interest rate levels were wound back in the 1980s. Earlier policy initiatives, notably the Commonwealth's formation of the Housing Loans Insurance Corporation in the early 1960s, continue to underpin the loan market for mortgage finance, though the HLIC is no longer in public ownership, having being privatised in the late 1990s. It is not clear whether privatisation of the market leader in mortgage insurance will have any consequences for effective access to mortgage finance, though it is possible that the application of risk management techniques, tighter credit controls on lenders and aggressive competitive action by the new owner, GE Capital Services, may exclude some marginal borrowers (Berry et al., 1999).
- *Private renting*: through provision of rent assistance paid to eligible tenants receiving Commonwealth benefits and pensions. In fact, the Commonwealth considers rent assistance as part of its income support policy and delivers it through the social security system. Other policies, such as landlord-tenant legislation, remain the responsibility of the State governments.
- *Social housing*: through provision of loan and grant funding to the States and Territories to fund public and community housing programs. In return for this funding the Commonwealth requires the States to provide matching funds and monitors the performance of state housing authority (SHA) programs.
- *Supported Accommodation Assistance Program (SAAP)*: the Commonwealth, in conjunction with the States and Territories, provides outlay funding for agencies to deal with crisis housing needs – i.e. homelessness.

The main institutional mechanisms for delivering housing assistance to Australian households are: the income tax system (tax concessions to home owners), the social security system (rent assistance to pensioners and beneficiaries) and the Commonwealth State Housing Agreement (CSHA). The CSHA, now in its fifty-sixth year, is a multilateral agreement between the States and Territories, on the one hand, and the Commonwealth, on the other, to funnel Commonwealth funds into the provision of public housing and for other agreed purposes. In the past this has meant that a proportion of Commonwealth funding provided under the Agreement could be (and was) diverted to providing subsidised home loans for public housing clients (Berry, 1988).

The CSHA has been renegotiated many times over the past half-Century. The watershed came in the 1970s when the governments decided to:

- move away from setting public housing rents on pooled historic costs (see technical appendix) towards charging market rents, rebated on a means tested basis;
- cease selling off public housing stock to sitting tenants on subsidised terms, and;
- (in some States) move away from building high rise estates towards dispersed acquisitions and spot purchase of a locational and dwelling type mix.

Subsequently, *a number of significant changes* were ushered in:

- the 1984 Agreement included as a major objective, the substantial expansion of the public housing stock. A general commitment was made to provide housing assistance to all households in need in order to solve housing-related poverty.
- The 1984 and 1989 Agreements limited the extent to which CSHA funds could be directed to financing owner occupation, so as to concentrate on the expansion of the public (and small community sector) housing stock. The States were encouraged to initiate their own home ownership programs, which a number did, drawing on wholesale funds in the debt market (see technical appendix). This was in keeping with the Commonwealth's expressed desire to move away from any direct support for owner occupation. Under these Agreements, the public housing stock expanded moderately through the 1980s.
- The 1989 Agreement substituted Commonwealth grants for long term Commonwealth loans to the States at subsidised interest rates. This formalised a trend towards grants that began earlier in the decade.
- Since 1989 the level of Commonwealth grants provided under the Agreement has been effectively capped at around \$1 billion per year in nominal terms, with similar implications for the States' matching funds. This represents a significant fall in the level of real funding for public housing throughout the 1990s, and is largely responsible for the fact that the annual additions to the public stock has fallen from around 15,000 dwellings to about a quarter of that figure during the last 10 years.
- The 1996 Agreement removed the remnants of any general commitment to meeting the housing-related needs of low income and disadvantaged households. This change underscored the strong shift in policy purpose towards targeting public housing to high-need groups. The States and Territories have, subsequently, each gone their own ways with respect to identifying and servicing their target clients, negotiating supplementary bilateral agreements with the Commonwealth.
- The 1996 Agreement has been extended until 2003.

These progressive changes in the CSHA have occurred in a broader public policy climate of ('microeconomic') reform. In 1993 the Industry Commission report on public housing concluded that this policy approach offered the most cost effective way of delivering housing assistance to those most in need (Industry Commission, 1993). However, the Commission also outlined a number of reforms necessary to ensure that the policy actually delivered appropriate outcomes. These included: clarification and prioritising of program goals; increased transparency in subsidy arrangements; establishment of benchmarks against which to measure program

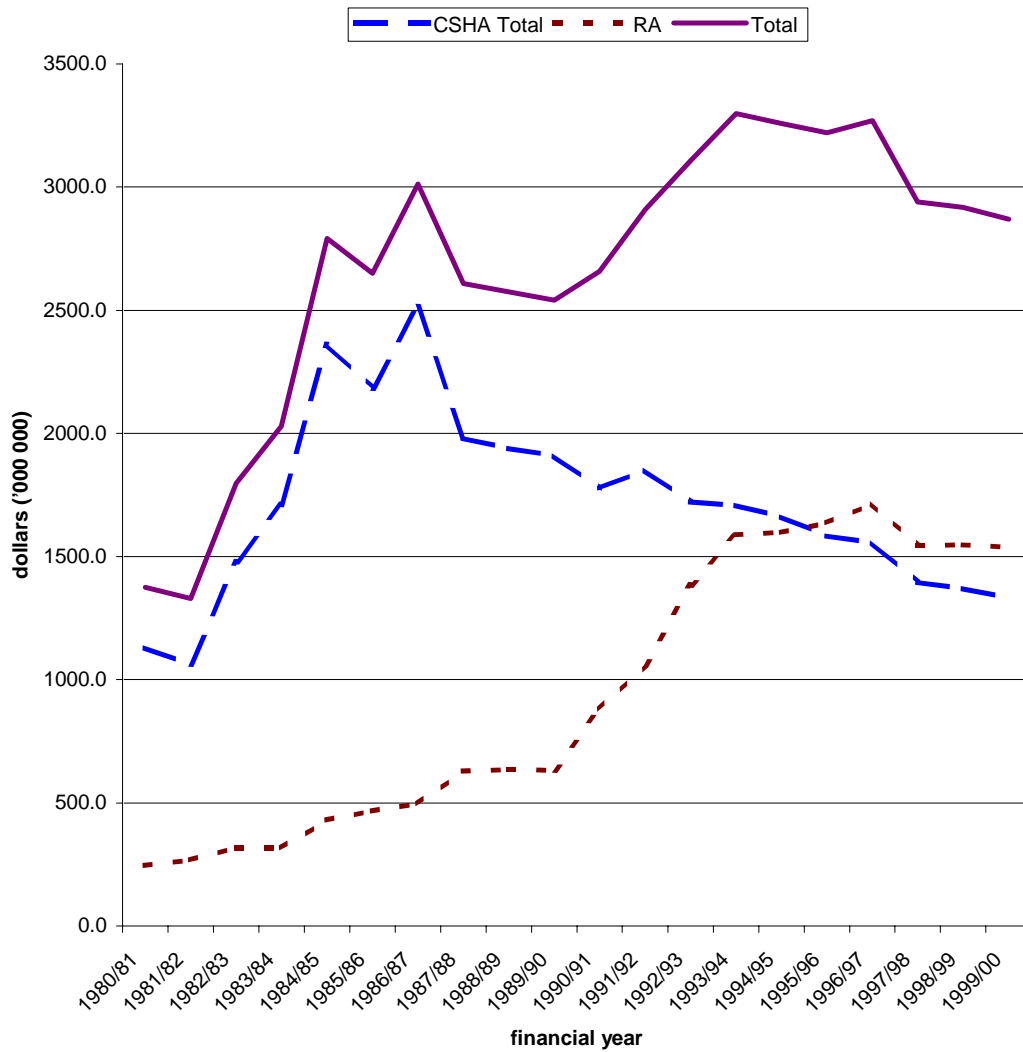
performance, and; a clear definition and separation of the roles of the Commonwealth and the States.

The recommendations of the Commission were subsequently taken up by the Coalition of Australian Governments (COAG), as part of the general government reform process. COAG required, in addition, that a national needs assessment be implemented to ensure that housing assistance provided was delivered on a consistent basis across all the jurisdictions, that output targets be established for the SHAs and monitored, and that a charter of resident rights be implemented. These measures are being implemented through the process of the bilateral agreements between the Commonwealth and State governments, though individual States and Territories have differed with respect to how some of these directives have been implemented. Victoria, for example, has moved to explicitly segment its waiting list (see technical appendix) for public housing in order to identify and prioritise households in high need.

All this change has occurred within a policy climate that has seen the emphasis of Commonwealth housing assistance shift from supply-side subsidies for social housing towards the demand-side in the form of rent assistance (RA). Strictly speaking, rent assistance is not paid as a housing allowance but as an income supplement for private tenants on social security benefits. In a way, this is akin to the housing cost determined component that used to be included in the award wages of workers through the arbitration system. But RA is *not* paid to low income workers who are renting, leaving them outside the total housing assistance system.

The broad pattern of housing assistance trends for tenants, public and private, is outlined below in Figure 1.

Figure 1 – Commonwealth and State Expenditure on housing assistance over the period 1980-81 to 1999-2000, in constant 2000 dollars



Source: Australian Housing Policy Project (2001), *Facts Sheet 3: Housing Assistance Funding Trends*, Australian Housing and Urban Research Institute, Melbourne.

2.2 Taxation Reform

Taxation reform has become a significant focus for government action in Australia over the past few years, especially at the Commonwealth level. The main areas of reform have been:

- Capital gains tax. Changes in late 1999 effectively cut the *nominal* CGT rate for individuals in half for assets held for more than twelve months. CGT for companies continues to be levied at the company tax rate, though the latter fell from 36 to 30 per cent during the 1990s.
- The Goods and Services Tax introduced in 2000 applies to newly constructed housing and major renovations. However, rental housing is input taxed rather than GST taxed. This means that GST is not charged on residential rents but landlords cannot claim input credits for supplying the service. Other things being equal, this suggests that rents will be higher than if input credits could be claimed and the net effective cost to the investor of supplying rental housing lowered.
- Personal income tax rates were cut as part of the introduction of the 'New Taxation System' (taxreform.ato.gov.au).

These collective changes to the overall taxation system have some very significant implications for the housing system, not all of which are immediately apparent. In particular:

- Investment by high income individuals in assets with a significant capital gains component in their overall return may be somewhat more attractive to other assets, as long as inflation remains low. In the previous CGT regime tax was payable only on the real (after inflation) component of gain. If inflation is low then nominal and real capital gains are similar and investors will therefore pay less tax under the new arrangements since they benefit from the 50 per cent discount on the marginal tax rate. Housing is only one asset type that would benefit in this way.
- Negative gearing is still applicable to investments, including rental property but, if leveraged, investors must now demonstrate an intention to repay loan finance from sources other than the final sale of the asset (in this case, the rental dwelling).
- Registered charities like the Churches are GST free. This means that they can claim input credits for the purchase and renovation of housing for rent, reducing the potential level of rent required, by comparison to rent charged by commercial investors.

Less visible are the effects of recent taxation reform on the largest tenure group – home owners. The changes outlined above have effectively reduced the taxation benefits traditionally enjoyed by this majority group. In particular:

- The effective (implicit) subsidy involved in exempting the owner occupied dwelling from capital gains taxation has been reduced by up to 50 per cent.
- Similarly, the reduction in marginal income taxation rates has reduced the value of the exemption of imputed rent for home owners.
- Finally, the imposition of the GST on the purchase of new, and renovation of existing, housing has increased the explicit taxation of home owners. This, in effect, is a backdoor way of clawing back some of the tax benefit on the exemption of imputed rent. This clawback has, in turn, been partly offset by purchasers of new housing who qualify for the

first home owners' grant. (First home owners who claim the grant and purchase existing homes are not affected by the GST in this manner, except to the extent that rising new house prices place upward price pressures on the existing stock.)

2.3 Capital Market Restructuring

Starting in the late 1970s, successive Commonwealth governments have moved to substantially deregulate the Australian financial system. The main components of financial market deregulation were put in place during the first half of the 1980s². The key steps were:

- Progressive removal of direct controls over the asset structures of the trading banks, and on the interest rates they could charge.
- Relaxation of foreign exchange controls and the 'float' of the Australian dollar (a move from fixed to flexible exchange rates).
- Granting of a number of new banking licences, which resulted in the introduction of a number of foreign banks to the country and the conversion of some large non-bank financial institutions to banks.
- Introduction of a market-based system for the sale of government securities. This was consistent with the move by the Reserve Bank of Australia to rely on open market operations rather than statutory regulation of the banking system to influence market-determined interest rates in the economy.

The consequence for housing of far-reaching financial sector deregulation has been the dismantling of what had been termed 'the trapped circuit of housing finance' (Berry, 1999). Housing investors (including owner occupiers) no longer had exclusive access to the deposits tied up in the savings banks or permanent building societies. They had to compete for loan funds in an increasingly integrated and competitive financial system. One consequence has been for an explosion of new providers of residential mortgage finance and the emergence of more liberal lending practices. The creation of a secondary mortgage market in the mid-1990s, after a stuttering start in the late-1980s, has created a growing pool of housing finance and a viable market in residential mortgage backed securities purchased by the large institutional investors. However, this expanding supply of housing finance has been associated with a switch away from first home ownership in favour of refinancing loans on existing housing. Housing wealth has been tapped by existing home owners to finance a range of non-housing as well as housing activities. In the face of growing affordability problems for low income earners and housing 'choices' by younger households to rent privately, the demand for long term rental housing is rising without necessarily creating an appropriate supply response – at least, this appears to be the case at the low cost end of the rental market throughout Australia (Yates and Wulff, 2000).

The other major policy-driven change to the financial system has been the creation of a compulsory national system of savings, resulting in the rapid growth of superannuation funds and parallel savings products in the banking system. By 2000 the total superannuation funds under management in Australia had risen to around \$450 billion on their way to a forecast \$2 trillion by 2010 (Clark et al., 1996).

² For a summary of the changes and timing see Perkins (1989) and Carew (1991, pp. 11-30).

The key developments in the creation of this massive, growing pool of finance were:

- The decision by the trade union movement in the mid-1980s to accept a 3 per cent employer contribution to employee superannuation in lieu of an award wage rise.
- The passing of the Superannuation Guarantee (Administration) Bill in 1992 establishing a universal system in which employers' contributions would rise to 9 per cent of wages or salaries over the succeeding decade. This effectively satisfied Federal Labor's pledge during the Whitlam Government of the early 1970s to introduce a universal superannuation scheme covering all workers in Australia – one of that government's three major social policy programs, the other two being a universal system of health insurance (Medibank/Medicare), which was enacted, and a national workers' compensation scheme (which wasn't).
- The passing of the Superannuation Industry (Supervision) Bill in 1993 allowing fund members a degree of choice over where and how their savings are invested.
- Following the Fitzgerald Report on national savings and the 1995-96 Federal Budget, the decision to require minimum employee contributions of 3 per cent matched by 3 per cent from the government, the latter in lieu of promised tax cuts.
- After the Federal Coalition's election victory in 1996 two further changes have been introduced. First, other financial institutions, notably the banks, can now compete for the growing pool of superannuation savings by offering retirement savings accounts. Second, an income tax surcharge has been placed on the contributions of high income earners.

The growth of superannuation savings has important implications for the housing system. The flow of such funds into residential mortgage backed securities has already been noted. This has allowed new mortgage lending organisations to access wholesale funds, including so called mortgage originators like Aussie Home Loans and RAMS. It has also led to a degree of 'economically targeted investment'³ by some industry superannuation funds. For example, during the mid-1990s the (then) National Mutual insurance company developed an arrangement with the large ACTU-related industry superannuation funds to supply home mortgage loans to fund members at very competitive interest rates. This had some effect in shrinking the lending margins of the mainstream mortgage lenders.

However, the obvious gap in the housing system, in this context, is the *absence* of superannuation fund investment in *residential* -- as opposed to commercial -- property. This situation relates to all rental housing, not just at the affordable end. Recent research has identified a number of reasons for this outcome, i.e. the existence of effective barriers to institutional investment in this area. This work is summarised in the next chapter. At this point it is only necessary to identify the lacunae – and to raise the obvious policy-relevant point that *if* these barriers could be reduced or summounted, the superannuation system has the potential to fund very significant increases in housing supply across both major tenures, including the provision of affordable housing. The base line requirement is that the investment instruments or vehicles developed must generate adequate returns for the risks borne.

³ Economically targeted investments refer to investments that return both appropriate risk-adjusted rates of return and collateral benefits, like employment generation for fund members or an increase in the supply of affordable housing (see Jobling, 1994 and Clark, 2000).

2.4 Some Recent Government Approaches

From the mid-1980s a number of SHAs attempted to supplement their mainstream public housing programs by leveraging private (and community) sector investment. Most of these attempts sought to move or keep social housing assets 'off budget' from the point of view of the States and therefore fall outside the constraints of the Loan Council (Berry, 2000). Before outlining below a number of past and current examples drawn from the three Eastern States, I identify the main forces leading to this policy direction.

Four main forces led to the greater (though still episodic) efforts of the States to access private finance for affordable housing during the past 15 years:

- The increasing 'welfarisation' of public housing – i.e. the concentration of tenants dependent on social security benefits in public housing -- resulted in a rising rent rebate bill (discussions with housing officials). When coupled with the increasing costs of maintaining and upgrading an aging public housing stock and the declining real value of Commonwealth grants (see Figure 1), this created an increasing revenue squeeze on the SHAs. If the latter agencies were to respond to expanding need, represented by lengthening waiting lists for public housing, then alternative means of funding stock increase would be required.
- Public borrowing controls imposed through the Australian Loan Council were effectively tightened during this period as governments at both Federal and State levels moved to reign in (the growth of) public debt, in line with the hegemony of neo-liberal economic principles in policy circles. Housing did not loom large on the infrastructure investment agendas of the State governments, which directed their Loan Council sanctioned borrowing programs into roads, hospitals, schools and other policy areas -- or failed to borrow up to their limits (discussions with housing officials).
- The process of financial deregulation described above, and the speculative flow of private investment into the property sector after the 1987 stock market collapse, saw financial sector operators aggressively seeking new investment opportunities, opening up new opportunities for joint ventures with government (Berry, 2000).
- Ideologically, the 1980s ushered in a search for 'smaller government', and a rhetoric favouring the transfer of many services traditionally provided by government to the private sector (Pusey, 1991; Rees, et al., 1993).

The next sub-sections (selectively) describe some past and current attempts to respond to these forces in N.S.W., Queensland and Victoria, for which data is available; given the time and scope of the project, the analysis is confined to these three jurisdictions.

2.4.1 N.S.W.

In the mid-1980s the Commonwealth Government replaced negative gearing on all assets, including rental houses, with a 4 per cent building allowance on new dwellings. This encouraged the formation of a rental trust (see technical appendix) in N.S.W. with returns guaranteed by the State Bank. Tax benefits received by private investors were generated by the capture of the indexation benefits (see technical appendix) of the (then) capital gains tax regime and the tax shelter provided by the 4 per cent building allowance. The capture of tax benefits and the revenue guarantee allowed new rental dwellings to be built and let at prevailing market rents. Similar trust arrangements emerged in some other States at this time. The major drawback in public policy terms was that there was little attempt to target the new rental dwellings towards the affordable end of the market. In any event, once Commonwealth taxation

policy changed – as it did in 1987 with the reintroduction of negative gearing and the reduction of the building allowance to its current level of 2.5 per cent – these rental schemes dried up. The return to risk profile no longer stacked up for investors. This trend was reinforced by the imposition of increasingly stringent taxation rulings which limited the extent to which government guarantees could be factored into structured arrangements with private investors – without investors losing the tax benefits from the building allowance and depreciation deductions. The Loan Council also cast a wider net over government off-budget deals in an attempt to prevent such arrangements from turning into public borrowing by stealth. The impact of these two constraining factors severely limited the extent to which government leasing and guaranteed buy-back arrangements could be used to transfer risk from the private investing party.

The tighter rulings of the tax office and public borrowing limits by the Loan Council led, in the later 1980s, to a search for genuine joint venture equity agreements between government agencies and private investors. The largest deal of this kind was the Public Equity Partnership joint venture between the N.S.W. Department of Housing (DOH) and the AMP Society – the so-called PEP1 and PEP2 schemes. These schemes saw about 1,500 dwellings acquired by an AMP vehicle and leased back to the DOH who managed the properties. Vacant dwellings could, after a minimum period, be rented to private tenants. The DOH provided AMP with an agreed gross real rate of return which reflected the capital gains tax indexation benefits captured by AMP. The DOH also provided a minimum capital guarantee of the residual value (see technical appendix) of the dwellings, in real terms, and shared in the division of any real capital gain above that minimum. The financial obligations of the State were provided for through a commercial insurance policy (in the case of PEP1) and by establishing a special government trust (PEP2). This represents one of the few examples to date of large scale institutional investor equity involvement in the rental sector in Australia.

Currently the N.S.W. government is pursuing two avenues with respect to attracting private investment into the provision of affordable housing. First, following recommendations by the Ministerial Affordable Housing Advisory Group, a small seeding program has been established to fund demonstration projects. Second, the Department of Urban Affairs and Planning is developing a State Environmental Planning Policy on affordable housing to give effect to legislative changes in 2000 to the Environmental Planning and Assessment Act empowering local planning authorities to require minimum provision of affordable housing units in private residential development schemes (to be discussed in a subsequent report from this study). Beyond that, the DOH continues to explore options for private investment in affordable housing, particularly with respect to the redevelopment and regeneration of existing dwelling stock. This provides a focus for the current research in this project.

2.4.2 Victoria

The Bracks Labor government was elected in 1999 with a promise to inject a further \$90 million of State funds into the provision of affordable housing, in cooperation with the community sector and drawing on private investment to leverage the government funds. The Social Housing Innovations Project (SHIP) has as its target the addition of 800 dwellings to the affordable stock in the State. The government funds are to be allocated in ways and to projects that attract at least a 15 per cent investment by the private sector. In late 2000 the Victorian Office of Housing called for proposals from community housing providers and private investors to access the first tranche (\$11 million) of those funds. A commissioned report recommending how to allocate the remaining funds is currently under consideration by the Housing Minister and Cabinet.

Prior to SHIP Victorian governments have not been actively seeking private investment in this area. Earlier programs focused on encouraging the growth of the small community housing sector through a variety of means, including:

- Grants: in the first half of the 1990s grants were made to established community sector providers under the community housing program.
- Headleasing: the government headleases dwellings from the private sector and on-leases to community housing organisations.
- Agency arrangements: the management of government owned stock is out-sourced to community housing providers. For example, the common equity rental cooperatives manage dwellings owned by a government vehicle, Common Equity Housing Inc. Other programs draw on the management resources of the larger community organisations like Supported Housing Development Foundation which specialises in providing appropriate housing for people with disabilities.

Some of these programs leverage resources from the community organisation involved – e.g. the Churches – but, by and large, do not draw significantly on the private sector. The major exception was the establishment, in the late 1980s, of a government vehicle, the National Mortgage Market Corporation, to securitise (see technical appendix) home mortgages targeted to low income earners, with the bonds sold to institutional investors. This was the last large scale effort by government to boost home ownership by providing mortgage finance to households who may have found it difficult to access the mainstream mortgage markets. However, repayment difficulties surfaced for many borrowers in the early 1990s – due to a mixture of high interest rates in the boom period and the technical structure of the mortgage products provided – and the program was phased out through the decade. In particular, it appears that low income borrowers effectively carry most of the risks associated with underlying movements in economic conditions that affected mortgage interest rates. When interest rates rose sharply at the end of the 1980s, in order to break inflationary pressures in the economy, many borrowers were faced with unsustainably high mortgage repayments.

2.4.3 Queensland

The Queensland Housing Department released a discussion paper on affordable housing in late 2000⁴. The paper establishes a rationale for government policy in this field and reviews a range of approaches government could take to expand affordability outcomes. These approaches included legislative, institutional, town planning, taxation and fiscal measures designed to encourage greater private and community sector involvement. The Integrated Planning Act (1997) provides the legislative platform for the possible introduction of State Planning Policies along the lines of the N.S.W. model allowing local councils to require the inclusion of a proportion of affordable dwellings in new residential developments. Under the Land Titles Act (1994) voluntary covenants can be attached to land to preserve its current use as low cost housing. The Department is currently exploring collaborative action with the Brisbane City Council, including the feasibility of establishing a joint affordable housing trust.

⁴ Queensland Department of Housing, Affordable Housing in Sustainable Communities: A Discussion Paper, Brisbane, November 2000.

Chapter 3

Literature Review

During the 1990s housing researchers in a number of Western countries pointed to the increasing social need for affordable housing in a situation where 'Globalisation' was undercutting the capacity of many people to house themselves through the traditional institutional forms of the market and government policy. Fiscal and other pressures were seen to be severely limiting the ability of governments to go on increasing subsidies provided to both home owners and social housing tenants. Wherever possible governments attempted to cap total housing subsidies by off-loading responsibility onto the private sector and households themselves. The discipline of the market was to be harnessed to increase the efficiency of housing provision and consumption, and direct government involvement was to be focused on those marginal cases where the market continued to fail. This re-emphasis on market processes resonated the sentiments of neo-liberalism dominant in the Anglo-Democracies like Britain and Australia – but also influenced housing policy reforms in many of the liberal and social democratic societies of Western Europe. Of particular salience was the concern to increase owner occupation rates, open up opportunities for a growing private rental sector and increase private investment in social housing, at the expense of the traditional social housing sector (Priemus, 1993; Pryke and Whitehead, 1993; Boelhouwer and van der Heijden, 1994; Miron, 1995; Whitehead, 1996; Kleinman, 1996; Oxley and Smith, 1996; Boelhouwer, 1997; Larkin and Lawson, 1998).

The next section (selectively) reviews policy-relevant studies and developments in a number of these countries. The following section focuses on similar developments in Australia over the past decade or so. A brief concluding section completes the review.

3.1 International Experience

This section looks at the developing situation with respect to the private financing of rental and affordable housing in Britain, the United States and the Netherlands.

3.1.1 Britain

New housing legislation, enacted early in the first Thatcher Government (1979-84), introduced 'the right to buy' for sitting public housing tenants. By the beginning of the 1980s, local government public housing accounted for about one third of the total dwelling stock. Thatcher's first Housing Act (1980) was designed to encourage public tenants, particularly those who were employed, to move into home ownership, supported by substantial discounts on the purchase price of their dwellings. By the mid-1990s over 1.5 million local council dwellings had been purchased by tenants and the stock of public housing had fallen to a little over 20 per cent of total stock (Kleinman, 1996, p. 30). The home ownership rate in Britain rose from just over 50 per cent in the 1970s to 67 per cent in 1990 (Oxley and Smith, 1996, p. 74).

Private finance flowed strongly into mortgage lending during this period, facilitated by a publicly funded mortgage insurance scheme ('Income Support for Mortgage Interest' or ISMI), means tested and delivered through the social security system. More generally, the central government continued to provide mortgage interest relief through the income tax system. However, from 1983 the mortgage interest relief scheme was progressively restricted in order to limit the total cost of the subsidy to government that threatened to blow out under the twin impact of rising home ownership and house price inflation. The total subsidy to home owners rose from 1.6 billion pounds in 1980-81 to peak at 7.7 billion in 1990-91, declining to 3.5 billion by 1994-95 (Kleinman, 1996, p. 31).

A second Housing Act (1988) in the last Thatcher Government (1987-90) introduced the policy of transferring local council dwellings to housing associations, according to the expressed preferences of the majority of tenants on a public estate. By 1995, 185,000 public dwellings had been transferred in this manner (Kleinman, 1996, p. 37). This process continued during the second half of the decade. The housing association sector has grown accordingly, to absorb stock transfers and access private loan funds made possible by central government provision of facilitating infrastructure. In particular, the government established the Housing Corporation to regulate and assure quality within the sector and to channel government grants and loan funds to the associations (ibid.). The associations can also borrow directly from banks and other private lenders. Private sources now supply up to 50 per cent of the cost of new stock (Aughton and Malpass, 1994).

Successive British governments have also sought to encourage the growth of the private rental sector which had fallen to less than 7 per cent of the total stock by the early 1990s (Crook and Kemp, 1996). In 1988 the Business Expansion Scheme was extended to cover companies investing in rental housing. Under the scheme investors received tax relief on dividends, up to a limit, as long as the shares were held for at least five years. Thereafter shares could be sold and any capital gains realised free of tax. This scheme was phased out in the 1990s and made little impact on actual investment patterns (Crook et al., 1995).

A second scheme – the creation of housing investment trusts (HITs) – was introduced in 1996 by the Major Government. HITs are housing-specific corporate vehicles designed to attract equity investment by delivering tax benefits to investors. Company income tax is charged at the lowest rate and capital gains are exempted. Crook and Kemp (1999) carried out a survey of 27 financial institutions to determine the attitude of institutional investors to the scheme. The overall result was that the scheme (like the earlier BES) had made little headway to date. Investors were concerned about the capital value constraints (scale), illiquidity (in spite of stock market listing) and lack of tax transparency. However, there were some signs of investor acceptance, by comparison with the earlier scheme, and more industry interest in developing the approach to satisfy investor concerns. A number of the institutional investors surveyed were either currently investing in residential rental property, or considering it. There was some recognition of the portfolio diversification benefits of investing in this asset type. Nevertheless, it was clear from the research that significant barriers to investment in rental housing still existed and would need to be further reduced before a large volume of private funds flows into this sector. Crook and Kemp (1999, pp. 57-58) propose two policy changes that would reduce barriers in this way:

- Create tax transparent 'TERLS' – tax exempt residential lettings schemes – which pass through untaxed net corporate earnings to equity investors to be taxed at their marginal tax rates (see technical appendix, note for page 19). In Australia, this would mean that superannuation funds would pay tax at the rate of 15 per cent on their dividends. This model is similar to the 'Real Estate Investment Trusts' (REITs) in the United States.
- Introduce and enforce industry-wide codes of practice establishing minimum standards with respect to the management and maintenance of rental dwellings. This would reduce risks associated with asset management and landlord reputation.

3.1.2 The Netherlands

Dutch housing policy has long favoured the growth of social housing. Private renting accounts for about 15 per cent of the national dwelling stock, a little less than in Australia, but owner

occupation covers only 45 per cent of the total, well below Australia and most other OECD countries. In this respect, the Netherlands is similar to Germany and Sweden. Housing Associations and other non-profit organisations own and manage 37 per cent of the stock, and local government a further 6 per cent (Oxley and Smith, 1996, p. 75).

Government housing subsidies have encouraged this particular tenure pattern of development. Until the late 1980s, housing associations received a range of cash subsidies on the construction of new dwellings and operation of their activities. Rental allowances were paid to their tenants to ensure affordable housing costs. Most of these subsidies have been phased out in the 1990s or converted to a once-over capital injection. This so-called process of 'grossing and balancing' (Boelhouwer, 1997; Larkin and Lawson, 1998) entailed the capitalisation of future housing subsidies and the sum applied to discharging housing association loans to government on their existing stock. This is, in effect, a one-off equity grant to the sector which is now responsible for managing that stock and adding to it by accessing private funds. It is part of a general effort by the Dutch Government to limit the growth in the fiscal cost of housing subsidies, a policy drift that is occurring in many of the European Union member countries (Boelhouwer, 1997; Kleinman, 1996).

Institutional investors, including the banks, have long invested in this sector, providing both debt and equity funds. In 1992, institutions owned about 6 per cent of the total stock (Oxley and Smith, 1996, p. 75). Private loans from the banks are secured on the asset base of the housing association, backed by a tripartite system of insurance and guarantees. First, housing associations must meet capital adequacy requirements and maintain their equity base in terms of a minimum benchmark value of their assets. Second, all associations contribute to a central insurance fund that covers interest and principal repayments on loans to each association. A second central organisation has been established to offer financial and management assistance to individual associations that get into difficulties that might lead to loan default. Third, ultimate responsibility for the financial viability of the sector rests with local and central government, which bear the final, catastrophic risk in the sector. The consequence of this structure of provision is that housing associations are generally able to borrow from the banks cheaply, at around 25 basis points above the government bond rate. Consequently, around 90 per cent of the cost of new dwellings in the sector was being financed by bank loans by 1997 (Boelhouwer, 1997).

This relatively low cost of finance has at least partly compensated for the removal of subsidies on construction and operation in keeping rents below full market levels. However, the fact that residual risk now resides with individual housing associations who are responsible for managing the assets and meeting all financial obligations, along with the removal of central government controls over rents, has encouraged associations to match rent levels with the total costs and quality of individual dwellings. The result has been an upward drift in rents through the 1990s and increasing concerns about declining affordability in the sector (Oxley and Smith, 1996, pp. 111-12; Larkin and Lawson, 1998).

The private rental sector is split almost evenly between private and institutional investors. Some rental dwellings are subsidised and some are unsubsidised. Landlords receiving subsidies must charge rents in line with central government policy; unsubsidised dwellings rent at full market value. Over the past 30 years government has wound back subsidies for new rental dwellings and focused one-off capital grants on the construction of low cost dwellings (Oxley and Smith, 1996, pp.150-53). At the same time, rising construction and operating costs, rent control and inflation have encouraged disinvestment in the sector, especially by individual landlords. A pattern of division has emerged in which individual landlords tend to own lower quality, lower cost dwellings while the pension funds and insurance companies own the better quality stock renting at the higher end of the market (ibid. p. 152).

Although owner occupation has traditionally been less important in the Dutch housing system and housing policy debates, very recent developments may be altering that picture. After more than a decade of housing reforms that effectively reduced the direct role of government in subsidising the social and privately rented sectors, a decade in which the economy grew strongly, home ownership appears to be on the rise. Policy discussion has now turned to embrace and further support this phenomenon (Lawson, 2001, pers. comm.).

3.1.3 United States

All three levels of government have been heavily involved in subsidising housing provision in the U.S. The Federal Government has intervened primarily through the tax system and regulation of the financial sector. Key *Federal* approaches include:

- The establishment in the 1930s of the Federal National Mortgage Association (Fannie Mae), originally to manage non-performing mortgage loans for the banking sector. Fannie Mae pioneered and now dominates the mortgage backed securities market and is responsible for about one-seventh of all residential mortgage loans outstanding in the U.S. Fannie Mae's mission continues to be the provision of finance to assist lower income households into home ownership (Stegman, 1999, p. 1).
- The introduction of the Community Reinvestment Act (CRA) in 1977 which requires all federally regulated banking institutions to demonstrably meet the full range of credit needs in the community. Access of low income households to affordable housing is included within the scope of this requirement. In effect, this forces banks wishing to gain the Federal Government's regulatory stamp – a critical factor in enhancing that institution's credit rating – to extend mortgage finance on favourable terms to disadvantaged households who find it difficult or impossible to access finance from mainstream lenders (Stegman, 1999, pp. 184-85). Since, 1992 more than US\$300 billion has been directed towards traditionally under-served populations in the loan market (Freedman, 1998).
- Real estate investment trusts provide equity and debt investment opportunities for individual and institutional investors. REITs pass all net income and capital gains to the equity investors for taxation at their marginal rates of taxation. REITs can draw on CRA sanctioned funding, benefitting from lower cost of finance, as long as the bulk of the dwellings are targeted to the low cost end of the market (Affordable Housing Finance 6, 1998).
- Federal taxation policy directly subsidises some rental investment projects. Between 1965 and 1983, more than 1.5 million rental dwellings were provided under the so-called 'Section 8' program. Investors were able to gain tax benefits through accelerated depreciation allowances and access to low interest finance in return for locking the dwelling into low cost rental for 20 years. Thereafter, the investor was able to rent the dwelling in the open market or sell it unencumbered to owner occupiers or other investors. Low income households received rental subsidies (vouchers). The end result was affordable rents for the agreed period. This scheme was closed to further expansion early in the first Reagan Presidency (1980-84) (Stegman, 1999, p. 127).
- Largely replacing the section 8 program, the Low Income Housing Tax Credit Scheme was introduced by the Tax Reform Act of 1986 as the Federal Government's major approach to encouraging the provision of affordable housing (McClure, 2000). The scheme delivers tax credits, redeemable against Federal tax liabilities, to selected developers who supply housing for low to moderate income occupancy for a minimum period, using specified

affordability benchmarks. The scheme is Federally funded but implemented at the State government level. Individual and syndicates of developers annually tender for the fixed volume of tax credits available in each state. The base term for investment is 30 years but there is an effective bailout option for investors after 15 years. Maximum rent levels that can be charged are related to average incomes and housing expenses in the regional housing market concerned. In recent years this scheme has been further leveraged by allowing developers to bundle other Federal subsidies – notably, section 8 program benefits – into LIHTC projects without losing the tax credits. (For more information on the LIHTC scheme and its impacts see McClure, 2000).

State and local government and community non-profit organisations are also involved in a range of programs designed to encourage private investment to flow into the provision of affordable housing, some drawing on Federal schemes like LIHTC. Stegman (1999) provides a summary of more than one hundred examples, many involving cooperation between government, community sector and private sector organisations. These approaches cover:

- Affordable home ownership schemes
- Preservation of the existing affordable housing stock
- Community-based affordable rental schemes
- The development of secondary financial market vehicles
- Rental assistance tied to the transition from welfare dependency to work
- Community development strategies involving housing area regeneration
- The creation of special housing trusts with a mission to direct revenue gained from a variety of sources into supporting affordable housing outcomes

City Councils in the U.S. are also able to use town planning controls to expand affordable housing supply, mainly through inclusionary zoning powers and the process of charging developers 'linkage fees'. Lawson (1995) describes a range of such mechanisms in operation in American and Canadian cities.

3.2 Australian Experience

Chapter 2 argued that Australian housing policy has moved away from encouraging owner occupation while seeking to attract more private investment into the provision of affordable rental housing. This shift of emphasis is running up against constraints embedded in the financial sector and economy at large. Long term renting is on the rise (Wulff and Maher, 1998), first home ownership is declining (Yates, 1999) but the supply of low cost rental stock is failing to keep pace with demand and, indeed, if the research results reported by Yates and Wulff (2000) are to be believed, the low cost rental stock is in absolute decline. Housing affordability is declining for low to moderate income private tenants, in particular (Hall, 1998). As the traditional housing career leading to home ownership is closed off for some people, and the public housing sector ceases to grow, more pressure is placed on private rental. Recent research has begun to indicate the nature of investment patterns in this sector and the current barriers to increasing investment to respond to market demand pressures.

The Australian Bureau of Statistics carried out two surveys of rental investors during the 1990s (ABS, 1998). The results have been analysed by Yates (1996), Beer (1999) and Berry (2000). The main picture emerging is:

- The majority of rental properties are owned by individuals or couples and the remainder by small partnerships and companies.

- Three-quarters of individual landlords own only one rental dwelling, and a further 16 per cent own two dwellings. Three quarters of landlords are also home owners.
- The average income of landlords is almost twice the national average.
- Most individual landlords are primarily concerned to ensure a long term secure return on their investment.
- At any time a significant proportion of landlords can be regarded as 'accidental', having inherited the rental property or temporarily renting out their owner occupied dwelling.

This singular pattern of investment in private rental has produced a highly fragmented 'cottage industry' with significant movement of investors and dwellings into and out of the sector (Yates, 1996). Gross rental yields vary widely and net returns are low or negative for a high proportion of landlords (Berry, 2000). In the latter case, negative gearing of rental losses against other income delivers tax benefits (especially) to high income landlords to add to prospective capital gains as the dominant component in overall return. The (virtual) absence of rent control in Australia, the prevalence of short term leases, and the absence (until the recent growth in direct share ownership and universal superannuation) of alternative investment opportunities for small savers reinforced this pattern of small scale landlordism.

The taxation system also encouraged the same outcome (Yates, 1996). Negative gearing has been allowed on all rental properties, except for a short period in the mid-1980s. Land tax levied by the State governments has a threshold that usually cuts in after one or two properties are acquired. Interest paid on mortgage loans against the rental property are normally deductible against income. The building allowance was increased from 1 to 2.5 per cent in the 1980s (with a brief interval where the allowance was set at 4 per cent). Rental housing can now be treated as any other business for income tax purposes, allowing the landlord to fully depreciate fixtures and fittings for income tax purposes. Capital gains taxation was not introduced until the 1980s and has always been levied at an effective rate that is less than that pertaining to other taxable income (Yates, 1996; Wood and Watson, 1999).

The major absence in this picture of rental investment in Australia is the institutional investor. Rental housing – as opposed to owner occupation – has never been an avenue for investment by the large banks, insurance companies and the superannuation funds. Berry (2000) has listed a number of key reasons for this outcome.

- *Low returns.* The cottage industry nature of the sector means that there exists a diverse collection of small landlords with a range of motivations for supplying rental housing. Rental yields vary significantly but around a relatively low average (5 to 6 per cent). This income yield is seldom high enough to attract professional investors who are well informed about alternative investment opportunities yielding higher returns for equivalent or lower risk, except where tax shelters deliver adequate compensating benefits.
- *High risk.* Rental investment generates significant and multiple risks associated with revenue flows, financing costs, operation and management, and public policy changes. It is this coupling of low returns with high risks that provide the basic barrier to institutional involvement in this sector.
- *High management costs.* The current small scale nature of the industry prevents the capture of economies of scale. Property and tenancy management costs are high on a per dwelling basis. Institutions prefer to allocate large tranches of funds in order to spread transaction costs, including the heavy compliance and due diligence processes that must accompany their investment decisions. The rental sector as currently configured does not meet this requirement.

- *Illiquidity.* All property assets are illiquid by comparison with asset classes like equities (shares). The institutions will invest in commercial property, directly and through company or trust structures, but generally require a premium on the rate of return and, over the past decade, many institutions have been reducing their exposure to commercial property in favour of more liquid assets, here and overseas. A higher required rate of return intensifies the basic barrier noted above.
- *Poor market information.* Information on property values and their movement over time is incomplete and uneven in quality, by comparison to the minute-by-minute tracking of share prices, for example. This makes it difficult for investors to accurately calculate and price risk on property assets. Uncertainty replaces risk which tends to load a further premium on the required rate of return.
- *No track record.* Allied to a lack of good market information, institutions have no real experience of large scale investment in rental housing in this country to judge outcomes upon. Institutional investors tend to focus on well trod ground. There is a certain 'herd mentality' in financial markets, where the performance of funds managers and consultants is judged against industry benchmarks – e.g. in the share market, the all ordinaries index or S&P 500 (Haugen, 1995). Untried investment niches normally require a pioneering investor and a 'novelty' premium on the rate of return.

All these reasons, taken together, mean that the risk-adjusted rate of return is normally insufficient to attract institutional investors into the provision of rental housing, especially in the case of equity investors. The policy implication is that if institutional investors are to be attracted into this sector – and the great advantage is that if they were then the large volume of funds attracted would have the potential to make a very positive contribution to the housing affordability problem – then government needs to find ways of reducing the gap between the required and actual rate of return facing those investors. The key government role is to reduce the barriers to large-scale private investment in this sector.

The remainder of this chapter briefly reviews some of the key findings of Australian research on the challenge of attracting private investment to this sector.

Key Australian Studies

- *Brian Elton and Associates (1991).* This report for the National Housing Strategy looked at the supply side of the private rental market. The main conclusion was that the Commonwealth should use the income tax system to deliver further benefits to individual and syndicated investors, by targeted increases in depreciation allowances. Syndication was thought to offer some attractions for institutional investors.
- *Caversham Partners et al. (1991).* The Caversham Report to the Commonwealth identified the (then) volume of funding necessary to support a viable social housing sector and the limits to raising those funds. They found a major barrier in the (then) indexation treatment of capital gains taxation that meant that the benefits could not easily be passed to investors in pooled equity or corporate structures. They conclude that real rate funding – inflation indexed debt instruments – is increasingly attractive to the institutions and recommended the creation of a single issuer of such securities for all the state housing authorities, falling outside Loan Council borrowing limits.

- *J.R. Hall and Associates et al. (1995)*. This study for the Commonwealth's Youth Housing Strategy analysed and compared three models for privately funding affordable housing for young Australians: a debt model, a leasing model and a corporate vehicle. Fixed, floating and real rate debt options were explored under a range of different economic conditions and the net subsidy cost to the two levels of government compared. The modeling demonstrated that the least-cost option for government is very sensitive to movements in interest rates, rents, inflation and construction costs. The least risky model for government as a whole (in terms of net subsidy cost per tenant housed) is the company structure with floating rate debt and Commonwealth equity subordinated to the private equity component.
- *East Perth Redevelopment Authority (1995)*. This was a proposal for the (then) Commonwealth funded Social Housing Subsidy Scheme, developed for EPRA by J.R. Hall and Assoc. The model was based on the construction of 50 medium density units in inner Perth. Private investors would finance construction in return for an equity share. Tenants drawn from Homewest's shared equity waiting list would be invited to take an equity share in the dwelling, with residual equity residing with EPRA. The investor would be guaranteed a rental yield through a sinking fund established and subsidised by EPRA and the Commonwealth. Subsidies to the sinking fund would be at a level to ensure the residents' housing costs were affordable. At the end of 10 years the dwellings would be sold and proceeds divided but with tenants given first option to purchase the remaining equity in the dwellings at the then market valuation. The Social Housing Subsidy Scheme was scrapped before this model could be implemented.
- *Brian Elton and Associates (1998)*. This report for the National Community Housing Forum reviewed the prospects for attracting private investment into the community housing sector. Key, in this view, was the need for community housing providers to find ways of increasing net rental yields for investors, especially by mixing resident income levels and improving management efficiencies. Government subsidies would also need to be factored in in ways that guarantee transparency and accountability. Recommendations included a preference for debt models and fixed rate borrowing (to guard against interest rate risk), exploration of a sector-wide borrowing vehicle and the development of organisational infrastructure in the sector.
- *Brian Elton and Associates (2000)*. This report revisits the scene addressed in the 1998 report. Several small scale joint ventures between community sector organisations and private investors are summarised and the report notes the strategic importance for the sector of 'scaling up', and working with State government as a sector. The need to further raise management standards and practices across the sector is critical in giving private investors the confidence to become involved. The report points out that the recent changes in the tax system, notably the introduction of the GST, may give community housing organisations with GST free status an advantage in investing in new rental housing.
- *Ecumenical Housing Inc. (1999)*. This study developed two investment models oriented to ethical investors. In both models rents are set at 25 per cent of income, including rent assistance. The partial debt finance model has a church or similar organisation provide the land component and construction is financed by mortgage debt. Lenders are assumed to accept the nominal interest rate on long term bank deposits. The equity investment-headleasing model entails an established community housing provider negotiating a sale and leaseback arrangement with an equity investor, the term of the lease up to 15 years. The returns to the investor comprise net rent, tax benefits and capital gain, with the benchmark return set at the real return on long term bank deposits. Using these assumptions and benchmarks the models suggest that affordable rents can be delivered in

many circumstances related to leverage ratios and economic conditions. This result is, of course, critically dependent on the willingness of the private investors, as ethical investors, to accept the assumed lower than market rates of return.

- *Berry, et al. (1998)*. This report to the Commonwealth reviewed the barriers to institutional investment in the rental sector, on the basis of selective interviews with key financial sector actors. The results were consistent with the barriers noted above. Investors expressed interest in new investment opportunities which would fill the gap left by the shortage in government bonds, as governments ran their budgets into surplus and repaid past debt through public asset sales. The report modelled a corporate vehicle for middle suburban medium density development, drawing on both equity and debt finance. Under conservative assumptions the required rent was found to be around 20 per cent higher than current market levels. The model explored some of the ways that this gap could be reduced – e.g. by capturing higher capital gains to equity investors or by achieving greater financing efficiencies – short of depending on government subsidies⁵.

In summary, these previous studies:

- Identify a range of barriers that currently prevent significant large-scale private investment in some forms of affordable housing, most notably in the private rental market. These barriers are summarised on page 28-29, above.
- Propose several options or models for private investment in affordable housing, each dependent on particular government subsidies and institutional arrangements to overcome the existing barriers.

These studies are, in general, one-off and have not led to concrete and continuing policy developments; nor have they systematically set out a conceptual framework for considering the key factors determining and constraining housing investment patterns. The first three research questions posed in this study do attempt to provide such a conceptual framework – viz. to look at the forces and motivations that are responsible for housing investment flows into the low-to-moderate cost sector of the housing market and to the barriers that constrain alternative investment outcomes. The third research question focuses on what governments can do to facilitate greater private investment in this sector, by way of subsidy delivery and other supports.

The fourth research question focuses on the implications for the ownership and management of the existing public housing stock, of greater involvement by the private sector. The final research question takes up the issue of how rental housing could become a new asset class for institutional investors – and therefore provide opportunities to develop new financial instruments for investment in rental housing.

⁵ The author is currently coordinating a project carried out by AHURI and the Allen Consulting Group for the Affordable Housing National Research Consortium that will provide findings and recommendations relevant to this study. These results are expected to be available by the completion of this project.

Chapter 4

Methodology

In order to answer the research questions specified in Chapter 1, this project will be carried out in a number of sequential stages.

Stage 1: A selective literature search has been carried out to identify recent research on issues and developments relevant to the project focus. The scope of this review includes both Australian and international work. The review also includes the policy context within which concern over expanding the supply of affordable housing has emerged. The review seeks to cover the overall system of housing provision, in terms of the major tenure groups. The role and limitations of private investment in the provision of affordable housing is discussed in Britain, the United States and the Netherlands, in order to compare and contrast developments in those countries with the Australian situation. Attention then turns to the area of greatest constraint in Australia – viz. the private rental housing market. The current pattern of private investment in this sector is outlined and the main factors responsible identified. The fact of and reasons for the neglect of this sector by large institutional investors are then outlined and discussed. The output from this stage is presented in the positioning paper, provided to AHURI in March 2001.

This stage has been completed and is the subject of this paper. It provides an initial answer to the first two research questions – what are the options for private investment in affordable housing and what are the current barriers to it, drawing on the existing literature?

Stage 2: A framework for analysing the current barriers to greater private investment in affordable housing will be developed, providing the basis for identifying the main forms of government support or subsidy necessary to reduce the gap between the investors' required rate of return and actual market returns. These forms of government support will be related to the ways in which they can be delivered to investors and the various options for accessing private finance. The feasible combinations of support, delivery mechanism and financing option provide a range of potential policy approaches designed to encourage private investment in this sector.

This stage will provide the conceptual and empirical support necessary to fully discuss the range of private sector options and the current market and policy barriers to their implementation (the first two research questions). It will analyse the range of policy interventions designed to overcome these barriers and encourage greater private investment in affordable housing (third research question).

Through interviews and discussion with key public and private sector actors, this broad range of approaches will be narrowed down to a number of specific options that involve significant State government participation. Given the resource limits and timing of the project, attention will focus on N.S.W., Victoria and Queensland where, as noted in chapters 1 and 3 above, current policy development in this field is proceeding. The research will analyse these current developments in terms of the analytical framework established. It seeks to evaluate the extent to which developments in NSW, Victoria and Queensland effectively surmount the barriers identified in ways which have the capacity to generate a large scale volume of funds at an acceptable cost to government. Implications will be drawn, where possible, for more effective ways of achieving the policy goals entailed.

Discussions with the financial sector will establish the developments that would need to occur for rental housing to be established as a new asset class. The growth of the 'socially responsible investment' sector will be explored in this context, seeking to establish the potential

for introducing 'positively screened' investment products that include affordable housing instruments.

The results of the first two stages of the project will be included in the early findings paper.

Stage 3: Drawing on the analysis in stage 2, a number of scenarios will be developed involving private investment in affordable housing projects. Based on assumptions concerning housing affordability trends and key economic variables, the implications for the volume of private investment funds and government support will be estimated in each case. Projections will be developed for the short term (5 years) and medium term (20 years) on the basis of assumptions concerning housing market conditions and policy settings. The sensitivity of outcomes to variations in those base assumptions will be explored.

This stage will provide an indicative account of how cost effective particular policy approaches would be in achieving greater private investment in affordable housing and will complete the answer to research question three. Stages 1, 2 and 3 will also allow answers to the fifth research question to be advanced – i.e. what developments and models would have the greatest likelihood of creating rental housing as a new asset class for institutional investors?

Stage 4: An analysis will be carried out into the value basis of the current public housing stock of the three jurisdictions noted above. Relying on relevant secondary data and interviews with relevant housing officials, the stock will broadly be categorised into (a) increasing in value, (b) constant in value, and (c) declining in value. A value-adding strategy will be outlined for category (a) stock, drawing on private investment options analysed in stage 2. Depending on data and key official availability, one or more of the three jurisdictions will be selected for attention.

This stage seeks to establish the ways in which private investment could assist SHAs in effectively and efficiently managing their existing stock.

Category (a) stock will be used since this will maximise the feasibility for involving private sector investment. Dwelling stock appreciates for a mix of reasons – location, demographic change, planning rules, changing housing preferences. A successful value-enhancing strategy will probably entail maximising the appreciating value of the land while minimising the depreciation of the dwellings. The potential for such a strategy to enhance the asset value of SHAs will be estimated. Likely policy goals and constraints limiting the extent to which the strategy can be realised will also be outlined; e.g. commitments to maintaining a geographic and/or social mix in public stock.

Stage 5: On the basis of the value-enhancing strategy developed in stage 4 – and depending on a suitable case being identified, in discussion with relevant housing officials – a particular redevelopment site or set of sites will be selected and a redevelopment proposal outlined which draws on private sector investment. The proposal will be framed to avoid the main barriers to investment identified by this study. This outline will not present a full investment appraisal. It is intended to clearly identify the main components of such a project, in the light of the research findings in this study, and therefore to provide the basis for more detailed assessment and application in the future. The input of key actors in the SHAs and property sector will be sought during this process.

This stage will – subject to a suitable case – provide an illustrative application of the conclusions reached in stage 4, along with, at least, indicative guidelines for SHA asset management strategies.

Chapter 5

Conclusion

This positioning paper has proposed a number of key research questions concerning the potential for (and barriers to) greater private investment in the provision of affordable housing. The paper reviews the public policy context in which this concern is being expressed and reviews a range of recent research findings on the nature and impacts of housing investment in Australia and several other countries where governments have attempted to attract more private investment into the housing system. Key outcomes from this review include the observations that:

- There has been a strong trend in Western societies towards greater reliance on market processes in achieving housing outcomes. This has been reflected in government attempts to cap or reduce the level of housing subsidies, and to target assistance more closely to households in need.
- At the same time, increasing inequality and insecurity, generated by changes in the wider economy, have impacted negatively on housing markets. Problems of housing affordability have increased through the 1990s, in spite of strong general economic growth.
- In Australia institutional investors have been loath to invest, in equity terms, in rental housing, in any part of the market. This follows from the existence of multiple barriers that prevent returns from being high enough, given the risks, to meet normal investment benchmarks. A broadly similar outcome appears to be characteristic of, for example, recent British experience, though – largely due to deliberate Federal Government policy – the same cannot be said for the United States, nor many Western European countries in which strong social housing sectors draw on the significant investment of private funds.
- In Australia, specific joint venture projects have been attempted by housing agencies and larger investors but these have been on a small-scale and one-off basis.
- The development of a secondary mortgage market for owner occupation has attracted a growing volume of funds into that sector. However, this flow of funding has increasingly been directed to refinancing existing home purchasers, rather than new and first home buyers, and has underpinned a general explosion in consumer expenditure and debt.
- The rapid growth in the demand for private rental housing at all levels has only partially been met by increasing supply. The stock of medium rent and high rent dwellings has increased over the past decade or two but the stock of low rent dwellings has declined. As a result, housing affordability has declined significantly for private tenants in the bottom two income quintiles.
- The growth of a compulsory national system of savings in Australia (through the superannuation guarantee legislation of the early 1990s) has generated a large potential supply of funds for housing and other infrastructural purposes. However, accessing this growing pool will depend on developing acceptable investment products – i.e. instruments that deliver appropriate risk-adjusted rates of return to the funds.
- Recent changes in taxation, including changes in the capital gains tax regime and introduction of the GST, alter the picture somewhat with respect to investment returns on assets like rental housing.

- Research carried out for government and community sector agencies has consistently pointed to the need for government to bridge the gap between required and actual rates of returns facing investors given current market conditions and policy settings. The range of possible policy approaches to achieve this goal is large. Governments must decide on (a) what form of support to provide, (b) how to deliver that support, and (c) what form of private finance is to be sought. Ideally the policy approach adopted should generate maximum private investment for affordable housing provision, while minimising the total net cost to government.

The paper finishes by outlining the methods to be used to answer the five research questions posed.

- What are the options for private sector finance of affordable housing?
- What are the main barriers preventing greater private investment in affordable housing in Australia?
- What policy approaches could be utilised to overcome those barriers in order to stimulate private investment in this sector?
- What are the implications for government housing assistance and asset management policies if barriers can be reduced?
- In the case of institutional investors, how might rental housing be turned into a new asset class?

The study will be based on a selective literature review of Australian and international research into investment in the provision of affordable housing, focused on how governments can reduce effective barriers and encourage private sector involvement. Interviews will be held with key actors in the social housing agencies and the financial sector. Secondary data concerning housing needs, current policy settings and economic conditions will be accessed. Assistance will be sought from the project user group to identify key interviewees and data sources.

Technical Appendix

Page 7: *'Deep market for debt investment in owner occupied dwellings'* refers to the rapid growth, since the mid-1990s – of a secondary mortgage market in Australia. Investment banks 'bundle' or pool together individual residential mortgages held by the banks and other lenders to create mortgage backed securities (MBS). These bonds are backed by the future repayments of all the individual mortgages making up the pool. Institutional investors like superannuation funds buy the bonds – in effect, they are buying a share of the future repayments of all the dwellings in the pool. The market value of those dwellings provide the security for the investors who can sell the MBS whenever they like, creating a liquid asset that is traded like other bonds or company shares.

Page 8: *'Debt and equity models'* refer to the use of investment instruments based on borrowing and ownership, respectively. Equity can be 'direct', in the sense that the investor owns the particular dwelling(s), or indirect, in which case the investor may own shares in the company or trust that owns the dwellings. Debt can be held in various forms and under various conditions. For example, the period of the loan can be long or short; repayment of the principal with interest during the term of the loan can be in a lump sum at the end; the interest rate can be fixed, vary with market conditions (and government monetary policy) or indexed to inflation. In general, the debt holder (lender) has a prior claim over the owner on repayment of any outstanding liabilities. This means that equity usually has a higher risk than debt, as far as the investor is concerned (the owner is at the back of the queue when things go wrong), and this will be reflected in the rate of return required by equity investors being higher than the rate demanded by lenders.

Page 9: The *'Capital Market'* is the financial sector of the national economy. It is comprised of a large and growing number of financial markets, each of which has a financial instrument or product (bonds, shares, futures contracts, options, swaps, etc.), investors buying and selling the instruments, and financial intermediaries like banks, brokers, merchant banks, etc managing and mediating the large flow of transactions (for a fee). Each product therefore has a price – interest rate, share value, option premium, etc, -- which reflects the changing expectations of investors as to relative future returns. A range of government regulations are imposed on the capital market to minimise the risk of market failure – bankruptcies, fraud, disruption to the general commerce of the country.

Page 11: *'Imputed rental income'* is the value of the housing services consumed by the owner occupier living in his or her dwelling. A (conservative) measure of the imputed rental value is the market rent that the owner occupier could charge if he or she moved out. (This is a conservative figure because the fact that owner occupiers stay on and don't move out suggests that they value the services more highly than the money they could get by moving out, renting their houses and living under bridges.)

Page 12: *'Pooled historic cost'* refers to the public housing rental policy (prevalent in Australia until the mid-1970s) of charging rents that meet the average costs across the total public housing stock. Rents on new dwellings would generally be lower than if they had reflected the actual costs of those recent additions to the stock, since they are effectively cross-subsidised by the lower costs of older dwellings in the stock. In effect, rents on new dwellings are subsidised by the lower construction and development costs of older dwellings. Conversely, rents on old dwellings are higher than their actual past costs.

'Wholesale funds in the debt market' refer to borrowings from the large institutions like insurance companies, who stand between borrowers and the individual investors (savers, purchasers of insurance policies, superannuation fund members). Financial intermediaries like investment banks often manage these transactions for a fee.

Page 13: The *'Segmented waiting list'* was introduced by the Victorian Office of Housing in the late 1990s. It creates priority categories for people with, for example, disabilities or who are homeless, and 'fast tracks' them into public housing. Eligible applicants for public housing who do not qualify for inclusion in the priority segments wait longer for offers of public housing. The segmented waiting list approach is currently being reviewed by the Victorian Government, based on wide community consultation.

Page 19: A *'rental trust'* is a legal entity that owns and manages a stock of rental housing. Equity investors in the trust receive an income flow dependent on the net rental revenue generated by the dwelling stock and the income and capital gains taxation of that flow. For example, in the United States, REITs or real estate investment trusts pass through net profits (before tax) to investors – i.e. trust income is not taxed in the trust but in the hands of the individual investors, at their respective marginal tax rates.

'Indexation benefits'. Until recently, the capital gains tax in Australia on individuals was levied on only the real gain – i.e. after inflation was taken out. This was not the case for other income sources. Thus, individuals effectively paid less tax on their capital gains than on other income. This benefit was not available to companies who paid tax on all income, including capital gains, at the standard rate of company tax. Property trusts that could pass their income straight through to the individual owners therefore delivered this benefit to their investors. Changes to the capital gains tax regime in 1999 removed this benefit.

With respect to the NSW PEP schemes, the Department of Housing provided *'a minimum capital guarantee of the residual value'* – i.e. on final sale of the dwellings the government was required to pay AMP any deficit if the actual resale value fell below an agreed value.

Page 20: *'Securitisation'* refers to the process of turning a real asset like a house into a financial asset or claim on future income flows generated by the real asset. For example, the investor doesn't own the rental dwelling but has a legally enforceable claim on a share of the future rents paid on the house. This claim can be in the form of equity (shares in a company that owns the dwelling) or debt (bonds or mortgage loan). These claims can, as noted above, be bought and sold in secondary markets.

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