

## **The use of guarantees in affordable housing investment—a selective international review**

authored by

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## ACRONYMS

AAA, AA+, BBB, ...	Credit rating evaluation by Standard & Poor's
ADI	Authorised Deposit-taking Institutions
AG	Australian Government Bonds
AHURI	Australian Housing and Urban Research Institute Ltd.
AME	Annually Managed Expenditure (UK)
ANRU	National Agency for Urban Renewal (France)
AUD	Australian Dollar
BNG	Bank Nederlandse Gemeenten (The Netherlands)
BP	Basis Points
CBH Act	Charter of Budget Honesty Act 1998 (Australia)
CDC	Caisse des Dépôts et Consignations (France)
CECODHAS	Federation of Public, Co-operative and Social Housing (Europe)
CFV	Central Fond voor Volkshuisvesting (The Netherlands)
CGLLS	Mutual Fund for Guarantees of Social Housing
CGS	Commonwealth Government Securities
CHF	Swiss Franc
CH	Community Housing
CHO	Community Housing Organisation
CO	Swiss Code of Obligations
CoA	Commonwealth of Australia
CPI	Consumer Price Index
CSO	Central Statistical Office (Ireland)
DCLG	Department of Communities and Local Government (UK)
DoF	Department of Finance (Ireland)
DSCR	Debt Service Coverage Ratio
EC	European Commission
ECP	Euro Commercial Paper
EGW	Emissionszentrale für Gemeinnützige Wohnbauträger (Swiss Bond Issuing Co-operative)
EIB	European Investment Bank
ENHR	European Network for Housing Research
EPEC	European PPP Expertise Centre
ESA95	European System of Accounts 95
EU	European Union
Eurostat	European Statistical Office



FaHCSIA	Australian Government Department of Families, Housing, Community Services and Indigenous Affairs
FHA	Federal Housing Administration (US)
FoH	Federal Office of Housing (Switzerland)
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GGB	General Government Balance
GGD	General Government Debt
GSE	Government Sponsored Enterprises
HA	Housing Association
HCA Board	Homes and Communities Agency Board (UK)
HFA	Housing Finance Agency (Ireland)
HLM	Habitation à Loyer Modéré (Moderate Rent Housing, France)
HM Treasury	Her Majesty's Treasury
Hong Kong SAR	Hong Kong Special Administrative Region
HSB	Housing Supply Bonds
HSBC	Hong Kong and Shanghai Banking Corporation
HUD	Department of Housing and Urban Development (US)
IAS	International Accounting Standards
ICR	Interest Coverage Ratio
IMF	International Monetary Fund
IPA	Infrastructure Partnerships Australia
IPSAS19	International Public Service Accounting Standards
LA	Local Authorities
LIHTC	Low Income Housing Tax Credit
LLP	Limited Liability Partnership
LTV	Loan to Value Ratio
MBS	Mortgage Backed Securities
MIILOS	Mission d'Inspection Interministérielle du Logement Social Government Inspectorate for Social Housing (France)
NAHA	National Affordability Housing Agreement
NHF	National Housing Federation (UK)
NHT	National Housing Trust (Scotland)
NPV	Net present value
NTMA	National Treasury Management Agency (Ireland)
NWB	Nederlandse Waterschapsbank (Dutch Water Boards Bank)
OECD	Organisation for Economic Co-operation and Development

PER	Ministry for Public Expenditure and Reform (Ireland)
PLAI	Lower income social housing loans provided by the CDC
PLUS	Standard social housing loans provided by the CDC
PPP	Public Private Partnership
PRS	Private Rental Sector
RBA	Reserve Bank of Australia
RF	Revolving Fund
RMBS	Residential Mortgage Backed Securities
RSL	Registered Social Landlord
S&P	Standard and Poor's
SDHC	San Diego Housing Commission
SECO	State Secretariat for Economic Affairs (Switzerland)
SFI	Special Financial Institution
SGB	State Government Bonds
SHG	Social Housing Guarantee
SNA93	System of National Accounts 93 (Europe)
THFC	The Housing Finance Corporation (UK)
VHB	Voluntary Housing Body (Ireland)
VNG	Association of Dutch Municipalities
WSW	Dutch Guarantee Fund Social Housing
ZKB	Zürcher Kantonalbank

## EXECUTIVE SUMMARY

This report is provided at a time when Australia and Europe are facing long-term infrastructure investment needs to support more sustainable and inclusive development. There are mounting demands by key stakeholders to design appropriate instruments and intermediaries to channel investment towards necessary infrastructure, including affordable housing. Government and sector based guarantees are a rapidly emerging area of policy interest and international innovation. This is demonstrated by new and expanding schemes in Scotland, the UK and Ireland, and growing interest in the established Dutch and Swiss schemes. There are proposals for special purpose bonds, guarantees and housing funds, involving key stakeholders such as European housing ministries, the Federation of Public, Co-operative and Social Housing and the European Investment Bank. Towards this end, this report provides readers with an extensive and contemporary international review of established and emerging practice in Europe and the US concerning the use of guarantees to support long-term investment in social and affordable rental housing.

International experience provides pertinent insights to guide the design of any such guarantee for affordable rental housing in Australia, and key lessons are elaborated in the conclusion of this report. One of the most important findings is the minimal impact guarantees have had on government budgets. A zero default rate amongst housing providers receiving guaranteed loans has been achieved through appropriate revenue support and regulation, sound business management practices and carefully structured guarantees. However, dedicated efforts are required to minimise a variety of ever-present but sometimes unforeseen risks, including policy risks.

This Positioning Paper informs a Final Report, which building on extensive consultation, will propose a model instrument and intermediary suitable for Australian conditions.

Affordable and social housing is an integral part of Australia's infrastructure needs, subject to strong demand and a revenue base underpinned by rent assistance and cost effective non-profit providers. Social housing comprises public housing, directly provided by State Housing Authorities, and Community Housing provided by registered regulated providers. Affordable housing landlords include a broader class of not-for-profit and for-profit providers that may be involved in financing or delivering affordable and deeply affordable housing. Delivered appropriately, social and affordable housing can serve multiple public policy goals towards more inclusive, sustainable and productive regions and cities.

Despite the low cost and efficiency of publicly raised funds, a trend away from direct government investment in social housing necessitates greater reliance on private investment to address mounting shortages of social and affordable rental housing in Australia. However, social housing systems that rely on private finance are always underpinned by substantial public support in the realm of land use and strategic planning, development finance and revenue assistance.

Much is expected of the Australian community housing sector in assuming a greater role in social housing provision and accessing private investment to do so. However, it is clear from extensive Australian field work that commercial borrowing terms and conditions demanded by banks from the community housing sector will significantly impede their role in supplying Australia's social and affordable rental needs. High interest rates, short terms and significant re-financing risks also diminish the benefit of any public subsidy in the package.

A new circuit of investment is required, which harnesses the potential role and responds to the investment demands of Australia's growing managed funds sector. This sector largely comprises superannuation or pension funds, which invest compulsory provisions for retirement made by employees and employers. Previous research has established that such funds require a straight forward, low risk and long-term bond instrument in order to provide suitable funds at scale with appropriate enhancement to reduce risk (Lawson et al. 2012). An Investigative Panel of key finance stakeholders has expressed considerable interest in the Housing Supply Bonds proposal (Lawson et al. 2012; Milligan et al. 2013, p.41) and this research builds on this body of work.

The challenge remains for governments to play a leading role in the development of bond instruments, financial intermediaries and guarantee enhancements to reduce barriers to the engagement of these managed funds, with the aim of supplying lower cost and longer term finance to the affordable and social housing sector. Enhancements may be any measure which gives comfort to investors by reducing their risks and thereby requiring lower yields.

Guarantees influence the credit allocation of lenders by giving comfort to investors in the form of an agreement, outlining conditions of coupon payment in the event of default by the borrower. Usually an intermediary pools borrowing demands from a consortium of small housing providers, to achieve a scale suitable for larger investors. Such an intermediary has specialist knowledge of the social and affordable housing sector and is able to assess their risks. As in the Netherlands, the UK and Switzerland, such intermediaries can be managed as public, not-for-profit or for profit entities and be licenced to issue special purpose bonds and also be licensed to provide guarantee certificates.

This report aims to build critical capacity amongst public policy-makers, towards the development of an appropriate bond instrument, intermediary and guarantee structure.<sup>1</sup>

## **Rationale for the use of Guarantees**

Guarantees are used by many governments to reduce reliance on public funds, build market confidence amongst new investor segments and accelerate investment in required social and economic infrastructure such as social housing. They aim to bolster the credibility of new initiatives and can be used to establish new pathways of investment. Ultimately, they aim to attract suitable long-term investment and reduce the cost of finance. In recent years, governments have used guarantees to ensure market stability in an era of crisis and change. Arguments against the use of guarantees include the moral hazard of supporting risky but desired investments. Also the difficulty in measuring the effect of a guarantee on loan interest and terms has been raised. Further, the danger of oversupplying investment to a particular market and creating unfair competition with other forms of investment has led to the refinement of some schemes. Some opponents argue that guarantees can promote inefficient practices as recipients receive lower cost credit without 'market discipline'.

There are many recent examples of the governments guaranteeing exports, savings deposits, infrastructure partnerships and mortgage backed securities.

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<sup>1</sup> The release of this report is also timed to inform a Social Housing Guarantee Think Tank in October 2013. Think Tank presentations by the research team and visiting experts from UK Housing Finance Corporation (THFC) and the Swiss Bond Issuing Co-operative (EGW) will also be available on the project website, <http://www.ahuri.edu.au/publications/projects/p53019>.

In the housing sector, guarantees are often used to address market failure, to expand access to home ownership to households otherwise neglected by the market and promote investment in social rental housing. Where public investment is limited, guarantees are one of a range of mechanisms which give comfort to private investors.

Guarantees can be a cost effective mechanism to direct private investment towards housing provision via the non-profit housing sector; a sector which is expected to deliver 35 per cent of Australian affordable and social rental housing in the near future. To use this policy tool to greatest effect, care should be taken to ensure that guarantees address well defined objectives in order to achieve tangible, well targeted supply outcomes.

## **Implications for government accounts**

What every government needs to know is how a guarantee would impact on government reserves, their borrowing capacity and their credit rating. This report informs readers how guarantees should be accounted for according to international public finance accounting standards, EU and Australian government policy. It also reflects on the actual practice of governments which differs from country to country. Justification for the use of guarantees is often framed in terms of cost savings to government, as the provision of direct funds decline. Notable is the near zero default rate amongst the European social housing guarantees reviewed, and their minimal impact on government accounts. In most schemes the debt is on the accounts of housing providers themselves and not their governments. Due to the very low or zero default rate contingent obligations of any guarantee are noted in the government's public accounts. This potential for government transfers relating to the guarantee depends on the structure and conditions of the guarantee and the rate of default. This risk is reduced by enforcing borrowing limits, demanding interest cover ratios and requiring sound business management. Obviously, the government plays a key role in sustaining social landlords, where it contributes key inputs such as land, start-up development finance and rental assistance, as in most social housing systems. Credit rating reports are also instructive in this regard, which keep a close eye on policy risk and their insights are reviewed in this report.

## **Use in growing and securing a market for social housing investment**

Guarantees are increasingly used by well-established social and affordable housing finance systems in Europe and the US to attract and stabilise longer term, lower cost investment in supply and renovation. This report provides the first detailed account of seven such guarantees in the Netherlands, Switzerland, France, Ireland, the UK, Scotland and the US. It examines their differing objectives, structure, market impact and cost to government, drawing on financial and ratings reports, performance reviews and face to face stakeholder interviews in several countries (listed in Appendix 1).

**Table 1: Selected social housing guarantee schemes and year established**

<b>Guarantee scheme and year established</b>	<b>Social housing as % of housing market</b>	<b>Coverage of guarantee as % of social housing</b>
Dutch Guarantee Fund Social Housing (WSW) backed by the sector, a fund and central and local governments (1983)	32	96
Swiss Bond Issuing Co-operative for Limited Profit Housing (EGW) backed by the Swiss Confederation (1991)	11	71
French Mutual Fund for Guarantees of Social Housing (CGLLS), backed by the French government (2001)	17	3 (97 by LAs)
Irish Housing Finance Agency backed by the Irish government (1982 LAs since 2012 VHBs)	8	New
UK Affordable and Private Rented Housing Guarantee Schemes, backed by UK government (in development mid-2013)	17	New
Scottish government's National Housing Trust, backed by the Scottish government (2010)	24	New
US Risk Sharing Scheme between Housing Finance Authorities and HUD, backed by Federal Housing Administration insurance (1992 pilot/2001 permanent)	52	NA

Sources: National Statistical Institutes in Housing Statistics in the European Union 2010; Schwartz 2010, Pawson and Wilcox 2012. Data for France is 2008, Ireland 2004 Switzerland 2000. US 2011, England 2010 and Scotland 2010 as updated in Pawson, Lawson and Milligan 2012, WSW 2013, EGW 2012, HFA 2012.

Most guarantees were established in response to weak or non-existent investor interest in affordable housing, at a time when governments were reducing their own investment role. As shown by the illustrations above, many governments have gone on to play a very positive role creating and growing investor markets, reducing the cost of private finance and in many cases lengthening loan terms. Few of the government or sector guarantees have been called upon since inception and the default rate was zero for all funds since the GFC.

One reason that guarantees have been so effective is that certificates are only restricted to those investments designed to deliver required returns. In particular, investment in *registered often non-profit* landlords providing rental accommodation with secure, assisted or indexed rental streams. Such providers must undergo regular and rigorous financial audits, examining not only their business performance and future plans but also the quality and stability of their financial management. This effort requires a specialist financial intermediary to certify provider capacity to cover interest on borrowings. Approved investment demands are pooled to achieve efficiencies in issuance costs, and lower cost funds are attracted by the presence of a guarantee.

In Europe and the US, social housing guarantees have been structured and capitalised in ways that have important implications for how governments, providers

<sup>2</sup> Includes public housing (1%), housing with project based subsidies (2%) and housing financed with low income housing tax credits (2%).

and investors share the risks. The bonds they back may be based on fixed or indexed revenue streams, projected value improvements or profits from defined sales (Appendix 2).

Bond coupon payments are secured by the obligation of the borrower to repay a loan secured by a legal agreement. Secondly, coupon payment is secured by an accumulated solidarity fund generated from a premium on the loan interest. Lastly the guarantee is backed by government treasuries. It is this element of the guarantee which has the greatest influence on the risk assessment and hence required yield of the bond.

## **Insights from international experience for Australia**

From the detailed international review, the final chapter distils seven important lessons for Australian policy-makers when designing appropriate investment enhancements. In summary these lessons are:

### *1. Agreed principles, facility agreement, predictable pipeline*

From the outset, agreed principles for investment eligible for government guarantee need to be defined by government and agreed by peak bodies to ensure appropriate targeting of implicit public subsidies and provide a clear signal of commitment to investors and borrowers for specific housing supply outcomes.

Once these principles are agreed there should follow clear government mandate for guaranteed obligations. Agreement on the limit should be based on defined supply targets and the current and potential borrowing demands and capacity of the social housing sector. Such a ceiling and review process would ensure greater market certainty and investor commitment.

### *2. Lowering risk of investment and avoiding any potential call on the guarantee*

It is vital to reduce the likelihood of the guarantee ever being called. First and foremost, the borrowers must be well managed, reporting appropriately and independently monitored. Accounts should be able to demonstrate whether their businesses are stable and critical conditions supportive.

Secondly, it is important to inform investors of the nature of the guarantee and the 'back stop' role played by the government. This component of the guarantee is the main factor influencing the rating of the bonds.

### *3. Informing investors and marketing the bonds*

Investment in well regulated affordable rental housing with a clearly defined and supported revenue stream differs markedly from investment in more risky infrastructure projects. The lower risk of rental housing, backed by loans with a government guarantee, needs to be reflected in lower anticipated yields by investors. Pro-active, government supported efforts need to inform relevant investors of the nature of risk and related guarantee enhancements. This would require an active marketing strategy or repeated 'road show' amongst relevant stakeholders.

### *4. Expert financial intermediary*

Investors are unlikely to have specialist technical and legal capacity to service the social housing sector, and hence the establishment of an independent financial intermediary is required. This intermediary should have the capacity to assess risks and ensure the requirements to be eligible for guarantee. Various models are possible, including co-operative buying groups as in Switzerland, non-profit

intermediaries as in the UK and the Netherlands, and publicly owned corporations as in Ireland and France.

### *5. Pooling demands and regularity of bond issues*

The size of the organisations is not definitive for their financial management efficiency and effectiveness, but the size of the bond issue is important to investors. Scale efficiencies can be achieved by pooling multiple smaller borrowing demands with cost of issuance shared between participating borrowers and added as a premium on the loans.

Pooling mechanisms can work effectively but regularity of issue is also important. Investors require issues to be regular and predictable, thereby developing a liquid market for the bonds. This requirement could dovetail with a long-term housing program with annual supply targets.

In Switzerland since 1991, quarterly pooled bond issues in 5000 lots have varied from CHF 23 million (AUD 26 million) to CHF 123 million (AUD 141 million), attracting strong and sustained interest from large and small investors.

### *6. Structure of the guarantee and accounting requirements*

In the event of any default, loss sharing arrangements need to be clear and agreed in advance. As with the WSW, the guarantee can be conceived as a series of layers or lines of defence against any default and consequently any call on the government.

Firstly, organisations must be accountable to a body that has real power to intervene and enforce compliance, where an organisation is failing to comply or needs assistance or re-organisation to comply. High calibre and professional expertise in the financial management of not-for-profit organisations is very important, both inside these organisations and those regulating them. This requires adherence to clear and appropriate commercial benchmarks for solvency ratios, interest rate cover and equity to be eligible for any guarantee.

Further, equity or equity like components of guaranteed schemes are also important and include indefinite public loans or other (tenant, landlord, government provided) equity. Properties which are guaranteed need to be well located, maintained in good condition and be highly rentable. The guarantee may be tied to a mortgage on an unencumbered property. Comfort to investors can be given via a legal agreement, where the bond coupon payments are ranked higher than other financial obligations, and hence these bond investors can claim first call on any repayment.

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

Alternatively, governments can act as an insurer, by pricing the risk and charging fees; thereby accumulating a fund. Otherwise they must account for this risk in their budgets, as contingent liability and set aside an acceptable proportion of the guarantee obligations. If they intend to regularly support organisations to meet their repayment obligations, the government is in effect taking responsibility for them and they should be accounted as such in the government budgets.



*7. A conclusion: well managed guarantee has little or no implications for government budgets*

As demonstrated by all the schemes reviewed in this study, a zero default rate has been sustained, with no call made to date on the government accounts. This is largely due to the supportive role of government in bolstering the equity position of housing providers and their revenue stream (co-financing, supporting low income tenants) and the financial management and monitoring regimes guiding housing sector organisations (auditing and enforcing compliance).

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

Building on the above international review, the following phase of our research into social housing guarantees will examine the:

- Borrowing needs and capacity of the Australian social and affordable housing sector.
- Expectations and requirements of appropriate bond investors (being pension funds, insurance companies and retailers of fixed income securities) for any potential social housing bond with guarantee.
- Australian norms and practice with regards to the use of government guarantees.
- Options for an appropriate and palatable SHG, refined to address Australian social housing finance needs and conforming to international best practice.

Research is well underway concerning the above and will be discussed at the forthcoming think tank in October 2013 and featured in the Final Report to be published early 2014.

# 1 INTRODUCTION

The need for long-term infrastructure finance<sup>3</sup> and the design and use of guarantees to attract investment towards social and affordable rental housing internationally is of direct interest to housing policy-makers in Australia. There, researchers and policy-makers are developing instruments and intermediaries to channel lower cost and larger volumes of investment towards non-profit providers, in the absence of deep public subsidy on both the supply and demand side. Such a guarantee must respond to the local housing and treasury policy climate as well as borrower capacity and investment conditions.

Recent AHURI research on Housing Supply Bonds concerned the role Australian governments can play in attracting private investment (Lawson et al. 2012). It demonstrated how carefully designed enhancements, such as tax incentives and guarantees, can be used to channel investment towards well regulated, co-financed housing providers. It was emphasised that these providers need to operate financially sustainable not-for-profit business models, and manage their debt within carefully monitored leverage limits.

One of the three bonds proposed in the HSB research was the AAA Housing Supply Bond, designed to attract investment from fixed income and securities investors, such as banks and defined contribution not-for-profit industry managed superannuation funds seeking higher quality lower risk assets. Given the tax regime affecting super-funds, a simple tradeable bond instrument with associated guarantee was considered more appropriate than any tax incentive. Lower cost finance to CHOs necessitates lower risk investments, and in establishment phase, such investment would require some form of guarantee.

Guarantees influence the credit allocation of lenders by giving comfort to investors. This comfort comes in the form of a third party (e.g. a government agency) legal promise of performance to a beneficiary (investor). Performance is typically defined as the payment of an agreed interest (coupon rate) or principle within a particular time frame. In the event that the borrower fails to perform as agreed, the guarantor may be called on to make these payments.

This report investigates the most appropriate guarantee and intermediary structure to suit Australian conditions. It is anticipated that appropriately designed such a mechanism could unlock much larger volumes of investment on more favourable terms, with very little impact on the public budget. Outstanding examples of good practice are Switzerland, the UK and the Netherlands which are given full attention in this report.

## 1.1 Aims and structure of this paper

The current research aims to build critical capacity among policy-makers concerned with the design of public or private sector sponsored guarantees. Such guarantees can play a role bearing and reducing the risk of long-term credit for affordable housing providers. The project has three key research questions:

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<sup>3</sup> According to the European Commission long-term investment ‘the formation of long-lived capital, covering tangible assets (such as energy, transport and communication infrastructures, industrial and service facilities, housing and climate change and eco-innovation technologies) and intangible assets (e.g. education and research and development) that boost innovation and competitiveness. Many of these investments have wider public benefits, since they generate greater returns for society as a whole by supporting essential services and improving living standards.’ *Green Paper on Long Term Financing of the European Economy, March 2013, p.2.*

1. How are different social housing guarantees capitalised, structured and accounted for in established social housing systems and what are their costs and benefits for relevant stakeholders?
2. Given international experience, local financial conditions and provider characteristics, what model of social housing guarantee would most cost effectively improve social housing financing conditions in Australia?
3. What are the key implementation issues and how could they be addressed?

This Positioning Paper responds to the first research question, focusing on the use of guarantees in social housing investment internationally and abstracting relevant issues informing the appropriate design of a guarantee for Australian conditions.

This paper has three main sections. The first briefly outlines the Australian policy and investment context and introduces the concept of guarantees in housing finance generally, reviewing broad arguments for and against their use in social housing finance. The second contrasts the design of seven different guarantees supporting investment in established social housing systems in Europe and the US. It also examines evidence, where available, for the effect of such guarantees upon the volume and cost of finance for social housing providers in context. The third and final section identifies issues relevant for the research and development of an appropriate Australian social housing guarantee scheme.

## **1.2 Scope and rationale for selection of international illustrations**

Understanding the rationale for different types social housing guarantees, as well as the factors sustaining and inhibiting their development, is a means to build critical capacity when crafting new housing instruments. A review of established and emerging international practice is particularly useful where direct local experience is lacking. It not only deepens local debate but working illustrations can catalyse local policy development. Thus, the intention of this review is certainly not to transfer one foreign scheme to an Australian host, but to inform and focus discussion on the relevant processes and relationships influencing guarantee design and good practice.

The basis for selecting the guarantee schemes reviewed is therefore not their similarity to or compatibility with Australia but rather their differences in role, ownership, structure and impact. This broad contrasting selection builds on and updates a growing understanding of social housing systems in each country and their financing arrangements. The selection not only builds of an existing knowledge base but also extends a network of local informants (Appendix 1; Lawson et al. 2010; Lawson & Milligan 2007). Of course, a more extensive review of schemes could also be valuable, such as those accelerating in South East Asia, but was for the time being beyond the scope of this project.

### 1.3 Selected illustrations

International cases examined in this paper include the following.

**Table 2: Selected social housing guarantee schemes, % social housing and guarantee coverage**

Guarantee Scheme and year established	Social housing as % of housing market	Coverage of guarantee as % of social housing
Dutch Guarantee Fund Social Housing (WSW) backed by the sector, a fund and central and local governments (1983)	32	96
Swiss Bond Issuing Co-operative for Limited Profit Housing (EGW) backed by the Swiss Confederation (1991)	11	71
French Mutual Fund for Guarantees of Social Housing (CGLLS), backed by the French government (2001)	17	3 (97 by LAs)
Irish Housing Finance Agency backed by the Irish government (1982 LAs/2012 VHBs)	8	New
UK Affordable and Private Rented Housing Guarantee Schemes, backed by UK government (in development mid 2013)	17	New
Scottish government's National Housing Trust, backed by the Scottish government (2010)	24	New
US Risk Sharing Scheme between Housing Finance Authorities and HUD, backed by Federal Housing Administration insurance (1992 pilot/2001 permanent)	5*	NA

Sources: National Statistical Institutes in Housing Statistics in the European Union 2010; Schwartz 2010 Pawson & Wilcox 2012. Data for France is 2008, Ireland 2004 Switzerland 2000. US 2011, England 2010 and Scotland 2010 as updated in Pawson, Lawson and Milligan 2012, WSW 2013, EGW 2012, HFA 2012.

\*Includes public housing (1%), housing with project based subsidies (2%) and housing financed with low income housing tax credits (2%).

## **2 AUSTRALIAN HOUSING POLICY, USE OF GUARANTEES AND THEIR ACCOUNTING TREATMENT**

Recent Australian studies have examined the barriers to institutional investment in affordable rental housing (Milligan et al. 2013) and the settings under which institutional investment could flow (Lawson et al. 2012). The latter proposed a package of instruments called Housing Supply Bonds (HSBs) with suitable public enhancements and a financial intermediary to pool demands, raise funds via the issue of HSBs and allocate lower cost loans to developers and managers of registered social housing. Industry and political response to this package has been positive (Milligan et al. 2013). However, it is recognised that this solution requires an active and sustained strategy of institutional development, implementation and longer term commitment by government agencies. It has also been argued that public and private co-financing of affordable housing can work, but the relationship between private financing mechanisms and public subsidies must be carefully designed and well-coordinated. Regular monitoring and adjustments to the chosen funding model will be required to respond to dynamic housing and finance market conditions, and also to changing needs. There is no one solution for all investors, all tenants and housing markets.

Australian social and affordable rental housing represents new pastures for investors and their asset consultants to cultivate, and hence policies guiding investment in this area have not been formulated (Milligan et al. 2013). Consequently, larger institutional investors such as superannuation funds and insurance companies have little experience in affordable rental housing, forcing social housing providers to rely on the four large banks and smaller fifth column banks (credit unions and building societies) who are Authorised Deposit-taking Institutions (ADIs). In the context of tight credit conditions and limited retail competition, the terms and conditions of commercial mortgages are poor. High cost finance, as well as limited and uncertain government support, has been a major constraint on the growth of the Australian non-profit housing sector (Deloitte Access Economics 2011). Promising research has identified the potential of superannuation funds to invest in this sector, and found strong support for investments with a government guarantee transferring investment risks and reducing management costs (Milligan et al. 2013; Lawson et al. 2012). Such a guarantee would positively influence their investment priorities, as suggested by a senior fund manager of Australia's largest pension fund:

John Hopper, investment manager for Australian Super which manages \$42 billion of funds, said the government guarantee proposed by AHURI would lower the risk profile of an investment by making it appear more like a government bond, lowering the return required.

'If structured the right way this could find a logical home in our portfolio,' Mr Hopper said. 'This is a pretty good step in that direction. I think now we just need to see more detail so we can make a proper investment assessment.'

Australian Financial Review, 31/5/2012.

In the context of continuing global economic volatility and amidst a tightening regime of regulation requiring financial institutions to hold more quality liquid assets on their balance sheets (Basel II and III), demand is strong for highly rated assets such as Commonwealth Government Securities and semi-government bonds. Currently, 10-year Australian government bond yields are at record lows (3.4%) and similarly Swiss

bonds (2.8%). Australia and Switzerland are also two of a handful of countries which can boast stable AAA rating by S&P and Moody's<sup>4</sup>.

Despite low or even no yield, (semi) government bond issues continue to attract investor interest. As mentioned above, this is partly due to regulations pushing demand for high quality liquid assets. However, governments such as Australia have tightened fiscal policy, capping the issue of Commonwealth Government Securities (CGS) as they try to keep within debt caps. Nevertheless, a number of state governments are issuing semi-government bonds to fund capital expenditure by government owned corporations. These SGBs have a similar or the same rating to Australian government bonds (AAA, AA+), and this market is now of a similar size to the CGS market (RBA 2011)<sup>5</sup>. To date, governments have not issued bonds specifically to invest in social housing. Housing departments have been forced to achieve their goals 'within the existing envelope' or less.

In Europe, a similar trend away from direct public investment has led some governments to guarantee and/or provide tax incentives for private investment in order to achieve similar goals. Examples include the Austrian Housing Construction Convertible Bonds (upon which the Tax Smart HSBs are adapted) and the Swiss bond issuing co-operative with Federal Guarantee (which inspired the proposed AAA HSBs). However, in both cases equity like co-financing was also included (again, as proposed by the NAHA Growth Bonds, Lawson et al. 2012).

As in Switzerland and many other well rated sovereign states, the Australian Government could lend their AAA rating to strategic investments via a guarantee in order to facilitate desirable policy outcomes. In many European countries and the US, such a strategy steers investment towards appropriately regulated and co-financed infrastructure, including social housing. Government guarantees have bridged international and national interests in quality asset securities with those of affordable housing developers.

In 2011, market research found that 'growth providing' community housing organisations faced borrowing costs of 7.2 per cent interest, this being 100 BP over standard variable rate charged to large businesses or about 30 BP over a BBB rated corporate bond yield (Deloitte Access Economics 2011, p.20). These findings have been updated since the Social Housing Stimulus via interviews with a similar group of providers by the research team. The results demonstrate declining competition amongst lenders offering high interest rate loans, with short two to five year terms posing significant re-financing risks for CHOs.<sup>6</sup> Further, negotiated arrangements often only cover interest payments and do not promote amortisation or a build-up of equity by CHOs. On the positive side, as experience with the sector grows, conditions can improve and covenants made less restrictive. Nevertheless, it is clear that a new more secure pathway for investment needs to be found.

One impediment is the small scale of borrowing required, leading to inefficiencies in sourcing private finance and limiting access to larger investors with an interest in larger issues (\$200 million plus). Options which have been canvassed by lenders and borrowers include a sector buying group to improve the scale and borrowing power of

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<sup>4</sup> Others countries with this rating are Canada, Denmark, Germany, Hong Kong, Lichtenstein, Norway, Singapore and Sweden.

<sup>5</sup> A description of this market is provided by the RBA  
<http://www.rba.gov.au/publications/bulletin/2011/sep/6.html>

<sup>6</sup> These results will be presented in the Final Report for this project (forthcoming, Lawson, Berry, Hamilton & Pawson).

individual CHOs.<sup>7</sup> Further, tax appropriate incentives on retail investment in social infrastructure have been canvassed as well as a government guarantee proposed by large institutional investors (CHFV 2010, pp.9, 14, 16; Lawson et al. 2012; Milligan et al. 2013). Similar proposals have also been made for nationally significant infrastructure projects (IPA 2009, p.22).

Thus while CHOs endeavour to implement the governments housing policy (including the target to provide 35% of social housing by 2014), firm and explicit government commitment is required. Policy risk coupled with fragmented and sporadic borrowing demands has clearly contributed to higher financing costs, eroding the benefit of other public subsidies. Further, the constrained lending volume of fifth column banks represents another impediment to investment outcomes, despite their constructive interest in serving this sector.

In this political and economic climate, interest is growing in the use of financial intermediaries and guarantees to pool and back investment in affordable rental housing. One option receiving strong housing and finance sector interest concerns a suite of Housing Supply Bonds (HSBs).<sup>8,9</sup> This research aims to build critical capacity amongst key stakeholders concerning the different types of guarantees used elsewhere and the lessons they provide for Australia.

## **2.1 Why governments try to influence housing markets**

Housing plays a crucial role in the distribution of social welfare and access to economic opportunities, it also underpins broader (labour, construction, finance) market stability and productivity. For this and many other reasons, governments intervene in housing markets to influence the actions and interactions of multiple stakeholders engaged in land, finance, construction, management and consumption markets, which in turn are subject to locally contingent, but also increasingly uneven and globally exposed market interactions. Reforms which take these complexities and contexts into account have the greatest potential to influence market behaviour and potentially improve housing outcomes.

While generalisations are dangerous, it is fair to say that due to their complexity and openness, housing markets are prone to market failure and crises (MacLennan 2012, p.10). 'Free' market dynamics operating under imperfect conditions (monopoly, asymmetric information, skewed incentives and barriers) can impede the sufficient supply, quality, location and allocation of housing and clearly violate core principles in neo-classical economics (Whitehead 2012, p.115).

However, market outcomes can change where there are enforceable requirements and appropriate incentives guiding stakeholder behaviour. The development of norms and regulatory systems affecting lending, land use planning, building construction, tenant-landlord relations, income assistance and the sale and exchange of real estate, are all examples of this effort. Often, regulatory systems are driven by a need to ensure decent quality standards, protect the interests of weaker market parties and tame the worst aspects of laissez-faire liberalism.

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<sup>7</sup> In particular, exploration of the 'Swiss model', which is covered in detail in this report and will feature in the Social Housing Guarantee think tank proposed later this year.

<sup>8</sup> See report in Australian Financial Review [http://www.afr.com/p/business/property/super\\_funds\\_could\\_back\\_cheap\\_homes\\_FHNta4F2w7uHhec8DfjmGN](http://www.afr.com/p/business/property/super_funds_could_back_cheap_homes_FHNta4F2w7uHhec8DfjmGN).

<sup>9</sup> See 'Addressing housing affordability in Australia: a 4 point plan for Australia' <http://housingstressed.org.au/wp-content/uploads/2011/09/Addressing-Housing-Affordability-v5-2.pdf> See point 1, p.5.

Housing policies can have adverse or unintended outcomes. Consider the impact of welfare targeting on the stigmatisation of public tenure, the role of capital gains tax exemptions in the 'flipping' of rental properties and the cheap available credit on the over-indebtedness amongst low income home owners. Of course, state policies have either promoted or impeded market processes such as securitisation, which have made investment in fixed housing assets much more liquid, tradeable and global (Fox-Gotham 2012, p.27). As demonstrated by the boom and bust of housing markets in the US, Spain, Ireland, the UK and the Netherlands, ineffective regulation, inappropriate or perverse incentives alongside inadequate planning directly contributes to economic vulnerability and social inequality. The consequences of turbulent housing markets not only impacts on national accounts but also global economic stability (Berry 2011).

However, ineffective policy and practice certainly does not justify a 'hands off' approach. Government instruments, subject to periodic review, can evolve efficient incentives and effective regulation to promote more stable housing markets, which in turn can promote social welfare and reinforce broader economic stability. The role of the Austrian government in this regard, provides a good example where housing policies have played an integral economic and labour market policy, promoting labour market stability, environmental sustainability and social welfare and making a tangible, measurable difference in outcomes (Czerny et al. 2007; Kratchmann & Amann 2011, p.19). In this report are also several examples of how governments, with limited public resources, attempt to steer private investment towards rental housing provided by not-for-profit associations and rental co-operatives.

The crucial but invisible pillar of housing provision is finance. Ideally, governments promote circuits which have the greatest housing benefit and choice. Since the establishment of mortgage markets, governments have used a range of instruments to influence the flow of funds, such as protected circuits of savings and loans, interest subsidies, taxation policy, insurance and guarantee schemes. Some have been designed to improve borrower access to the capital market amongst the broadest range of home owners, landlords and tenants. However, in recent years there has been a trend towards their deregulation, leading to the withdrawal of policies such as direct public investment, semi-protected circuits of savings and investment, financial intermediation and loan insurance. In liberal regimes such as the UK, US and Spain, savings flows are unregulated globally and the level of securitisation is very high. In more controlled institutional regimes, such as Switzerland, Austria and Sweden, savings flows into housing are to some degree segmented from broader capital movements (Schwartz & Seabrook 2009). In parallel, the acceleration of securitisation of home loans has often occurred alongside policies favouring individual home purchase, such as mortgage interest tax deduction and exemptions from capital gains tax, over other tenure options, such as co-operative and rental housing.

However, there are constraining ideological barriers to 'market distorting' government intervention. Alternatively, researchers have even argued that urban planners, housing policy-makers and treasury officials, while not the cause, are certainly complicit in the practices of financial markets which have in turn generated crises prone housing markets (Fox-Gotham 2012). Others claim that narrowing housing choices and social inequality is an inherent feature of increasingly globalised capitalism (Aalbers 2012).

This paper takes the pragmatic view, that informed with knowledge of how housing and investment markets behave and are mediated by regulatory and taxation regimes, governments should have the capacity and leadership to design more appropriate institutions and instruments to achieve the greatest public outcomes.



## 2.2 Why governments use guarantees to back social housing investment

Generally speaking, government guarantees aim to reduce perceived risk and thus required yields, in order to improve the borrowing conditions of third parties such as affordable rental housing developers. Their use has come to the fore in the context of diminished direct public and increased reliance on private investment (OECD, various reports 2008–12<sup>10</sup>). Government revenues and their capacity to borrow have been eroded by low or no growth economies and strict public sector borrowing limits, accelerating their reliance on private sources (despite the often lower cost of raising public debt). This reliance now occurs in the context of much tighter commercial lending conditions and regulatory requirements (Basel II and III) affecting financial institutions, diminishing the availability of long-term credit, typically required by social housing providers. Guarantees have been important to the social housing sector, improving access, loan terms and credit conditions. However, to date such guarantees have not been the focus of extensive international review.

In Europe, a wide range of guarantees exist to serve different purposes: to improve credit conditions for export; to entice private partners in public private projects; and to secure deposits held by financial institutions. These very different guarantees have been designed to give comfort to both savers and investors. They may aim to reduce the cost and broaden access to credit, facilitate investment in needed social and economic infrastructure where government funds are lacking and provide much needed stability to particular financial markets (e.g. Australian RMBS markets).

A small number of housing researchers and market commentators such as Elsinga et al. (2009), Buckley et al. (2003, 2006) and Mersmann and Schiffer (2005) summarise the rationale for government guarantees in housing credit markets from the perspective of market failure and the need to channel lower cost credit to undersupplied segments of the housing market. They argue such markets ration access to credit, based on the limited information investors have at hand concerning the risk and return profile of different investment opportunities. Due to information asymmetry, this rationing can lead to under-investment of lower cost rental housing, thereby impeding the achievement of desired welfare goals. Government guarantees are used to shift investment strategies to address market failure and promote better housing outcomes.

Elsinga et al. (2009) have reviewed ownership guarantees in Europe and note that many aim to address this information asymmetry and broaden access to housing finance. A six-country review of home ownership guarantees by Mersman and Schiffer (2005, p.25) argues that long-term government guarantees have proved to be an effective and efficient way of increasing the accessibility and affordability of housing markets, progressively influencing social welfare, much more so than commercial insurance. A review of Asian financial intermediaries makes a similar claim (Chan et al. 2006).

Mersman and Schiffer also note that in some countries, guarantee schemes are the main instrument of housing policy, replacing interest subsidies and government loans. Like Elsinga et al. (2009, p.69) they argue that a government mortgage guarantee schemes place considerably less pressure on public budgets than other forms of direct or explicit means of financial support. They report on declining public investment and shifting policies on housing market intervention to achieve optimum

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<sup>10</sup> Access to these numerous reports can be found on the website OECD Financial Sector Guarantees <http://www.oecd.org/finance/financialsectorguarantees.htm>

efficiency and social welfare outcomes via appropriate capital market investment (Mersman & Schiffer 2005, p.25). In a recent review of UK policy developments, the emergence of government guarantees there offers further evidence of the more widespread use of guarantees as governments shift away from direct capital subsidies (Gibb et al. 2013, p.51). As demonstrated by the Scottish National Housing Trust model, covered later, complex Limited Liability Schemes have been devised to limit government's exposure on default and avoid any (reported) potential capital transfers from national budgets.

Other rationales are also used. The European PPP Expertise Centre (EPEC), hosted by the European Investment Bank (EIB) and EU member states, aims to demonstrate where government guarantees might be required and to assist the public sector in their design (EPEC 2011, 2012; EPEC/Broom 2011). They categorise the motivations for guarantees into financial and public policy drivers.

Public policy drivers include:

- Reducing reliance on direct public funds in an era of budget austerity.
- Building market confidence amongst new investor segments less familiar with public infrastructure investments.
- Accelerating investment in particular areas, such as public infrastructure.
- Bolstering program credibility to achieve policy initiatives and attract lower cost funds.

Financial drivers include:

- The improvement of credit quality to attract (new) investors and improve market competition.
- Reduce the cost of capital.
- Achieve higher leverage ratios and pertinently.
- Promote market stability in an era of volatility (EPEC 2011).

## **2.3 Varying role and design**

As demonstrated in Appendix 2, bonds have various characteristics and their promise to repay, their obligations, can be linked to various revenue streams, such as indexed rents or asset appreciation and eventual sale. To provide comfort to investors, these payments can be guaranteed by a third party, with a strong credit rating and wider revenue base, such as a government's broad tax base.

A government guarantee can reduce the perceived risk by bond investors and thereby moderate their required yield. Ideally an efficiently run not-for-profit bond issuing financial intermediary passes on the full benefit (less the cost of issuance) to housing associations, in the form of lower cost finance, as in the UK, Netherlands, Switzerland, Ireland, France and the US. These loans would have lower interest rates than traditional mortgage instruments and ultimately reduce the cost of providing and managing social housing (UN Habitat/Oxley 2009; Lawson et al. 2010).

Guarantees can be any arrangement under which a third party (directly or indirectly through an entity or otherwise) assures, on a conditional or unconditional basis, the payment of another party's obligation. They differ in terms of their design features and of course the investments they support. Design features include capitalisation, structure and accountability.

True guarantee schemes are not intended to be called on. Indeed, considerable effort is made to reduce any chance of default. This is because the rating of the guarantee

is what provides the greatest benefit to borrowers and any default would undermine this and thereby increase the cost of borrowing for all. Hence, most schemes stringently apply borrowing norms and conditions applicable in the commercial sector. Transparent monitoring and compliance processes also give comfort to investors, otherwise unwilling to invest. Where repayment problems do occur, problems are often resolved by members before any possible resort to the guarantee (as in the Netherlands, Switzerland and France).

In this project we are focusing on guarantees to protect investors, which aim to facilitate investment and in turn produce dwellings for affordable rents. However, guarantees often have more extensive roles, such as improving the management capacity and the financial strength of the entire social housing sector.

A further distinction concerns how the guarantee is capitalised. Some guarantees are self-funded and cost recovering. Some are established first with government support and then move towards self-sufficiency. Others continue to be subsidised by governments who fund the liability posed by riskier borrowers (Elsinga et al. 2009, pp.68–69). These are political decisions, best informed by a transparent evidence based debate informing the allocation of guarantee beneficiaries. Such a debate can also polarise competing interests, as in the Netherlands between private for-profit and non-profit landlords, when the former perceived an unfair advantage leading to a narrowing of eligible investment priorities. Likewise, there are important differences in the accounting policies, norms and practices required and applied by governments and their agencies, which influences the level of reporting in public accounts. These issues are discussed in the following international section providing more detail on a case by case basis, how different countries account for their guarantees and any losses they incur.

In general, a guarantee does not necessarily provide 100 per cent coverage of a loan's full repayment and interest obligations and may be structured in very specific and limited ways for defined time periods. Table 3 below outlines conditions which may be included in any given guarantee.

**Table 3: Conditions of guarantee agreements**

<b>Guarantee features</b>	<b>Definition</b>
Acceleration	The extent and pace of repayment, where loan interest and principle will be paid either in full when called or as agreed by instalments over time.
Fullness	That payment is full or partial.
Ranking	That government equity/grants/other loans are ranked higher or lower than claims on other investor contributions.
Refinancing	That the government will or won't pay the difference when refinancing terms and conditions are more expensive and scarce when debt matures.
Usage	The government may guarantee certain usage levels (i.e. vacancy rates).
Service charges	The government may guarantee certain usage costs (i.e. minimum rent levels and indexing).
Regulatory stability	That the government may commit to certain undertakings critical to the financial return, in the context of an undeveloped policy or limited track record of policy commitment.
Termination payments	That the government agrees to a certain level of compensation where performance fails or the contract ends prematurely on the borrowers default.
Debt assumption	That the government assumes the debt obligations where the borrower defaults.
Residual value payments	That the government undertakes to payment of a pre-defined amount to reflect the residual value of the underlying asset.

Source: Authors interpretation of EPEC 2012, pp.13–18

Guarantee schemes often require adherence to specific borrowing limits and target investments, framing the type of loans they guarantee. For example, the Dutch Social Housing Guarantee Fund, one of the most sophisticated examples covered in this report, uses a debt service coverage ratio (DSCR) which indicates whether the operational cash flows are proportionate to the debts serviced. Secondly the interest coverage ratio (ICR) indicates how many times a company pays its interest expenses with free operating cash flows. The loans must be used for affordable rental housing, within a defined price range and for defined household incomes. The French CGLLS only applies to loans provided by the government's financial intermediary pooling funds from tax free savings accounts. More about these specific conditions is covered in the review in the third section of this paper.

## **2.4 Views on the use of government guarantees**

As mentioned, the use of government guarantees is a matter for policy debate, which should be informed by rigorous research and international experience. There are polarised views of whether guarantees are either virtuous circuit makers or market distorting mechanisms and some of these are outlined below in Table 4.

**Table 4: Arguments for and against use of government guarantees**

<b>Arguments for and against use of government guarantees</b>	
<b>For—A ‘virtuous circle’</b>	<b>Against—A ‘distortion’ of natural markets</b>
Broadens access to mortgage credit to important but neglected segments of the housing market.	Unnecessary as they have minimal effect on the cost of finance.
Stabilise housing markets, act counter cyclically by promoting mortgage bond liquidity and ameliorate negative effects of credit down turns on housing markets.	Over-investment in under-demanded assets, leading to over-supply and posing excessive risks to guarantee provider.
Protects investors from loss when lending criteria is broadened to encompass borrowers otherwise excluded by lack of asset policy or low yield.	Shifts the risks inappropriately, promoting profit reducing and inefficient practices amongst borrowers.
Reduces the cost and improves the terms of mortgage loans to regulated non-profit providers supplying lower rent dwellings accessible to lower income households.	Undermines market discipline and misallocates credit, creating incentives for financial markets actors to take on excessive risk (moral hazard).
Supports social and economic policies of governments for environmentally sustainable investment in infrastructure such as social housing.	May spill over to compete with other investments and crowd out investment.

Sources: contents assembled by the author using various sources: Min 2012, EPEC 2012, Elsinga et al. 2009, IPA 2009

According to Min (2012) in the US, a more critical view of government guarantees has emerged since the GFC. Some commentators contend that guarantees increase financial instability because they encourage excessive risk-taking and reduce market discipline. However, others argue that guarantees have been vital to economic stability in the housing finance system and for this reason are typically introduced following times of credit crisis as in the Great Depression and today (Min 2012).

In this debate, housing policy is under the spotlight. It is claimed by many that the emergence of deep and pervasive, misaligned and perverse incentives lay at the heart of the global financial crisis. However, the view that *all* forms of intervention are distorting or that all deregulation is to blame for the current crisis have been surpassed by more sophisticated arguments concerning crises prone nature of contemporary capitalism (Aalbers 2012) and nuanced illustrations of the very different impact of the GFC on different states and national economies (Schwartz & Seabrook 2009).

Recent policy developments in the US suggest there are moves in favour of *better* regulation. There is also a less singular focus on deep home ownership promotion in Europe. The UK government is designing more effective incentives to promote *rental* housing. It is worth mentioning that three of the seven social housing guarantee schemes reviewed in this paper have been introduced since the GFC and all target investment in rental housing.

The overriding rationale is that inherent market failure in housing and finance markets requires active and adaptive policy measures to channel long-term, lower cost funds towards necessary social and economic infrastructure. There is a need to strike and adapt the right balance between direct government participation and incentives to influence ‘normal’ patterns of investment. With the aim of promoting stable investment

across the housing market, and in the context of constrained public direct investment, governments across Europe and the US increasingly look towards the use of various forms of guarantees to promote investment in affordable rental housing.

Gibb et al. (2013, p.4) caution that despite an appetite for state-backed guarantees, care should be taken in their consideration, design and eventually implementation. Further, EU competition policy may affect their coverage and use. Market conditions will always affect their utility and the perception of government risk may actually increase the cost of borrowing. Amongst many public administrations, the drive for balanced budgets and rationale that public interventions distort markets has combined to override policies promoting social solidarity and even economic growth. These ideas also affect the role and scale of social landlords in housing markets. For example, EU Competition Policy has played a constraining role leading to systemic revisions to national systems of social housing provision, narrowing tenant eligibility and cross subsidisation activities in Sweden and the Netherlands and leading to the introduction of a 'bedroom tax' on social tenants in the UK. The on-going European sovereign debt crisis has affected government ratings and in turn the cost of credit it backs, as in the Netherlands and Ireland.

These challenging issues mediate the design of guarantee schemes, requiring careful consideration.

## **2.5 Accounting norms and practices when using guarantees**

Influencing and even driving the use of guarantees are policies and accounting standards concerning borrowing limits and affecting reporting on public finances, which in turn are scrutinised by credit rating agencies.<sup>11</sup> Ratings are important because they influence the cost of funds which governments wish to raise in order to operate various programs and make specific capital investments.

Public finance standards specify how government assets and liabilities are defined and reported and in turn influence the purpose and design of guarantees. For example, the definition of contingent liability, arising from any call on a guarantee, requires specialist assessment of the (policy, financial, management) risks involved. While international standards exist, they are quite general and typically must be adapted to local norms and contexts. Indeed, a one size fits all approach could be inappropriate.

International Accounting Standards (IAS) are based on best practice agreed by IAS members. There are also standards concerning contingent liabilities of guarantees in use by the public sector (IPSAS). IPSAS19<sup>12</sup> recommends that contingent obligations be accounted for when the probability of claim exceeds 50 per cent and the cost of this risk can be estimated and quantified.

This is not a hard and fast rule and there is debate over the adequacy of this standard, for example should guarantees be given if they are likely to be called on and further, given that the probability that risk is dynamic, certainly it requires more regular monitoring and accounting than the 50 per cent rule would suggest (Golland 2006, p.3).

IPSAS standards for accounting for guarantees are sometimes adopted by countries, often taken as a reference, but they certainly have not been implemented across all

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<sup>11</sup> Such as ESA95 Manual on Government Deficit and Debt and State Aid Rules

[http://epp.eurostat.ec.europa.eu/cache/ITY\\_OFFPUB/KS-RA-13-001/EN/KS-RA-13-001-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-RA-13-001/EN/KS-RA-13-001-EN.PDF).

<sup>12</sup> International Public Service Accounting Service Standard 19—Provisions Contingent Liabilities and Contingent Assets (2002). <http://www.ifac.org/sites/default/files/publications/files/ipsas-19-provisions-cont-1.pdf>.

countries consistently. For example, the UK and Australia have developed their own standards in accounting for guarantees and the Netherlands has adapted the IPSAS to ensure its own 'back stop' guarantee for the social housing sector meets EU requirements, as below.

Members of the EU aim to meet standards for reporting government assets and liabilities according to the European System of Accounts 95 (ESA95). The most recent European Manual on Government Deficit and Debt explains why guarantees should be treated as contingent assets and liabilities and provides guidelines on how to account for different types of government guarantees, including when calls on the guarantee are made repeatedly and where guarantee fees apply (Eurostat 2013, pp.317–28). The rationale for the treatment of guarantees as contingent liabilities is provided as follows (ibid, p.321):

27. The general principle is that such guarantees of payments granted by third parties are considered as contingent assets/liabilities. This means that at least one condition must be fulfilled before a transaction due to the guarantee, and involving the guarantor, takes place and before economic value is transferred (SNA93 11.25).

28. ESA states that, 'In the system, a contingent asset is a financial asset in case where the contractual arrangement itself is tradable or can be offset on the market. Otherwise a contingent asset is not recorded in the system' (ESA95 5.05).

29. As a result, contingent liabilities are not recorded in the ESA balance sheet and are excluded from government debt. In the general case they are recorded only when activated. This leads to debt assumption. In debt assumption the amounts recorded are the 'payments in fulfilment of guarantees which free defaulting debtors from their obligations' (ESA95 4.165f).

30. Any call of a guarantee, which may cover all or part of the debt guaranteed, is thus equivalent to a debt assumption by government.

Further, Eurostat considers that:

'The government guarantee must be considered as a contingent liability, not recorded in national accounts as a government liability according to the general ESA95 principles. In this respect the risk borne by government is only a potential one as it depends on the occurrence of certain specific events. As a result, neither government expenditure nor government revenue is recorded as long as the guarantee is not used.' (ibid, p.22)

A summary of Eurostat's advice for general and more specific forms of guarantee is provided in Table 5 below.

**Table 5: Accounting standards for various types of government guarantees ESA 95**

<b>Guarantee assumptions</b>	<b>Accounting standard</b>
General case	<p>Guaranteed debt is recorded as borrowings solely of the corporation. For the government, guarantees are recorded as a contingent liability. Guaranteed debt is not recorded in core accounts until the guarantee is activated.</p> <p>Information on the existence of the guarantee should be public.</p> <p>If called and government takes over debt, it is recorded as a capital transfer. It may enter into further transactions to repay the debt to creditors.</p> <p>A partial call, or cash call, must be recorded as a capital transfer expenditure for the amount of the cash call.</p> <p>Where repeated calls (&gt;3) government assumes outstanding debt and records the financial transaction to repay that debt.</p>
Government repays debt of corporation which issues	Debt is issued by a corporation but assumed by government, thus payment are recorded in public accounts as a capital transfer (4.2.1/6).
Judged government is or will repay debt	Probability of repaying the debt is high and regular (3-year plus) provision is made in government accounts for this purpose, outstanding debt is assumed by government, despite no legal obligation, and debt assumption is recorded as above.
Call involves financing assets on a third party	Assets may be transferred to the government and recorded in the public balance sheet and government assumes the payment of debt to the creditor, which may be outstanding on the asset, influencing government lending and borrowing capacity. This asset and payment is recorded in the public accounts.

Source: Authors interpretation of Eurostat 2013, pp.317–20.

Fees for guarantees are to be spread over the life of the scheme and recorded in the accounts as service fees.

Thus, in Europe, as per IPSAS 19 and under ESA 95 governments are required to report in full on their national accounts assets for which it bears most of the risks, being more than 50 per cent of the capital costs. Where government guarantees are considered as contingent liabilities, they are *only* reported in national accounts in many countries when they are called on or where it is *likely* that a debt will be called on. For only under these circumstances, does a contingent liability count as government debt and appear in the national accounts (EPEC 2011, pp.25–26).

According to the European PPP Expert Centre (EPEC), the actual practice of reporting of contingent liabilities is not pervasive and the recognition and disclosure of risk is only noted in a few national budgets. This is because most governments have created self-financing arms-length companies, albeit publicly owned, whose assets and liabilities are professionally accounted for. Only when an actual or repeated capital transfer occurs from government, is the government required to include details its own national accounts.

Below is a brief summary Australia's policy on reporting of guarantees. A more detailed discussion of Australian norms and experience with regards to the use of guarantees appears in the forthcoming Final Report.

In Australia under the Charter of Budget Honesty Act 1998 (CBH Act) section 5(1)(a) the government is required to 'manage financial risks faced by the Commonwealth



prudently'. Australian government agencies currently guarantee a wide range of investments, and these are supposed to be registered. Advice on this practice is outlined in the Department of Finance and Administration's Guidelines for Issuing and Managing Indemnities, Guarantees, Warranties and Letters of Comfort (Department of Finance 2003) which states that guarantees are a risk transferring mechanism, involving legally binding obligations that can result in significant budget costs if the contingent event occurs. Guarantees should not set an undesirable precedent and where available, commercial insurance is preferable. In the event that risks are guaranteed by government agencies, they need to be managed carefully, with the exposures they represent being adequately monitored over the life of the instruments. The Australian government's policy is to only accept risks by guarantee when the expected benefits, financial or otherwise, are sufficient to outweigh the level and cost of the risk which the Commonwealth would be assuming. It also states that risks should be explicitly identified and only be borne by those best placed to manage them (ibid. 2003, p.7). A critical analysis of costs should be taken into account in evaluating value for money of the guarantee. The guaranteeing agency would be required to fund liabilities, in the first instance, with their own resources. The CBH Act requires all quantifiable and non-quantifiable contingent liabilities posed by a government guarantee that could affect the actual budget outcome in future years to be disclosed in the Budget Papers.<sup>13</sup> Under the Financial Management and Accountability Orders 1997, quantifiable risks greater than 5 per cent must be reported and unquantifiable risks or those less than 5 per cent probability must appear as notes in the financial statements (ibid. 2003, p.10).

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<sup>13</sup> In 2003 contingent liabilities with a possible impact on the forward estimates greater than \$20 million in any one year, or \$40 million over the forward estimates period are disclosed in Budget Paper 1 (CoA 2003, p.10).

### **3 AN INTERNATIONAL REVIEW OF GUARANTEES BACKING SOCIAL HOUSING FINANCE**

The following outlines seven illustrations in six countries of established and emerging practice in the use of guarantees for social housing investment. It draws on a review of official websites, financial reports, stakeholder interviews, rating agency surveys and scholarly evaluative research.

The devil is truly in the detail. Guarantees vary significantly in purpose, capitalisation, structure and accountability. The contextual settings and characteristics of each guarantee are described briefly below but more holistic descriptions of each country's social housing system and their financing arrangements can be found in Lawson, Gilmour and Milligan (2010). A final sub-section compares key features in tabular form, to aid comparison.

#### **3.1 Dutch Social Housing Guarantee Fund**

The Dutch Social Housing Guarantee Fund (*Waarborgfonds Sociale Woningbouw*—WSW) is one of the largest social housing guarantee schemes in Europe. Established in 1983, the WSW is a private non-profit financial intermediary and guarantee organisation. It operates in co-operation with the publicly owned solidarity fund (*Central Fond voor Volkshuisvesting*, CFV). The CFV has the right to extract taxes from all member housing associations to aid those in financial difficulty. Loans for registered social landlords may be guaranteed by the AAA rated WSW to enable them to borrow at relatively favourable terms for new housing construction, renovation and refurbishment.

The Dutch guarantee mechanism was viewed as essential by government when housing associations, both large and small and of varying solvency, moved towards financial 'independence' in the 1990s. Financial 'independence' was only achieved by the grossing up of association balance sheets by central government, in exchange for housing associations foregoing future operating subsidies. The guarantee was necessary to give comfort to new investors and to this day, has never been called on. The WSW fund was originally established by the central government with a lump sum transfer of 70 million guilders (AUD \$45 million) in the 1990s. This has since been added to by housing association member contributions and invested to grow to a considerable sum. The WSW has assisted housing associations in raising more than €90 billion of investment since its inception.

The central government considers the guarantee as a series of dikes or lines of defence, which protect public treasuries from any risk. The senior official responsible, who was interviewed for this research, evaluates the risk to government as zero and stresses the private nature of the WSW, therefore not requiring the reporting of contingent liability in the public accounts.

The first dike is the fund accumulated by the WSW being almost €500 million, second the €3 billion equity held by the housing associations and third the back stop of the government.

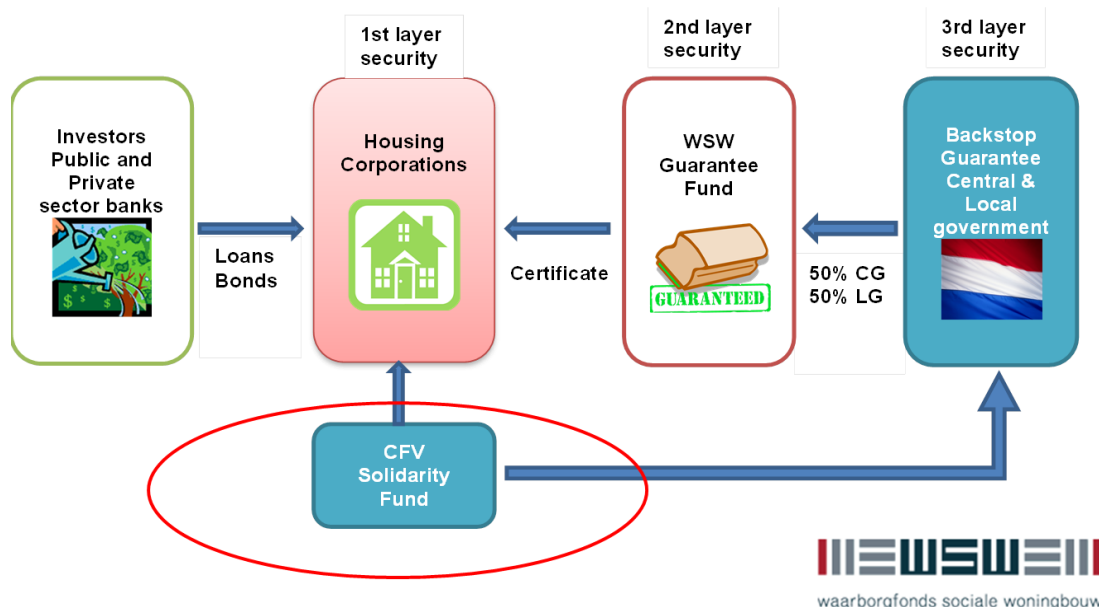
The WSW describes the guarantee in similar terms: backed by the stock of the sector, the capital of the WSW fund and an agreement by local and central government.<sup>14</sup>

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<sup>14</sup> Basic details of the WSW security structure in English can be found at: <http://www.english.wsw.nl/investorrelations/security%20structure#1>.

An important aspect of the WSW is financial auditing and compliance. The WSW assesses the creditworthiness of applicants and where this not sufficient, can assist by arranging restructuring support via the Central Fund for Social Housing (CFV). When a guaranteed association is unable to meet its financial commitments, the lender may call on WSW for these amounts. Figure 1 below outlines the Dutch guarantee structure with various layers of security. Circled in red is the all-important solidarity fund which has considerable taxation and re-organisation powers.

**Figure 1: Structure of the Dutch social housing guarantee**



According to the guarantee agreement, in the event that a guarantee is called by a lender, the WSW can seek recourse from the relevant borrower, who has pledged debt free properties as security. The WSW can establish a mortgage on such properties and has recourse to the participant's other assets. In this way the WSW substantially limits any losses that can be incurred by the WSW (WSW 2013, p.32).

The second layer of the guarantee is the WSW's own capital. In 2013 this amounted to €493 million. If WSW's capital falls below the capital-to-guarantee portfolio ratio of 0.25 per cent, there is an obligation of all member housing associations to contribute additional capital to the WSW.

Developments in the risk capital of the WSW and committed capital of the housing association sector can be found in the most recent annual report.<sup>15</sup> Total risk capital plus committed capital as a proportion of the total volume of loans guaranteed (at face value) was 4.34 per cent in 2013, with the aim to reach 4.5 per cent in coming years.

WSW's risk capital is made up of investments, cash, less creditors, accruals and deferred income and long-term liabilities. By the of 2013 financial year, this amounted to €480.9 million and committed capital from housing associations €3.3billion. In the event of a claim where the risk capital falls below 0.25 per cent of the total guaranteed volume after calling the committed capital, a call will be made on the backstop arrangements with the government and the municipal authorities, this is the third layer of security (WSW 2013, p.43).

<sup>15</sup> For details of the development of risk capital of the WSW, which provides the second layer of security of the HA loans see WSW (2012, p.43-44) Guardian of the Guarantee: WSW Annual Report 2012 Cash Flow Forecast 2013–17 [http://www.english.wsw.nl/uploads/media/558\\_WS1008512\\_DEF\\_ENG.pdf](http://www.english.wsw.nl/uploads/media/558_WS1008512_DEF_ENG.pdf).

There is an unlimited obligation of the Dutch state and municipalities to provide interest-free loans to WSW to ensure this level is met (WSW 2013; Moody's 2012, pp.1–2). Again, this obligation is considered so remote that it is not reported in the public accounts. This third layer of the guarantee known as the government 'backstop' may only be called on when the first two layers of security (housing association assets and WSW capital) are not sufficient.

This responsibility is shared equally by central and local government (Association of Dutch Municipalities, VNG) according to a detailed legal agreement. Under this agreement, the government must pay the WSW interest-free loans for the amount of the shortfall in its capital base, which has to amount to at least 0.25 per cent of the guaranteed capital (WSW 2013). This backstop agreement cannot be terminated until existing commitments have been repaid.

Obviously this requires a high degree of accountability between all stakeholders. The WSW is required to inform the central government and VNG of its budgets and cash flow forecasts and provide annual reports, accounts and report changes in policies concerning discounts, assessing the creditworthiness of registered housing associations and developments in WSW's capital. The backstop position of the central government and municipalities represents the ultimate layer of security in the structure and has never been called on.

The amount that can be borrowed by associations and guaranteed by the WSW depends on the cash flow projection and the financing of the housing association, which is assessed annually by the WSW and is based on a cash flow forecast over three years. Funding needs include the costs of maintenance and refinancing of secured loans less income from the sale and positive operating cash flows, using standard software Corpodata. From this data, WSW provides an assessment of the volume of funds which can be borrowed by housing associations.

Furthermore, guarantees are only issued for rented properties within a certain price range. However, the government has temporarily lifted the price level for higher-priced dwellings to enable associations to support the depressed private housing market.

As stressed by the senior government official interviewed, the WSW is not a public body. Rather it is a foundation with an independent management structure, a supervisory board, Advisory Committee and Members Council, which employs 54 staff. Despite its independence, rating agency Standard and Poor's notes the integral relationship of the government with the WSW. It is the strength of this relationship which informed their high credit rating of the WSW based on:

1. Long established relations with the Central Fund, the Ministry of Finance, and the Ministry of the Interior and Kingdom Relations (formerly Ministry of Housing, Spatial Planning and the Environment).
2. Centrality to achieving national social housing policy.
3. Agreement of central government and municipalities to provide interest free loans to the WSW, if its capital were to falls below a certain level.
4. Recent re-iteration by the government of the importance of WSW's role and its intention to support the organization, if and when required. (Standard and Poor's 2011, p.3).

The WSW is considered an influential and cost effective mechanism to improve access to credit markets for approved association developments, even during the GFC. However, it has faced a recent challenge from one housing association Vestia,

which faced heavy losses (from a derivatives call). This event and unstable government housing policy could undermine the financial strength of the sector.<sup>16</sup>

To illustrate the robustness of the guarantee and the low risk it presents to both lenders and government, the central government has pointed to the handling of the Vestia case. In 2011 the largest housing association in the Netherlands, Vestia made a loss of €2.5 billion when a bank called on loans backed by derivative instruments. The impact of Vestia's losses involved the forced sale of 30 000 of its dwellings, being one third of its stock, and reduced investment in new social housing and neighbourhood rehabilitation across the entire sector. To co-ordinate this solidarity payment, the government-owned Central Housing Fund (CFV) contributed €1 billion of Vestia's outstanding losses, drawn from member associations. The cause for Vestia's losses has been attributed to deficiencies in governance, and risk management and WSW policies regarding the use of derivatives have now been tightened.

Overall since 1983, the WSW has been able to cover 80 per cent of loans to the large and well developed housing sector, reducing rates by a considerable 1.0–1.5 per cent, with its triple-funded guarantee structure. WSW can secure loans with a maturity of at least two years and a repayment schedule of up to fifty years. The interest period and method of amortization are to be agreed between lender and borrower. It is possible to repay guaranteed loans early, provided that the lender and borrower both agree. Corporations directly receive a quarterly bill from the WSW for the risk premium to be paid for the guarantee.<sup>17</sup>

The WSW is a rated bond issuer by Standard and Poor's (2011b) and Moody's (2012). In 2012 Moody's rated the WSW as AAA (same as the government) and considered that WSW credit strengths were as follows in Table 6.

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<sup>16</sup> See article in UK's Inside Housing <http://www.insidehousing.co.uk/solidity-of-dutch-guarantee-is-tempting-in-troubled-times/6500855.article>.

<sup>17</sup> WSW loan documentation standards (2013) <http://www.wsw.nl/wetenendoen/marktinformatie>.

**Table 6: Strengths and Weaknesses of WSW, according to Moody's**

<b>Strengths</b>	<b>Weaknesses</b>
Government-defined mandate to provide guarantees to lenders for Dutch housing corporations.	Potential exposure to greater risks due to increasing involvement by Dutch HAs in commercial property.
Securing of WSW guarantees of HA loans on specific properties and by individual HAs for each loan.	Development and construction of new social housing.
Obligation of all member HAs to pay in additional capital to WSW if capital-to-guarantee portfolio ratio falls below 0.25 per cent and unlimited obligation of the Dutch state and municipalities to provide interest-free loans to WSW to ensure this level.	Untested nature of the full range of support mechanisms for Dutch social housing, including contractual provisions of back stoppers.
Market dominance 96 per cent participation by Dutch HAs.	Increasing individual exposures against WSW's own liquidity reserve.
Generally good financial fundamentals of Dutch HAs, but potential cash flow pressures from operations and margin.	
Yet, recent calls under derivatives contracts in limited cases.	
Established monitoring procedures to ensure that only creditworthy HAs are guaranteed.	
No guarantees have been called since inception.	

Source: Moody's 2012, p.2

Moody's credit assessment was reduced from stable to negative, largely due to the ongoing Euro debt crisis but also due to the risk posed by the government's policy overview of the social housing sector.<sup>18</sup>

As described in Lawson et al. (2010), typically housing associations in the Netherlands have a range of different short and longer loans to cover different funding needs, for example short-term two-year loans for the start-up phase of a project and longer term loans for established concerns (WSW 2009). The treasurer actively manages these loans to reduce overall financing costs and minimise interest rate risk during refinancing. Most loans are obtained from two AAA rated public financial institutions: the Bank Nederlandse Gemeenten (BNG) and Nederlandse Waterschapsbank (NWB). BNG and NWB have traditionally specialised in providing private finance to the public sector, including the social housing sector. There have been attempts to broaden the market for loans via the formation of an alternative buying group, but these have not borne fruit, especially since the GFC. Indeed, investment by commercial Dutch banks has declined from 11 per cent in 2007 to 5 per cent in 2011. Public sector banks provided 89 per cent of funding in 2011 and there has been a slight increase in interest in the social housing sector by insurance and pension funds, contributing 3 per cent of total funding in 2011 (WSW 2012, p.25).

Dutch commercial banks (either fully or partly nationalised) continue to exercise constraint, limiting 'long-term' funding to periods of more than three years. Of course housing associations are very much reliant on loans with longer maturities. This

<sup>18</sup> Moody's Investor Service Credit Opinion—Waarborgfonds Sociale Woningbouw 26 July 2012 [http://www.wsw.nl/uploads/media/405\\_Waarborgfonds%20Sociale%20Woningbouw%20-%20Moody's%20Credit%20Opinion%20-%20July%202012.pdf](http://www.wsw.nl/uploads/media/405_Waarborgfonds%20Sociale%20Woningbouw%20-%20Moody's%20Credit%20Opinion%20-%20July%202012.pdf).

mismatch means suitable loans are in very limited supply and short term loans must be regularly refinanced. When this proves to be a problem, WSW facilitates by advancing a guarantee, firstly for refinanced loans and afterwards for new investments. However, even with the guarantee the average maturity of new loans arranged by associations and length of fixed-interest periods has shortened since the crisis. Further, the spread above the SWAP rate has increased. The most recent Annual report (2012) reveals that the spread on WSW paper is 77 BP above the rate payable on Dutch state paper in 2011, compared with 53 in 2010 and 35 in 2007 (WSW 2012). This difference is attributed to the high cost of handling lower volumes of paper compared to the Dutch state and the private nature of the issue.

As mentioned earlier, participating associations must meet WSW's strict assessment criteria, primarily concerning solvency, which is regularly monitored. Assessment involves examination of project development and regeneration policies and strategies relative to actual performance, existing stock management practice and capital adequacy. The WSW focuses on cash flow analysis and applies various stress tests to inform WSW's judgment on likely calls on the guarantee. The most recent annual report raises concerns over declining net cash flows, constrained rent indexing policy and the capacity of housing association cash flows to cover their operating, maintenance and finance costs (WSW 2012).

Debt Service Coverage Ratio (DSCR) helps to determine whether cash flows are sufficient to cover financing costs. WSW uses a target ratio of 1.2 assuming 2 per cent notional repayment, yet for 2010 this was 0.9 per cent, insufficient to eventually cover financing costs and well under notional 2 per cent repayment targets. Interest Cover Ratio (ICR) is another target which the WSW uses to indicate financial solvency and the ability to cover interest payments. Housing associations with a ratio below 1.4 are considered 'bad cases'. On average, the ICR was 1.6 in 2011 across all members. However, this hides considerable variation, with 62 housing associations with an ICR of 1.3 (WSW 2012, p.32).

### **3.2 Swiss bond issuing co-operative with guarantee<sup>19</sup>**

The *Emissionzentrale für Gemeinnützige Wohnbauträger* (EGW) provides an interesting model for raising private finance suitable for a small but important affordable rental housing sector in Switzerland. The guarantee performs a similar role to the WSW but is much less complex and structured. The EGW shares many similarities with the UK's Housing Finance Corporation (THFC), with the pooling of borrowing needs of providers. In this respect, the EGW has more potential for adaptation to an Australian context.<sup>20</sup>

As a government backed, member owned and non-profit bond issuing co-operative, the EGW is firmly established and cost effectively run. It illustrates how a scheme that serves both the borrowing needs of the affordable rental sector and requirements of Swiss bond market can deliver lower cost finance to permitted members over an established period of time.

Permitted members are those housing organizations providing accommodation for the public good and typically structured as not-for-profit associations or foundations. They

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<sup>19</sup> Many thanks to the EGW, Zurich Kantonalbank, Zürcher Kantonalbank, HSBC and FoH for information provided via interviews and provision of relevant documentation.

<sup>20</sup> Interest in the EGW model has also been expressed by peak housing bodies (CHFV 2010) and raised in the Deloitte Access Economics (2011) report. An HSBC presentation on financial intermediation for social housing also considered the EGW exemplary and a potential model for European Social Housing Bonds (CECODHAS/HSBC/Gay Guggenheim 2011).



are beholden to a Charter developed in 2004<sup>21</sup>, which defines their purpose, activities and business model. They must also comply with affordability, governance and quality standards to receive revolving loans or guaranteed EGW finance. These affordable rental housing providers vary from numerous locally active organizations with around 100 dwellings to a number of very large cross regional housing developers. While some larger non-profit entities are financially strong, the EGW pool allows smaller non-profit builders to join together (many with less than 100 dwellings), improving their access to finance on more favourable terms.

Swiss not-for-profit co-operatives and associations are financed with commercial bank loans; low interest loans from a state-funded revolving fund; and importantly, loans from bonds issued with Federal guarantee plus a defined percentage of their own or tenants equity.

In the late 1980s commercial lending rates were prohibitively high (with interest rates of 8 to 9% for new mortgages). As a consequence, like elsewhere, new mechanisms (securitization) to enable direct access to capital markets were studied and discussed, but contrary to the banking sector that was not interested in this approach, the non-profit housing entities saw its merits and agreed on the establishment of the EGW.

The EGW was jointly founded as a cooperative in 1991 by the Swiss Federal Office for Housing and three umbrella associations of the non-profit housing sector making use of a special section in the Federal Housing Act of 1974 which entitled the government to support such builders with loans and guarantees. The pro-active role of senior public servants from the Federal Office of Housing (FOH) was critical to EGW development. Their long-term commitment has been maintained since 1991. Indeed, FOH remains on the Board, alongside senior managers of housing associations, as well as business economists, finance and legal experts.

There are 406 members of EGW, of which 288 have benefited from EGW loans. The EGW decade long zero default rate is largely due to care taken credit assessment and ongoing monitoring. The borrowers must complete an annual questionnaire and also submit independently audited documents such as balance sheets, annual compliance reports and the like. These documents are reviewed by independent experts for internal use by the EGW. Bond rates are tied to investments in specific properties. Loan applications are assessed using conventional mortgage considerations and typically involve a credit check and yield calculation. To ensure public policy compliance, the subject property must comply with affordability, ecology and sustainability Decrees for housing assistance (SECO 2010).

The EGW requirements with regards to financial sustainability of borrowing members are outlined in its regulations (EGW 2009).<sup>22</sup> Bonds are generally secured by mortgages on the title of the financed property. Loans are conditional upon meeting certain principles: Funding as a rule is limited to a maximum of 70 per cent of the capitalised value of yields. A higher limit of up to 80 per cent can be offered if the *additional* 10 per cent is amortised on another bank mortgage during the EGW loan or if other conventional securities can be provided as collateral. These commitments are defined in an agreement between the EGW and the borrower.

The provision of guarantees, including those offered by government, is regulated by the Swiss Code of Obligations (CO). These apply to simple guarantees (CO article

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<sup>21</sup>The Charter for Co-operative and Limited Profit Housing was developed with the Swiss Federal Office of Housing and regional housing sector peak bodies in 2004 (in German) [http://www.wbg-schweiz.ch/wohnbaugenossenschaften\\_schweiz.html](http://www.wbg-schweiz.ch/wohnbaugenossenschaften_schweiz.html).

<sup>22</sup> Eligibility guidelines are available, in German, at: [http://www.egw-ccl.ch/upload/docs/reglemente/EGW\\_Bewilligungskriterien\\_2009-12-04\\_d.pdf](http://www.egw-ccl.ch/upload/docs/reglemente/EGW_Bewilligungskriterien_2009-12-04_d.pdf).



495) and solidarity guarantees (CO article 496), concerning bond issues for specific properties or a group of lenders with a program of developments. As recent requests show, the level of demand for the Swiss housing bonds is very high. Institutional investors, such as pension funds and insurance companies, are attracted to EGW bonds by the Federal guarantee and high credit rating (AAA).

The Swiss stock exchange requires<sup>23</sup> a prospectus for the EGW bonds, which can be sold at CHF 5000 lots to retail investors. The most recent prospectus outlines the conditions of the guarantee and the claims process as follows:

## 5 Guarantee Obligation

The Swiss Confederation provides a federal guarantee to ensure this borrowing requirement and is solely liable under Article 496 Swiss Code of Obligations with the PE. (Translated from German, 2013 EGW Prospectus, series 45, p.7)

A fuller text describing the maximum coverage of the guarantee, related expenses, and the role of the lead bank in representing bondholders is further outlined in a supplement to the prospectus.

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

Once exhausted a new credit line must be opened by the Parliament. As with all Swiss Federal Government initiatives, the EGW is subject to five yearly efficiency reviews (SECO 2010). On the basis of continuing favourable performance, the Swiss Parliament extended EGW's credit facility in 2010 to allow new bonds issues by another 1.4 billion CHFs (with a vote of 109 to 64). The Minister of Economy, the Swiss Union of Cities and the Association of Swiss municipalities were important drivers for the renewed credit cap.<sup>24</sup>

With regards to reporting contingent liabilities, until the mid-90s no provision was made for honouring eventual claims in the annual budget. It was considered that whenever the need should arise, a supplementary credit line could be procured via the Parliament in the running year. However today the policy on reporting has changed and a certain lump sum is included in the ordinary budget.

It should be noted that this provision has not been used since 2003. If losses were to occur, this sum could be utilised without further notification of the Parliament. However, if the losses exceed the budget line a supplementary credit would have to be procured. This is not a special arrangement, rather the contemporary Swiss way of accounting for guarantees and potential payments.

The diagram below illustrates the different layers of security offered by this fund raising mechanism. First and foremost, non-profit associations and co-operatives are required to be financially sustainable as defined above. The second layer of security is the EGW fund, which has accumulated reserves from membership and loan fees charged to borrowers on top of their interest payments. The third layer of security and

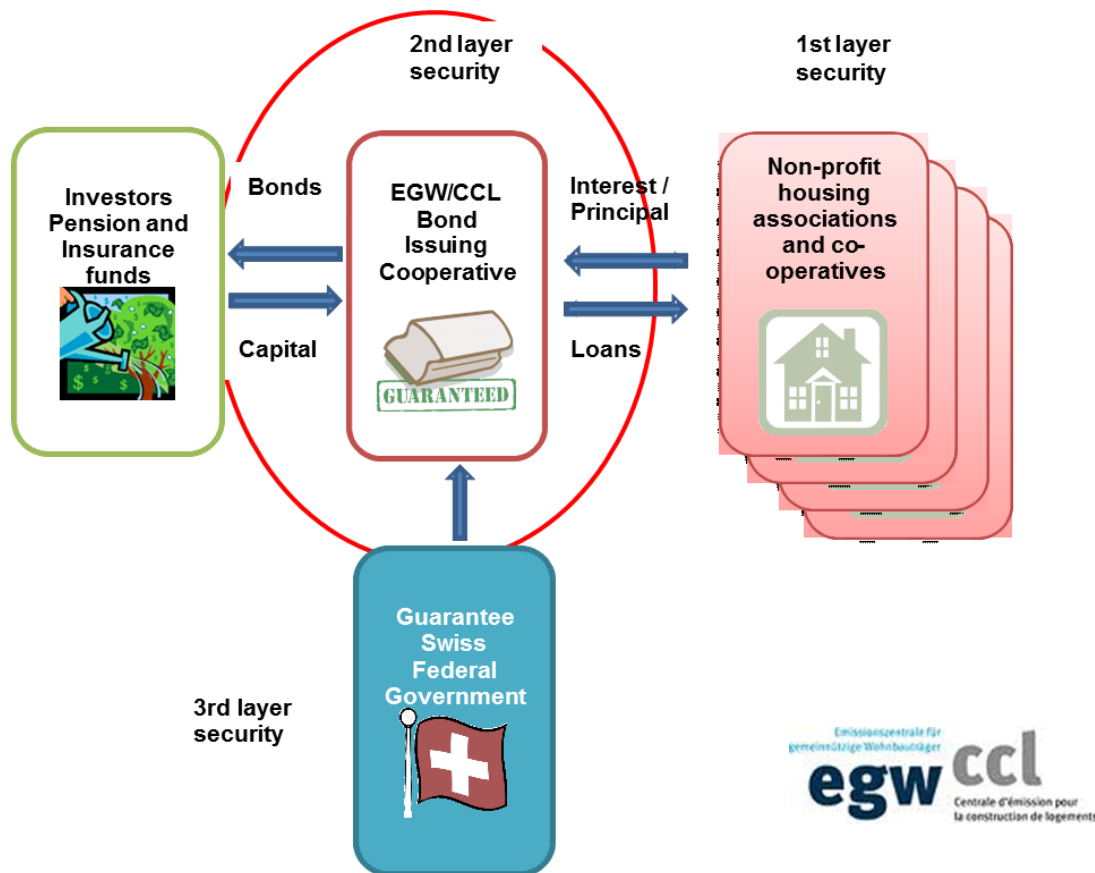
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<sup>23</sup>The Swiss Stock Exchange has a Directive on Guarantee Commitments, where Article 8 requires clear information (and where it cannot be referenced, full text printed in prospectus) as well as information on how any claims against the government can be raised and enforced, available at: [http://www.six-exchange-regulation.com/admission\\_manual/06\\_06-DGC\\_en.pdf](http://www.six-exchange-regulation.com/admission_manual/06_06-DGC_en.pdf).

<sup>24</sup> As reported on the EGW website: <http://www.egw-ccl.ch/index.cfm?srv=cms&rub=461&id=100368>.

the most important in the eyes of investors is the Federal Government guarantee, which backs EGW coupon payments, as illustrated below.

**Figure 2: Structure of the Swiss Bond Issuing Co-operative EGW**



EGW loans comprise up to 70 per cent of the investment requirements of not-for-profit developments. Managing yield expectations and interest costs is therefore critical to affordability and supply outcomes. The first ever EGW bond issue in 1991 raised funds at considerably lower rates than then commercial lenders were offering (with a discount of 3–5%). The first bond issue raising CHF 85.1 million was issued in 1991 for a running period of 10 years. In the 1990s, the market conditions for bonds were more favourable than bank loans of the same maturity. The EGW has now issued CHF 4.49 billion CHF in a series of 63 bonds and placements (as of March 2013). Since that time, lending rates for the non-profit housing sector via the EGW have consistently matched the very low rates for Government Bond issues.<sup>25</sup>

Alongside the guaranteed loans financed by EGW bonds are also commercial loans and important 'equity like' loans from a Revolving Fund (RF). This fund dates from 1975 and is funded through periodic contributions by the Federal government. It is administered by the umbrella organisations of the housing sector themselves and provides low interest loans of CHF 30–45 000 per dwelling at currently 1.5 per cent covering around 5–8 per cent of the projects financing needs. In 2013, the RF totals about CHF 400 million and will be expanded gradually to CHF 500 million by 2016. This limit has been fixed by the Parliament in accordance with the governing majority's wish to phase out housing subsidies altogether. However, given the new

<sup>25</sup> See graphic comparing Government 10 Year Bond Yield and EGW 10 Year Bond Issues 2005–13 [http://www.egw-ccl.ch/upload/docs/diverse\\_unterlagen/EGW\\_Renditeverlauf\\_Bundesobligationen\\_2013-03-25-d.pdf](http://www.egw-ccl.ch/upload/docs/diverse_unterlagen/EGW_Renditeverlauf_Bundesobligationen_2013-03-25-d.pdf).

tensions on the housing market it is anticipated that new allotments will be negotiated in the years ahead. Part of the proceeds on interest can be used to cover the expenses of the fund management while the remainder must be remitted to the treasury. More about this fund can be found on the official website<sup>26</sup> and in Lawson, Gilmour and Milligan (2010).

The following paragraphs focus on the activities of the EGW.

Demand for EGW bonds are highly sought after, according to independent and official government evaluation (SECO 2010). It is particularly strong<sup>27</sup> amongst pension and insurance funds (99%) and EGW bonds are sold within moments of issue. Sometimes private placements are made with a single investor. On average about four EGW bond issues with prospectus or private placements are made each year. As with all issues in Switzerland, publicly launched bonds are offered in 5000 CHF lots and have a prospectus which specifies the guarantee. As mentioned above with this guarantee, the bonds are rated AAA (ZKB) and since 2003 have a zero default rate.<sup>28</sup> It cites the most recent rating of EGW as AAA, being equivalent to the Swiss government.<sup>29</sup> ZKB attributes this rating to the multiple safeguards built into the system as listed below:

- Commitment to financial reporting and the internal rating system.
- Sound business model, reviewed by independent experts.
- Co-financing (by revolving funds, land).
- Existence of government guarantee.

The lead bank for EGW bonds is also the Zurich Cantonal Bank, which has firewalled rating and investment divisions. The current financial status of the EGW is summarised below in Table 7.

**Table 7: EGW—Key financial indicators (in CHF)** <sup>30</sup>

Indicator	Year	2009	2010	2011
Total assets (million)		1856	1945	2008
Bonds issued (million)		1546	1523	1565
Private placements (million)		254	364	401
Cash and cash equivalents (million)		20	17	21
Securities / investments (million)		16	20	21
Equity (million)		3.6	3.9	4
Provisions (million)		14	15	16
Net income (million)		1.3	0.2	0.04

Source: Zürcher Kantonalbank (ZKB) 2012, p.1

<sup>26</sup> The official website for this fund is <http://www.wbg-schweiz.ch/finanzierung/darlehen.html>.

<sup>27</sup> As in Australia, there is significant unmet demand for highly rated bonds, even those offering a very low yield (even 0%). Financial institutions are required to hold high quality assets in order to meet Basel II and III regulations.

<sup>28</sup> The EGW bonds are officially rated by the research department of the Zurich Cantonal Bank, which rates all bonds which are offered on the domestic Swiss market (Moody's and WSW rate bonds with a global market).

<sup>29</sup> Swiss rating of EGW bonds is AAA for a risk assessment report in German. See [http://www.egw-ccl.ch/upload/docs/diverse\\_unterlagen/EGW\\_ZKB\\_Rating\\_EGW\\_2012\\_d.pdf](http://www.egw-ccl.ch/upload/docs/diverse_unterlagen/EGW_ZKB_Rating_EGW_2012_d.pdf) A translation of this report is provided in the Appendix.

<sup>30</sup> 1 CHF= AUD 1.08 on 30 May, 2013.

The operational model of the EGW is very efficient, enabling it to maximise the interest benefit from low yield bond issues to not-for-profit co-operative. It contracts out specialist financial and legal services to third parties and hence, the EGW itself employs no staff. Rather its activities are managed by a professional board to which a review committee reports. All financial administration is entrusted to a private law office on a fee for service basis. It is estimated that this firm dedicates two to three full time staff to EGW requirements.

Only members paying a modest membership fee (CHF 200) can participate in and benefit from EGW issues. In the establishment phase of the EGW a project examination fee from members interested in bond proceeds was also required. EGW reserves are now sufficient to cover this cost and the examination fee has been abolished.

The administrative costs stemming from the bond coupon are recovered by the lead bank to service investors. Costs arising from the legal and financial services provided by the contracted firm are attached entirely to the loan. They also include a small provision (0.15%) for non-paid interest. As mentioned above, the purpose of this fee is to enable the EGW to make up for any potential arrears of payment or downright insolvencies over one year, being the 'second line of defence'. This is considered a sufficient period before any claim can be made on the Government Guarantee. It is important to note that no claims have been made on the Federal government guarantee since the passage of the new housing bill in 2003.

For housing providers, the proof of the pudding are the conditions (interest and costs) of the loans the EGW provides.<sup>31</sup> These have closely matched government bond rates and always been considerably cheaper than fixed-rate mortgages with comparable maturities. Of course, bond rates depend on market circumstances and the characteristics and rating of the pooled housing providers. An independent review of EGW by the federal economic department (SECO) in 2010 found that it reduced interest rates on similar standard mortgage loans by 1 per cent. Further, interest is payable quarterly and fixed interest bonds have promoted stability in rent levels, since non-profit housing entities apply in general the cost-rent principle.<sup>32</sup> Observance of the cost-rent principle which lies at the root of the EGW induced stability of rent levels in the social housing sector.

Key financing indicators are the interest rate for fixed-rate mortgages with the same maturities, all-in-costs of EGW bonds, the interest rate on the EGW bonds and the volume of EGW-bonds issued over time. This information is provided on the EGW website (in French and German).<sup>33</sup> In 2011 the HSBC bank compared a range of government guarantees including the EGW and found that EGW offered significant pass on benefits to borrowers, marginally above Swiss Government bond issues of a similar duration (CECODHAS/HSBC/Gay Guggenheim, 2011). More detail on EGW bond issues is provided in Appendix 3.

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<sup>31</sup> A detailed table of bond issue interest, all in costs, loan interest is provided for 2004-2013 on [http://www.egw-ccl.ch/upload/docs/diverse\\_unterlagen/EGW\\_Konditionen\\_ausstehende\\_Anleihen\\_2013-03-25-d.pdf](http://www.egw-ccl.ch/upload/docs/diverse_unterlagen/EGW_Konditionen_ausstehende_Anleihen_2013-03-25-d.pdf).

<sup>32</sup> In Switzerland, rents are pegged to financing costs but not to the mortgage rates of individual landlords. The mortgage reference rate (MRR) used is an average interest rate calculated by the National Bank and published by the Federal Housing Office in three month intervals.

<sup>33</sup> The original (in German) is published online at: [http://www.egw-ccl.ch/upload/docs/grafiken/EGW\\_Entwicklung\\_Anleihevolumen\\_und\\_Zinssatze\\_2013-03-25-f.pdf](http://www.egw-ccl.ch/upload/docs/grafiken/EGW_Entwicklung_Anleihevolumen_und_Zinssatze_2013-03-25-f.pdf).

### 3.3 French Mutual Fund for Guarantees of Social Housing<sup>34</sup>

In France, the Caisse des Dépôts et Consignations (CDC) provides 70 per cent of the finance required by social housing companies building and managing low to moderate income housing<sup>35</sup>—including the Habitation à Loyer Modéré (HLM). The very important CDC acts as a financial intermediary which pools the deposits of specific low interest tax free savings accounts ‘Livret A’ and invests these deposits in very long-term (15–35 years) low interest loans for social and economic infrastructure, such as social housing. These highly regulated loans from savings deposits must be guaranteed by government, and is a requirement of all funds derived from the CDC.<sup>36</sup> Default rates are very low, almost zero.

HLM loans are typically guaranteed by local authorities, which in return receive allocation rights,<sup>37</sup> but when this is not possible (in 3% of cases<sup>38</sup>) by the Mutual Fund for Guarantees of Social Rented Housing known as the *Caisse de Garantie du Logement Locatif Social* (CGLLS). The CGLLS fulfils two main functions:

- Guarantees the loans of HLM when local authorities cannot (or do not want to) or when their signature is not agreed by CDC because of their financial situation.
- Assists HLMs to recover when these are in difficulty; estimated to be 11 per cent of HLM (CGLLS 2013).

Combined, these tasks reduce the default rate of HLM loans, including financially weaker HLMs, to zero.

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<sup>34</sup> Many thanks to CGLLS’s director, staff and the Special Adviser to the National Council of Cities and former Chief Economist for the CDC for input and detailed feedback on this section.

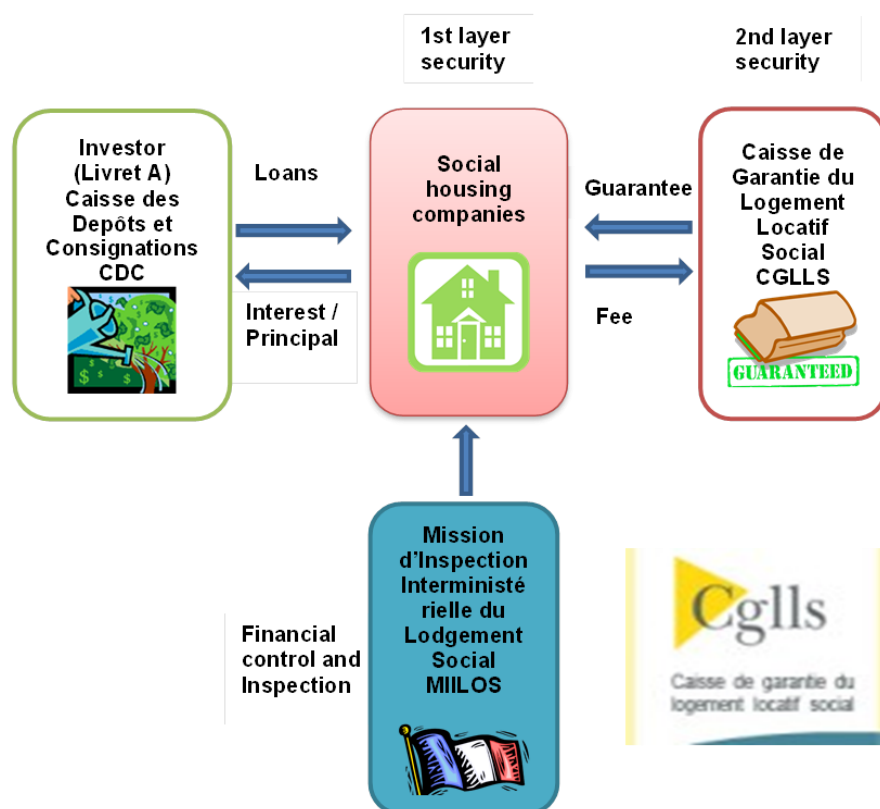
<sup>35</sup> There are at least four ‘families’ of social housing in France: including co-operatives, public companies, private not for profit companies and mixed enterprises.

<sup>36</sup> The French Treasury requires all loans issued from the CDC using ‘Livret A’ deposits to be guaranteed by the state.

<sup>37</sup> A guarantee from an LA often comes with tenant allocation requirements, e.g. to address local waiting lists. By law, LAs are required to have at least 25 per cent of social housing in their areas, yet this is resisted by many LAs.

<sup>38</sup> This occurs when a local authority lacks the credit capacity to back the CDC loans or because the LA lacks the political will or the technical, financial resources to do so. It may also resist development of social housing and the accommodation of certain types of households in their local area.

**Figure 3: Structure of the French Mutual Fund for Guarantees of Social Housing CGLLS**



The CGLLS assists with the financial recovery of weaker HLMs by strengthening their financial capacity, risk monitoring and professional skills. Alongside professional management training, organisational development and, if necessary, re-organisation the CGLLS also provides guarantees. To prevent any call on the guarantee, CGLLS provides loans or grants to providers struggling to pay off any losses and also undertakes significant re-organisational measures to return these organisations to an operating balance.

Beneficiaries of the guarantee include registered HLMs, joint venture companies providing social housing, as well as registered government approved organisations who contribute to housing for disadvantaged persons<sup>39</sup>. The guarantee ensures that when the borrower defaults, the CGLLS agrees to meet payment deadlines at the request of the lender.

Guarantees may be extended from two to 50 years depending on the approved loan beneficiaries and specified purposes. There are specific types of loans, sourced from the CDC, which are permitted to be guaranteed by CGLLS and these are specified by government Decree<sup>40</sup>. CGLLS only guarantees PLUS and PLAI loans of 40–50 years for social housing (HLMs) and very low income rental housing (HLMs and private landlords) (Scanlon & Whitehead 2011). Various property and consumption tax exemptions also apply to eligible borrowers.

<sup>39</sup> Article 3, Decree of 18 March 2002 on the guarantee fund of the guarantee fund of social rented housing from <http://www.cglls.fr/Mediatheque/Fichiers-PDF/Nos-garanties/Arrete-du-18-mars-2002-relatif-au-fonds-de-garantie-de-la-CGLLS>.

<sup>40</sup> Guarantee-able loans by CGLLS under government Decrees 2002 and 2006 <http://www.cglls.fr/Garanties/Conditions-d-octroi/Prets-garantissables-par-la-Cglls>.

In addition to the assessment made by the CDC, MIILOS (*Mission d'Inspection Interministérielle du Lodgement Social*) offers an important method of financial control of social housing in France and has significant powers. It inspects around 200 social landlords per year and each social housing body every five years auditing their accounting, financial, social, technical and administrative activities. Sanctions issued by MIILOS vary from recommendations to improve management practices, to dismissal of the board. In recent years, emphasis has been placed on conditionality in financial support, strategic asset management and preventing the misallocation of grants. When facing serious financial problems, landlords can be forced to merge with stronger ones (Lawson et al. 2010, p.20).

Provision of a guarantee backing CDC loans requires written risk analysis, both in terms of the financial health of the organisation and the balance of the transaction. In some cases, the guarantee is provided where the debt is secured by a legal first mortgage or other collateral. CGLLS works in concert with MIILOS and CDC to ensure guarantees are appropriately allocated and compliant.

CGLLS is a publicly owned and administered specialised financial institution, financed by taxation deducted from the almost 800 social rental housing companies, and was created in 2001.

As a specialised FI it is subject Basel II and III debt to assets ratios, like any bank. CGLLS must report to the French Banking Regulator on its solvency ratio and division of risks. As with the Dutch WSW, at least 0.25 per cent of loaned capital is set aside in a reserve fund. Further it is not possible to guarantee more than 0.25 per cent of CGLLS equity to any single social housing company or group of companies. The current solvency ratio is 0.34 per cent, very high due to the quality of its equity.

The CGLLS is supervised by three French ministries: Housing, Economy and Treasury under a Code of Construction and Housing. It has a government nominated board (extendable three-year term), supported by expert committees specialised in the administering, auditing and re-organisation of the HLM sector and managed by an Executive Director. The board has seats representing the government (4), representative social housing bodies (4), one additional qualified expert and the director of the National Agency for Urban Review (ANRU). The Government plays a key role in approving the decisions of the board, including its budget, financial statements and the financial assistance it provides to the HLM sector and ensures compliance with laws and regulations governing the operation of the CGLLS. The current default rate on CGLLS loans is zero (since 2008), due to the preventative and pro-active activities of the fund, but it has been higher in the past (4%).

The CGLLS produces its own accounts and has its own taxation sources (see below). For this reason, CGLLS assets and liabilities do not form part of the government's budget and debt. However, the French government has a strong and increasing role (e.g. in urban policy) in the governance of the CGLLS. Further, Eurostat norms are increasingly broad in their definition of general government debt and could in the future encompass CGLLS. This of course would have an impact on France's debt ratios. Currently the obligations of CGLLS (with a stock of €3 billion of guarantees) are not required to appear in the government accounts and the equity of the CGLLS is sufficient to back the obligations issued. If the government were to take over CGLLS it would affect their European debt ratio and for this reason the French government does not do so.

The CGLLS has two main sources of revenue, these are taxes are paid by the landlords based on the income in the accounts of the HLM companies, and fees of 1.40 per cent of their rent revenue. A further fee is paid by peak bodies. Together



these contributions make up three quarters of the required resources to operate CGLLS. The remainder is derived from guarantee fees as explained below, and interest on investments made by CGLLS.

HLMs benefiting from loans with a guarantee pay a commission to CGLLS. The amount of this fee depends on the nature of the loan (0% of the guarantee amount for 'very social' CDC loans, 0.5% for bridging loans and 2% of the amount of collateral for other loans guaranteed by CGLLS). The guarantee fee due to CGLLS is imposed by the CDC during the disbursement of the loan and returned to the CGLLS.

The role of the CGLLS has increased significantly since 2001, doubling activities in 2011. This has largely been due to the increasing number and volume of loans issued by the CDC as an economic stimulus measure post 2008. In 2011 CGLLS loan guarantees for new construction and improvement totalled €248 million up from €178 million in 2010, an increase of 39.6 per cent. The number of organisations benefiting from a guarantee also rose from 67 in 2008 to 95 in 2011. This increase should be seen in the context of LA guaranteed CDC loans for social housing which jumped from €4 billion to €10 billion during the post GFC period, with a total production of 80 000 units (Schaeffer, interview notes, 2013).

In terms of housing projects, the CGLLS contributed to the construction, acquisition, improvement and rehabilitation of 7032 units in 2011 (against 4516 units in 2010), being an increase of 55.7 per cent (CGLLS 2011). There has also been an increase in the proportion of loans for very social and social housing dwellings supported by the guarantee as well as new eco-loans to enhance the energy efficiency of social housing.

### **3.4 Irish Housing Finance Agency**

Social housing in Ireland has predominantly been provided by Local Authorities with 100 per cent public loans and subsidies for capital costs. Since the 2007–08 financial crises, efforts to reduce the share of public investment and necessarily increase the role of private finance via off public budget voluntary housing bodies (VHBs) have accelerated.

As an established and efficient aggregator of borrowing demands for Local Authorities, backed by the Irish government, the HFA is now extending this role to VHBs. VHB share many similarities with Australian CHOs. There are 27 000 units, most of which were formerly 100 per cent grant funded providing low income and special needs housing. This small and emerging sector is the preferred sub-sector for future social housing provision, as a vehicle to harness private investment. Stock transfer of LA housing to VHBs is on the policy agenda. Regulation and capacity building is considered critical in this process and a new regulatory code has recently been launched. Adoption is currently voluntary but anticipated to become mandatory soon. There are calls for a predictable policy and funding stream in an era of economic volatility. Currently, the guarantee is only available to LA housing providers and is not extended to VHBs.

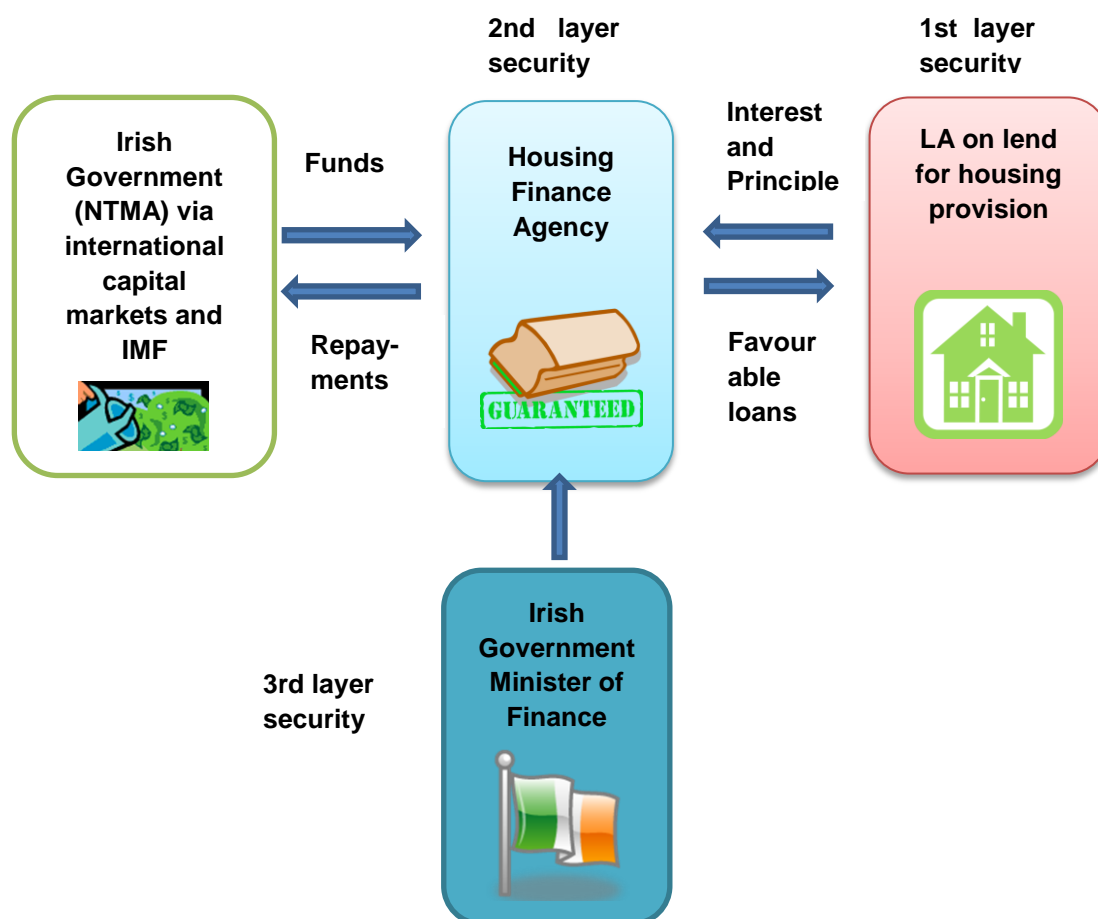
The ongoing purpose of Ireland's Housing Finance Agency plc (HFA) is to contribute to the fulfilment of Irish housing policy, which aims to enable every household to have available an affordable dwelling of good quality suited to their needs, in a good environment and, as far as possible, at the tenure of their choice. The HFA does not formulate housing policy but facilitates access to more favourable loan finance for government schemes and projects which promote these aims.



Since 1982, the HFA has raised short term funds on the international capital markets<sup>41</sup> for longer term investments in local authority (LA) housing and related infrastructure and most recently voluntary housing bodies (VHBs).<sup>42</sup> As a specialist financial intermediary it aggregates loan demands, raises and structures finance to lend to LA and VHBs as annuity mortgage loans for affordable home ownership, shared ownership, rental finance and loans for social housing schemes. The Agency also provides finance for housing maintenance and certain community-enhancing projects provided by local authorities.<sup>43</sup> The goal is to lower borrowing costs for these organisations, in order to facilitate government housing policy and make declining public subsidies go further. In the long term is hoped that lenders become more familiar with investments in affordable housing and a commercial markets grows to serve its needs. In the mean-time, the HFA acts to deepen market access, increase lending volumes and improve loan terms and conditions.

The role of the HFA illustrated by Figure 4 below.

**Figure 4: Structure of the Irish Housing Finance Authority and Guarantee**



<sup>41</sup> Until 2011, the HFA raised funds via the state guaranteed eurocommercial paper program (ECP), its Guaranteed Notes Program and Note Issuance facilities (NIFs).

<sup>42</sup> See Section 11 of the Housing Finance Agency Act 1981 concerning a guarantee: [http://acts2.oireachtas.ie/zza37y1981.1.html#s4\\_p1](http://acts2.oireachtas.ie/zza37y1981.1.html#s4_p1).

<sup>43</sup> See official website: <http://www.hfa.ie/hfa/Live/Release/WebSite/HomePage/index.html>.

The total amount that can be raised by the HFA has been amended several times and is currently capped at €10 billion.<sup>44</sup> In 2011 the HFA loan book was €4.36 billion. Since the financial crisis, the Irish Government has no longer been active in international capital markets and funds for the HFA have been allocated from the EU/IMF Program of Financial Support for Ireland, via the National Treasury Management Agency (NTMA).

The NTMA, which borrows on behalf of the Irish Government, also borrows on behalf of the HFA and hence the HFA's short term credit rating is linked to the Irish Sovereign's, which according to Moody's is P2 on Euro Commercial Paper (ECP) program. Due to the government's unfavourable rating and consequently poor borrowing conditions<sup>45</sup> an alternative source of floating rate funding was provided through the multilateral EU/IMF Programme of Financial Support for Ireland via the NTMA and remains in place today until end of 2013. Any change in source depends on the prospects for Ireland's independent self-funding.

The HFA does not lend to individuals directly, but rather block lends to local authorities, and they in turn lend to individuals and projects. Local authorities use HFA finance to provide bridging finance, loans for land acquisition, capital loans and related capital infrastructure (water, waste, environmental utilities). All loans to LAs are guaranteed by the Minister for Finance. The target group for housing and related projects are low income home owners, tenants and people with support needs. As mentioned, since 2011, the HFA has lent directly to approved VHBs.

The HFA is a publicly limited company with all shares owned by the Minister for Public Expenditure and Reform (PER). It has a professional board with directors appointed by the Minister for the Environment, Community and Local Government, with the consent of the finance minister. It provides annual audited accounts to the Minister for the Environment, Community and Local Government as well as quarterly and half year unaudited reports, which are forward to other relevant Ministers concerned with public expenditure and finance. Accounts are produced according to Generally Accepted Accounting Principles and externally audited by KPMG. The HFA has a professional board and a staff of 11. The current chair of the board and CEO were interviewed for this report.

In the context of EU policy on State Aid and to secure greater certainty for the tasks of the Housing Finance Agency, the Irish government sought and gained a decision from the European Commission that these tasks conformed with Article 86 (2) of the EC Treaty on State Aid in 2004. (EC 2004)

The HFA is self-financing. It does not receive any grant from Treasury and is funded by adding a small margin to the cost of loans to cover its own operating and risk costs, which is about 0.0035 per cent of the loan amount. The HFA sets loan interest rates at a level that enables it to achieve a break even result.

Aggregation allows the HFA to lend for new social housing at interest rates of 3.25 per cent, well below that for similar loans on the open market (5–6% and above), with LTVs of 70–80 per cent of NPV. A recent fixed rate facility for €100 million for VHBs has been negotiated at less than 7 per cent, which is competitive with rent-to-buy loans on the open market.

Commercial lending is almost non-existent in this area and typically 2 per cent higher than HFA rate but limited market for commercial lending makes comparisons difficult.

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<sup>44</sup> This is regulated by the Housing (Miscellaneous Provisions) Act 2009 which sets a borrowing limit of €10 billion, up from €6 billion in 2004.

<sup>45</sup> The rating is currently BBB+ and stable for both Moody's and Fitch (NTMA 2013).

Rigorous evaluation of the HFA's impact on the cost of lending for LAs and VHBs has not been conducted nor is it a requirement of government (as in Switzerland every five years). The HFA has responded to the changing demands of the Irish governments housing policy (including the shift towards VHB provision and direct lending) and public sector accounting requirements.

For VHBs market savings are achieved via the intermediating and aggregating role of the HFA, without which most VHBs would not be able to access private funding. The very small proportion of HFA loans provided to VHBs, being private bodies, do not attract a guarantee and are therefore more expensive than LA loans (obtaining rates as low as 2% with the guarantee).

Organisations eligible for loan funding must be approved by the Minister for the Environment and Local Government and include local authorities and more recently voluntary housing bodies (VHB). VHBs operate on a non-profit basis and serve the housing needs identified in local authority assessments. The minimum criteria for eligible VHBs to apply for HFA loans include:

- Evidence of at least three years' operation of projects under the Capital Loan & Subsidy Scheme.
- Acceptable legal form (company, co-operative, society).
- Three years' audited financial statements.
- Current Tax Clearance Certificate. (HFA 2013)

The extension of loans to VHBs in 2012 has required the HFA to design and implement additional credit risk policy, assessment and monitoring procedures. VHBs are now assessed for their suitability for lending via a Credit Committee, which ensures all loans are within policy requirements and meet documentation standards.

By December 2012, the HFA received 18 applications for loans from VHBs and following financial assessment and due diligence, only six organisations were permitted to receive loans totalling €22.57 million (HFA 2013, p.15). The HFA plans to increase the range of products and services suitable to this segment, and has recently negotiated a €100 million facility which can be drawn down by eligible approved VHBs.

To date no LA or VHB has defaulted on its loan obligations, thus the default rate for the HFA is 0 per cent. This low rate, the HFA argues, is due to the careful risk assessment of all funding applications which minimises any potential call on the government guarantee. All loans issued by the LAs are directly accounted for in the government budget. The contingent liability cost of the guarantee (based on a 0% default rate) is not explicitly noted in the government accounts.

According to the HFA, the principle obstacle to greater participation by the Irish VHB sector in the HFA is the emerging nature of the sector, some of which lacks financial management capacity and borrowing experience. Importantly, a more regulated sector, with standardised financial reporting and a strong history of good management and financial performance, would greatly improve investment conditions. The HFA believes it can play an important role in facilitating a more 'investment ready' sector in the future.

### **3.5 Emerging guarantee schemes in the UK**

Financial intermediaries aggregating the borrowing demands of small registered social landlords are already an established feature of the social housing finance system in

the UK.<sup>46</sup> Yet until recently, these loan aggregators were not guaranteed bond issuers and hence were 'only as strong as the credit worthiness of their weakest member' (Gibb et al. 2013, p.52). Since June 2013, the Housing Finance Corporation has been licensed to issue guarantee on the government's behalf.<sup>47</sup>

In the context of major cuts to public expenditure on affordable housing and a deep decline in housing construction, governments in the UK are developing new additional mechanisms to attract private investment.

Recently guarantees have been considered a necessary feature of the UK social housing finance system. While banks had previously considered registered social landlords (RSLs) a sound long-term investment, commercial lending conditions changed dramatically after the GFC and new banking regulations inhibit long-term lending.

The UK social housing sector has been forced to address their borrowing needs more directly via the institutional sector. Some RSLs have successfully raised finance via the bond issues with major investors being pension funds and insurance companies, which account for 75 per cent of private financing of housing associations in 2012 (Homes & Communities Agency 2013, in Pawson & Milligan 2013, p.8). According to Gibb et al. (2013, p.51) bond finance clearly works for non-profit housing providers and since the beginning of 2012 more than £1 billion of funding has been raised.

As capital grants for RSLs diminish there has also been a substantial shift in government policy concerning the role of government guarantees. In their submission to the Montague review the National Housing Federation (NHF) recommended that:

Government support and underpinning of a pilot housing investment fund run by housing associations, would enable the development of mixed tenure sector schemes at scale and would attract investors and create confidence in the market hopefully acting as a prelude to it increasing in scale. Housing associations could reach an agreement with government around underpinning the risk and guarantee on investor return, but the clear backing and support of government would attract and reassure investors and government could play a role as broker. (NHF 2012, point 7.6)

### *3.5.1 Affordable and Private Rented Housing Guarantee Schemes*

In September 2012, the DCLG announced debt guarantee schemes for both affordable and private rental housing. HM Treasury has been instrumental in the design of a scheme that involves debt guarantees to underpin up to £10 billion investment in rental housing. It aims to open up access to long-term finance (up to 30 years), and to reduce the cost of finance to a small margin above British government bonds (gilts). DCLG also announced a related revolving fund to contribute development finance for construction in the private rental sector, outlined at the end of this section.

The UK guarantee schemes aim to secure 'investment finance' rather than more risky development finance. In order to limit Government exposure, guarantees will cover only 80 per cent of scheme borrowing. Thus, the investing organisation will need to contribute 20 per cent of its own equity. This will provide a substantial cushion or buffer against the possibility of the guarantee being called.

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<sup>46</sup> The Housing Finance Corporation (THFC) was the subject of a detailed case study for the WA government (Gilmour et al. 2013).

<sup>47</sup> Developments are moving fast in this area and readers are encouraged to view the presentation by Piers Williamson to the think tank for the research project, made 29 October 2013 available on the project website.

There are two versions of the scheme—one for affordable housing (AH) and one for the private rental sector (PRS). They differ in terms of minimum size threshold—for AH £5 million, and for PRS £10 million. The basic aim of the threshold is to encourage larger schemes from which scale economies can be derived, but the AH threshold is lower so as to facilitate the possible participation of smaller HAs.

For the affordable housing schemes the guaranteed debt will be secured against organisational assets, just as in the case of regular borrowing. For PRS schemes, the lender will take security on the funded scheme only.

The PRS guarantee will be available for draw down only at the point of scheme completion (in line with the intention to facilitate long-term investment rather than underwriting the development phase). For affordable housing projects it will be possible to invoke the guarantee from the point at which the scheme is approved. Important here is the expectation that the guarantee will provide access to ‘cheaper money’, hence suppressing total scheme costs to minimise the call on grant—in line with the Ministerial priority to further reduce affordable housing grant rates.

As mentioned above, the UK government guarantee program is significantly different from the Scottish NHT model. The affordable housing variant of the UK scheme is linked with grant-aided schemes under the Affordable Rent program. Guarantees can extend over a 30-year period, depending on the duration of the relevant loan term. The timescales for submitting schemes are extremely demanding. Interestingly, the scope of the scheme (PRS variant) is UK wide, so could potentially stimulate PRS investment in Scotland.

The recently announced ‘build to rent’ revolving fund plays an important role in riskier development finance. The fund capped at £1 billion, is to be allocated amongst successful bidders for project development costs. It is a revolving facility, through which it is envisaged that government will be eventually repaid when schemes are refinanced by developing agencies or sold to investors. However, the funds may be outstanding for up to 10 years, since the ‘drop dead’ date is not until 2025. To date most have been (consortia of) housing associations with developers. Allocations totalling £700 million were announced in April 2013 providing 30–50 per cent of the project costs. Forty-five schemes were supported which intend to generate 8000–10 000 homes, mostly in London.

In addition to the provision of a guarantee, a financial intermediary aggregates smaller loan and guarantee demands, to raise required funds and then on-lend these to investing agencies. Following a tender process in April 2013, The Housing Finance Corporation (THFC) was selected and licenced to provide guarantees for affordable housing under the scheme. The first scheme to be supported involves a group of 20 housing associations in Wales, who have combined to raise £32 million via the THFC with the guarantee. Notably, the consortium of providers also raised institutional investment of £98 million from institutional investor M&G. According to media reports, the guarantee offers consortia the cheapest means of raising funds. However, the government’s terms and conditions are viewed by some as onerous, requiring landlords to commit a high level of properties as security and borrow a minimum of £5 million. This is considered too high by some smaller organisations.

It is worth following the progress of this scheme in order to understand the impact of conditions, fees and commissions on the cost of borrowing. These features are important design considerations when developing a guarantee scheme.

The role of intermediaries in this scheme is very interesting. THFC is a non-profit financial intermediary which serves small and medium sized Registered Social Landlords in the UK. It has been ascribed a credit rating of A+/Stable/A-1 by Standard

and Poor's (2012), based on their assessment of the following strengths and weaknesses.

**Table 8: Attributes of the Housing Finance Corporation (UK)**

<b>Strengths</b>	<b>Weaknesses</b>
Strong franchise value supported by growing demand for its services.	Modest liquid financial resources that heighten liquidity risk.
Strong support from the U.K. government, which underpins borrower creditworthiness.	Exposure to a single sector, with borrower-concentration risk.
Match-funded approach minimises asset-liability risk.	Vulnerable to operational risk stemming from small staff numbers and key personnel risk.
Robust collateralization of loan book.	

Source: Ratings Direct, Standard and Poor's, December 2012

Since June, the THFC has taken responsibility for the vetting and due diligence needed to provide assurance that submitted projects meet viability and other essential requirements. It has established a special purpose entity Affordable Housing Finance PLC to channel funds to RSLs. It aims to use funds sourced from the European Investment Bank (EIB), which is currently appraising THFC's application for GBP 500 million to fund the Affordable Housing Guarantee Scheme to be run via Affordable Housing Finance PLC, in conjunction with GBP 450 million in supporting UK government grants. These scheme aims to support up to 30 000 new affordable homes to rent by 2015 (EIB 2013).<sup>48</sup>

According to interviews for this study, exactly how the guarantee will score in the public accounts is still being finalised. A draft guarantee agreement was not yet publicly available at the time of writing. However, it is anticipated that documentation will become available as the scheme allocates guarantees.<sup>49</sup>

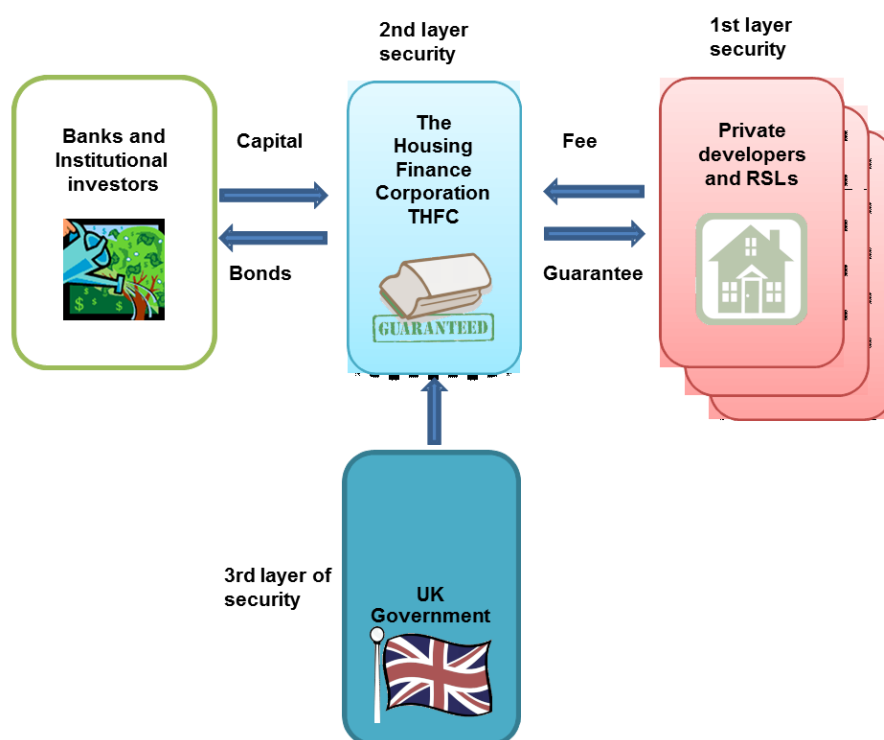
DCLG modelling work suggests that the real risk of guarantees being called is close to zero. On this basis it is being argued by DCLG that it would be legitimate for the scheme to be entirely 'off the books'. It is anticipated that, at the very most, the scheme will be shown in the accounts as a small 'contingent liability' which factors in the low risk of a call on its resources.

Similarly, the Build to Rent fund is classed as a 'loans and equity' instrument which—as a repayable loan—is not expected as being recorded as public spending. However, public accounting treatment of both instruments has yet to be determined, and a judgement will emerge only through on-going negotiations involving Treasury, ONS and Eurostat. Again, the results of these negotiations will be reported UK experts during the up-coming think tank for this Project.

<sup>48</sup> The CEO of the THFC will be present the details on the guarantee to our research think tank on 29 October 2013, and this presentation will be uploaded onto the project web site from November 2013, see <http://www.ahuri.edu.au/publications/projects/p53019>.

<sup>49</sup> As above.

**Figure 5: Structure of the UK Guarantee for Private and Affordable Rental Housing**



The UK guarantee scheme is significantly different from the Scottish variant below.

### 3.5.2 Scottish government's National Housing Trust

Since 2010 the Scottish Government has been travelling down another guarantee path with its National Housing Trust (NHT). This guarantees Local Authority investment in affordable rental joint ventures. The impetus behind the NHT was the perception that tight credit conditions were likely to prevail. Initially, the aim was to rescue unsold (completed) or stalled schemes. However, the time required for the scheme to establish meant that it now focuses on new joint venture projects. In September 2012 a new variant of the National Housing Trust scheme was launched offering guarantees to housing associations participating in joint ventures. This scheme commenced in 2013 (Scottish Government 2013).

The Scottish Government has no borrowing powers and the model requires the utilisation of local authority borrowing capacity (Public Works Loan Board, PWLB). It offers a selective conditional guarantee which protects the LA against loss due to inadequate rent revenue or sale proceeds involved in the joint venture. Rental properties are sold after five to 10 years.

The original NHT model is based on the concept of a joint venture between local government and private developers. Rental developments are funded by loans from the councils, alongside private sector loan finance and equity. NHT properties are offered with starting rents beginning at or below local housing allowance ceilings. After five to ten years the properties will be sold, with the sale proceeds used to repay loans, recoup any calls on the Scottish Government guarantee and potentially earn a return for the private sector on its equity investment. A Scottish Government Guarantee covers the principal risks to the council partner, being loss due to vacancies or reduced rent and any capital loss on resale (ibid.).

As mentioned above, the NHT scheme was conceived to address market weakness and credit crunch conditions, a time when developers are interested in joint ventures

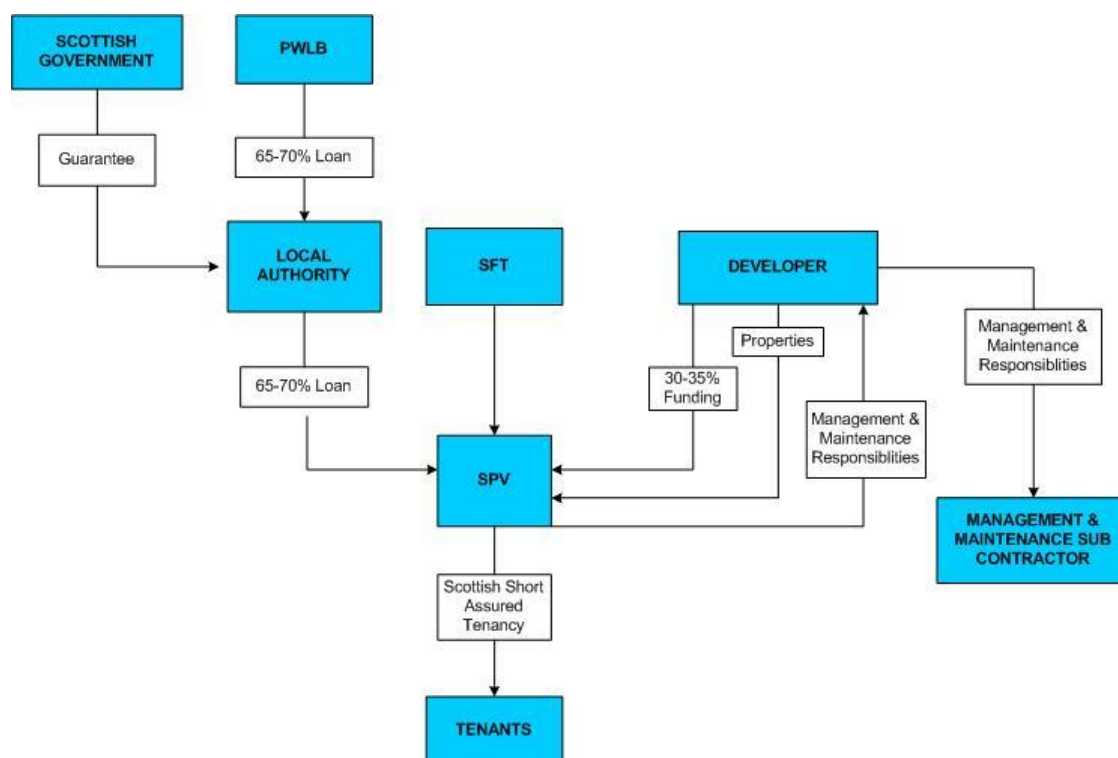
with the public sector. In this way it could be seen as a complementary mechanism to developer contributions to affordable housing development secured through the planning system—a measure more successfully invoked in periods of stronger housing market activity. Relevant to this point, most Scottish local authorities (LAs) have accepted that NHT schemes can be counted towards developers' affordable housing contributions.

When properties are sold after five to 10 years it is assumed that this may be to tenants in residence at the time (although there will be no discount on market value). If it becomes operational, the variant scheme developed for partnership with housing associations (instead of local authorities) may result in the homes being taken into HA ownership at this point—via refinancing (possibly through institutional investment).

The scheme has proved much more attractive to LAs in more pressured housing markets in the East of Scotland—presumably because of the higher market rent levels prevailing in these areas and higher demand from potential tenants (less risk of properties proving unlettable). Because of the expectation that properties will be let at 'near market' rents (originally around 80% of market values) and the reliance on sale proceeds after a few years, there is a commercial discipline around scheme proposals.

There are a number of variations evolving. The Edinburgh 'Resonance' model allows more flexibility, with some properties being sold in year one, but a small number potentially being held by social landlords as affordable housing in perpetuity. The Stirling model is constructed as a partnership between the local authority and the Scottish Government, without any developer equity contribution. The core relationships in the model are illustrated in Figure 6 below. Once again, note that the Scottish Government only offers its guarantee on the PWLB's loan. Also the Scottish Future Trust (SFT) is the originator of the special purpose vehicle (SPV).

**Figure 6: Structure of the Scottish National Housing Trust**



Source: Scottish Housing Trust 2013



Turning to the recently established HA variation of the scheme, the Scottish Government has received expressions of interest from providers. Unlike the LA version, no Limited Liability Partnership is required because there is no need for a device to minimise HA borrowing since this does not in any case appear on the public balance sheet. However, some contenders have predicated their proposals on government grant and/or on-lending from local authorities, as well as Scottish Government guarantee.

In the most recent bidding round the Scottish Government has relaxed its rules around rent levels to make it possible for individual schemes to deviate away from the 80 per cent of market norm. Their most recent strategy report (*ibid.*) refers to the construction of 700 new affordable dwellings and contract taking the program past 1000 homes was recently signed (in March 2013).

As noted above, the purpose of the Scottish guarantee is to insure local authorities against losses arising from rental shortfall or capital resale values falling below those projected in business plans. However, LA exposure is limited by the contribution of developer equity—usually around 30 per cent. Effectively, this cushions any possible LA loss against which the guarantee could be invoked (due to falling capital values).

The guarantee puts a wrap-around PWLB borrowing to give councils confidence to participate. One way of looking at this is to say that the guarantee has been necessary to overcome the ‘novelty’ factor as seen from the LA perspective. It is a debt guarantee, ‘not a rental guarantee which could be affected by landlord performance’.

The guarantee is currently costed at £2800 per property. This amount is based on the total guaranteed sum (£146 million, so far) multiplied by the estimated probability of default, divided by the number of homes covered.

With the programme recently having passed the 1000 dwelling mark, the total value of the guarantee as reflected in Government’s Annually Managed Expenditure (AME) accounts is approximately £2.8 million (not £146 million). Crucial here is the establishment of Limited Liability Partnerships involving LAs and developers—otherwise the borrowing would score on the balance sheet in its entirety. Additionally, however, accounting practice requires that funds are set aside annually in the Government’s Departmental Expenditure Limit (DEL) budget to make provision for any in-year guarantee expenditure. If there is no call on these funds they can be spent on other things at year end.

The main limiting factors for the NHT (original version) are (i) local authority borrowing headroom (under prudential borrowing guidelines) and (ii) Developer appetite—it would be expected that this would diminish in the face of a housing market recovery. Similarly, the housing association version has to work within limits imposed by HA gearing ratios.

EU state aid rules are another potentially limiting factor. Compliance with these obligations was thoroughly explored at the outset. These have implications for rent levels in relation to local market norms. If rents rise above the 50th percentile of the local rent distribution the guarantee is withdrawn.

Through its contacts with the industry, the Scottish Government believes that pension funds are now more interested in residential investment than was true historically. In particular, low risk and steady returns have become a more attractive prospect.

The ongoing delegation of additional taxation powers to Scotland (irrespective of the independence referendum) opens up the possibility of the Scottish Government looking to configure charges such as stamp duty to enhance incentives for rental

housing investment. Acquisition of borrowing powers could enable the simplification of the NHT model because it might no longer be necessary to utilise LA borrowing capacity.

The following section broadens the review beyond Europe and considers relevant developments in the US and very briefly growing policy and program interest in social housing in selected countries in Asia.

### **3.6 US risk sharing strategies**

In addition to low income housing tax credits (LIHTC), both tax exemptions and guarantees on mortgage bonds have also been very significant instruments in the US affordable housing finance system, such as the Federal Housing Administration (FHA). Where FHA guarantees have been issued via highly regulated institutions for specified products, they have been able to channel mortgage finance to eligible borrowers within appropriate leverage constraints, reducing the likelihood of default.

The US debate about the role of guarantees is polarised. During the 2000s, with the reduction of borrowing standards and rise of private label RMBS issued by investment banks, a bust occurred in the RMBS market which eventually generated the current financial crisis. The bust led to the costly bailout of two government sponsored enterprises (GSEs) Fannie Mae and Freddie Mac that were originally designed in the 1930s and 1970s to stabilise US housing markets by playing an active role in the secondary market for RMBS.<sup>50</sup>

There has been much debate over the role of these institutions. Three options for reform of the privatised then government rescued GSE institutions were put to the US congress by the Obama administration in 2011. The first proposed the entire removal of the government guarantee from the portion of the market currently served by the GSEs; the second proposed a limited government guarantee to be normally inactive that would 'scale up' during credit downturns; and a third option kept the government guarantee largely in place, but limited its scope and increased protection for taxpayers (see Min 2012, p.8, for discussion of Treasury and HUDs report of February 2011).

Conversely, Min (2012) argues that in general US government guarantees have ensured the provision of consumer friendly products, with favourable terms and conditions, in turn reducing the risk of default and any call on the guarantee. Indeed, there are many examples of federal, state and city based programs which have been successful in channelling lower cost funds to not-for-profit rental housing.

As mentioned above, there are many important instruments in the US affordable housing system beyond the LIHTC. The Internal Revenue Code of the Federal government allows the tax exemption of interest on bonds providing mortgage finance

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<sup>50</sup> There has been much debate over the role of Government Sponsored Enterprises (GSEs) in the US housing market. Freddie Mac (Federal Home Loan Mortgage Corporation est.1970) and Fannie Mae (Federal National Mortgage Association est.1938) were originally established to promote stability in this market by providing a steady flow of funds for mortgages, beyond mere bank deposits, buying up mortgages and refinancing banks to allow continual lending. However, a significant decline in underwriting standards and the rise of private label MBS during the mid-2000s undermined the ability of the GSEs to monitor and manage mortgage flows. Many defaults led to calls on the guarantee and a substantial decline in the value of stocks in these privatised GSEs. A government bailout followed, as well as delisting from the stock exchange and being placed under conservatorship. Today, the GSEs continue to play a role in the secondary mortgage market and purchasing mortgages issued by retail banks and selling these obligations as residential mortgage backed securities (RMBS) to pension funds, insurance companies and other global investors.

for not-for-profit rental housing.<sup>51</sup> Also the Federal government offers insurance to eligible Housing Finance Agencies (HFA), via the Federal Housing Administration (FHA). This enables below market financing to be raised by state and local government HFAs for qualified rental projects to accommodate specific income groups. A well-established local scheme, which draws on Federal mortgage bond tax exempt instruments is the San Diego Mortgage Revenue Bond Scheme.<sup>52</sup> An illustration of a state based guarantee scheme is the Florida Affordable Housing Guarantee Fund, which operated from 1993–2005.<sup>53</sup>

The focus of the following sub-section is the well-established risk sharing scheme which combines the financial strength of Federal Housing Administration FHA with the local expertise and monitoring capacity of qualified state and local Housing Finance Agencies.

### *3.6.1 HUD and HFA Risk-sharing scheme*

The Housing Finance Authority (HFA) Risk-sharing scheme backs investment in affordable rental housing in partnership with qualified bond issuers raising finance for affordable rental housing. It was first piloted in 1992<sup>54</sup>, made permanent in 2001 and continues to be administered by the US Department of Housing and Urban Development (HUD) in partnership with qualified state and local HFAs. The program devolves maximum responsibility to these HFAs, who are largely responsible for processing responsibilities in selecting projects to receive financing.

Partnership agreements define the distribution of credit enhancement for mortgages of multifamily housing projects whose loans are underwritten, processed, serviced, and disposed of by qualified state and local government HFAs. Partners may elect to share from 10 to 90 per cent of the loss on a HUD loan. Backing HUDs commitments is the Housing Finance Administration<sup>55</sup> which reimburses HUD in the event of a claim pursuant to terms of the risk sharing agreement. The program provides full FHA mortgage insurance to enhance HFA bonds to investment grade.

The structure of the scheme is outlined in Figure 7 below. It shows three layers of security provided by housing providers, state and local housing finance agencies and the Department of Housing and Urban Development, with the Housing Finance Administration guarantee subject to a risk sharing agreement. The notable feature of this scheme is that agreements are tailored to allocate responsibility for guarantee obligations between the two parties and hence their corresponding level of oversight.

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<sup>51</sup> Sections 103 and 141-150 of the Internal Revenue Code are most relevant to the tax law requirements for housing bond issues. These sections aim to maximise the pass on benefits of the exemption via the bond issuer to the end user of the funds raised. For a clear outline see Rock, 2007, p.30.

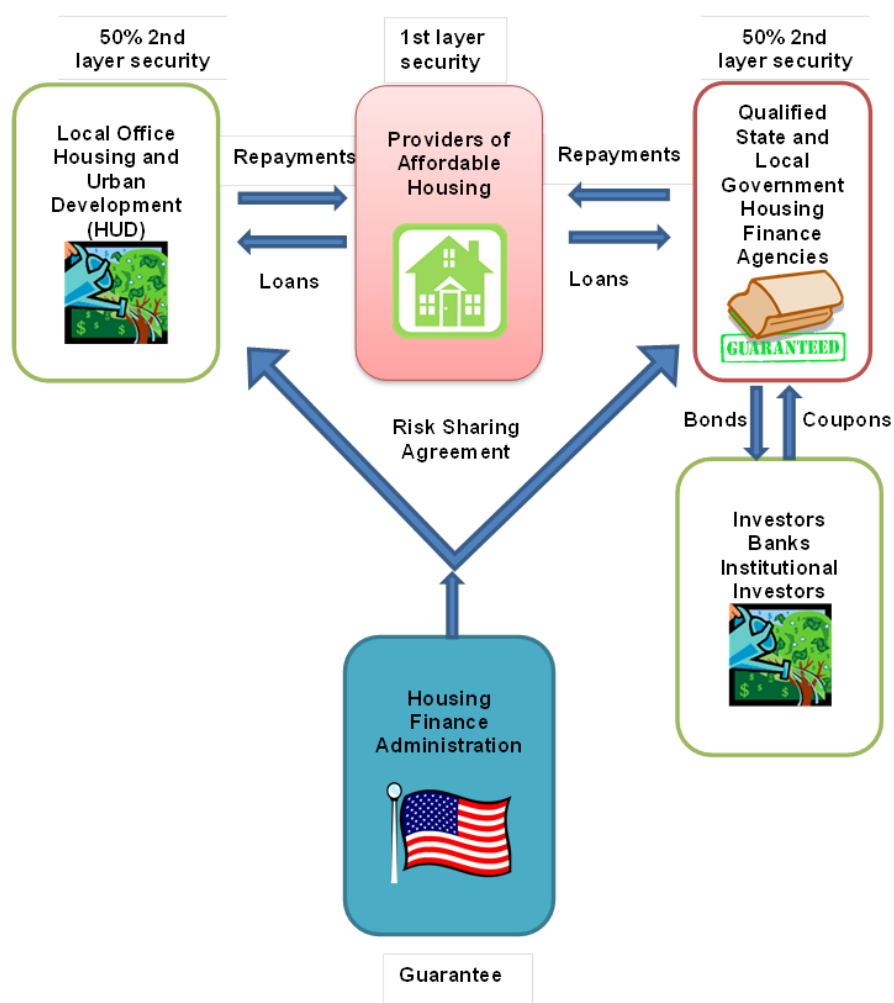
<sup>52</sup> The details of San Diego's policy on Mortgage Revenue Bonds can be found on [http://www.sdhc.org/uploadedFiles/Real\\_Estate/Developers/Multi%20Family%20Housing%20Bond%20Policy%20PO300.301%20Final%20executed%2006.11.10.pdf](http://www.sdhc.org/uploadedFiles/Real_Estate/Developers/Multi%20Family%20Housing%20Bond%20Policy%20PO300.301%20Final%20executed%2006.11.10.pdf).

<sup>53</sup> More about this Guarantee Scheme which ran 1993-2005 can be found on <http://www.innovations.harvard.edu/awards.html?id=141751>.

<sup>54</sup> Housing and Community Development Act of 1992 Section 542(c)

<sup>55</sup> The Federal Housing Administration, generally known as 'FHA', provides mortgage insurance on loans made by FHA-approved lenders throughout the United States and its territories. FHA insures mortgages on single family and multifamily homes including manufactured homes and hospitals. It is the largest insurer of mortgages in the world, insuring over 34 million properties since its inception in 1934. [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/housing/fhahistory](http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/fhahistory).

**Figure 7: Structure of the US HUD HFA Risk Sharing Scheme**



The detailed HUD Handbook for this program specifies that a risk sharing contract between the HFA and HUD must specify the portion of the loss to be incurred in the event of any default by the HFA while federal insurance is in force (HUD 2007). Where an HFA accepts less than 50 per cent of the risk on a loan it is subject to closer regulation by HUD than an HFA that accepts 50 per cent or more.

To be eligible HFAs must be:

- Credit rated by a recognised agency as 'top tier', or
- Be issuing bonds which are rated as a for its general obligation bonds.
- Demonstrate its capacity as a sound, well-managed agency that is experienced in financing multifamily housing;
- Have at least five years experience in multifamily underwriting; and
- Be a HUD-approved multifamily mortgagee in good standing.

The loans provided by a qualifying HFA can be given to investors, builders, developers, public entities, and private Non-profit corporations or associations in order to serve individuals, families, and property owners who are eligible for affordable housing. Potential borrowers apply to qualified HFA. The lender on behalf of the borrower then submits an application directly to the HFA. The HFA obtains specific

approvals from the local HUD Program Centre, based on their previous participation and local assessments.<sup>56</sup>

For example, County of San Diego Housing Authority (approved HFA) raises low cost investment for San Diego Housing Commission (SDHC) (eligible borrower) to finance homes for low income households (eligible customers) with a government guarantee (third party shared agreement backed by full mortgage insurance through Federal Housing Administration).

The SDHC is a former public housing authority that was transferred to become a private real estate developer in 2009. It has retained its social task and maintains a strong relationship with local government. It is governed by board of Commissioners appointed by the Mayor and Councillors of the City of San Diego.<sup>57</sup> It was officially rated as A+/stable in 2012.<sup>58</sup>

### **3.7 Important European Developments and a brief look towards Asia**

There are highly relevant and ongoing debates and policy discussions occurring at a European level which are of interest to developments in intermediaries and guarantees for long-term infrastructure and affordable rental housing.

Access to long-term finance by governments and SMEs is considered by the European Commission to be critical economic growth. In March 2013, it launched its Green Paper on Long Term Financing for the European Economy for stakeholder consultation (which included the social housing sector, see below). The report focuses on the process of long-term investment in infrastructure and how this might be reformed to improve regional and national economies. It considers the establishment of Long Term Investment Funds, to channel investment via pension funds towards long-term infrastructure projects. It is concerned about the impact of banking regulation and accounting requirements on long-term investment, as well as differential tax treatment of bond and equities. It recommends reforms to deepen the bond market and encourage an environment where investors buy and hold long-term assets. The report specifically mentions the important role of the bond market, specialist intermediaries and regional development banks such as the European Investment Bank in this realm.

The European Investment Bank has a growing financial role in addressing specific market gaps, catalysing private investment and supporting the social housing sector in several member states, including the UK, where it provides lower interest longer term financing for major urban redevelopment and housing developments via one of the intermediaries outlined in this report, the Housing Finance Corporation.

The Union of Social Housing Providers (CECODHAS) has established a special working group on long-term financing needs, which has met several times since 2011. It is now exploring the development of special instruments and guarantees at a regional (EU) level with its members and is developing proposals to put forward to an Informal<sup>59</sup> Meeting of EU Housing Ministers in December 2013.

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<sup>56</sup> An outline of the Risk Sharing Program can be found at: <http://www.hud.gov/offices/hsg/mfh/progdesc/riskshare542c.cfm>.

<sup>57</sup> The transferral allowed SDHC access to equity and better utilise revenues generated by 1366 apartment units at 150 properties previously under HUD control (Standard and Poor's 2013).

<sup>58</sup> The most recent rating report up graded SDHC from A+ negative to A+stable, see full report at: [http://www.sdhc.org/uploadedFiles/Resources/Standard%20Poors%20Report\\_2013.pdf](http://www.sdhc.org/uploadedFiles/Resources/Standard%20Poors%20Report_2013.pdf).

<sup>59</sup> It is called Informal as these meetings have not been systematised in the EU to date. However, there are proposals to do so.

In preparation for this important meeting, the Director Generals of European Housing Ministers met on 11 September 2013 to discuss the need for sustainable financing of housing policies in times of economic crises. The DGs prepared for the European Ministers the following recommendations:

1. European guarantee for projects financed by the markets but meeting specific characteristics as to their purpose and nature (including sustainability).
2. The 'EU project bonds' (issuance of bonds by project companies and enhanced by a credit from the European Investment Bank, a credit which takes the form of a subordinate instrument).
3. The creation, within the group of the European Investment Bank, of a 'European Sustainable Housing Fund', which could contribute:
  - To the funding of major programs aimed at developing the supply of sustainable and affordable housing but also at renovating and rehabilitating existing public housing in order to improve its comfort, energy efficiency and/or the quality of the architecture and the urban integration.
  - To the funding, within the framework of specific agreements, of organizations that support projects for the less well-off households with regards to property matters (project relate to ownership, full or partial, or to renting).
  - To the development of a center of expertise whose mission would be to analyse and continuously assess the financial product related to real estate markets.

Agreement on these recommendations is pending the EU Housing Ministers' Meeting in Brussels on 9–10 December 2013.

So far we have considered efforts in Europe and briefly the US. It should also be noted that many Asian governments have created government supported financial intermediaries and guarantee schemes to achieve their housing goals. In their study of Hong Kong SAR, India, Japan, Korea and Malaysia, Chan et al. (2006) found that:

In many of the cases considered, housing agencies appear to have played a constructive role in the development of residential mortgage bond markets. They have helped eliminate barriers to securitisation, initiated more systematic issuance of MBSs, improved access for households and provided liquidity to banks. (ibid. p.71)

While the above study focused expanding access to home ownership, many Asian countries such as China, Korea and Taiwan are now also focusing their efforts on the promotion of social rental housing and policy and program developments are on the resurgence (Ronald, presentation to ENHR 2011)<sup>60</sup>. China, where housing for low income families has become a national priority, the government has pledged the equivalent of 1 per cent of its GDP towards housing subsidies to produce an extraordinary supply of new public housing by 2015 (Wang & Murie 2011, in Ronald forthcoming).

While these efforts are beyond the geographical scope of this review, they certainly deserve more detailed attention by Australian researchers and policy-makers in the near future, tapping into the knowledge base of active Asia Pacific Network Housing Researchers (APNHR) and other researchers and policy-makers active in the field.

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<sup>60</sup> See presentation by R. Ronald to ENHR 2011 Public-Private And Social Housing In Post-Crisis East Asia [http://www.canal-u.tv/video/universite\\_toulouse\\_ii\\_le\\_mirail/public\\_private\\_and\\_social\\_housing\\_in\\_post\\_crisis\\_east\\_asia\\_richard\\_ronald.7588](http://www.canal-u.tv/video/universite_toulouse_ii_le_mirail/public_private_and_social_housing_in_post_crisis_east_asia_richard_ronald.7588).

## 4 DISCUSSION AND COMPARISON

Government and sector based guarantees are clearly a growing area of policy interest and innovation, as demonstrated by emerging and expanding schemes in Scotland, the UK and Ireland, and growing interest in the established Dutch and Swiss schemes. There are also very interesting proposals for the development of special bonds, guarantees and special funds at the European level, involving the EIB. This interest has been catalysed for several reasons:

- Ongoing and recently significant declines direct public investment in social housing in Western Europe, particularly the UK and previously the Netherlands.
- Concern about the lack of suitable long-term investment from the private sector.
- Growing expertise in PPP arrangements, and importance of guarantees to these.
- Efforts to reduce government balance sheets and manage specialised sector risks more effectively as EUROSTAT policy focuses efforts and practice evolves.
- Weak supply conditions from traditional commercial lenders in the UK, the Netherlands, France and Ireland, strengthening the need for public enhancement.
- Emerging investor relations between social landlords and institutional investors in the UK, opening new avenues of investment as commercial lenders recede from the market.

In this context, some guarantee schemes are now considered market leaders and even touted as potential European models in raising lower cost finance for non-profit rental housing (CECODHAS/HSBC/Gay Guggenheim 2011). Indeed, the Dutch WSW has been an inspiration (and a caution) for the UK, while the Swiss EGW has been elevated as a potential model for European Social Housing Investment Bonds (put forward by HSBC at a CECODHAS financial forum in 2011). All three schemes have played a remarkable and well documented role both in gaining access to capital markets and in reducing the cost of private investment for social housing landlords. They have all maintained a zero default rate since the GFC. The WSW and Swiss schemes are highly rated, matching their governments' strong government rating. All three illustrate very different models of organisational ownership and resourcing.

### 4.1 Guarantee structure and role

The ownership of financial intermediaries reviewed in this paper varies from membership co-operatives and non-profit stakeholder managed organisations (Swiss EGW, THFC) to publicly owned companies reporting to governments with strong powers over the guarantees role and administration (e.g. Irish HFA and French CGLLS).

Most schemes have a strong role in monitoring and strengthening the financial capacity of their borrowing social landlords, preparing them to be worthy of the low risk rating. Schemes use a variety of tools to do so. The Dutch fund monitors cash flows amongst its' members using standardised financial reporting software (Corpodata) and has a number of levels from intensive to light, for monitoring and mentoring performance. In this way the lending capacity of more than 400 members can be individually defined on an annual basis. Likewise, the Swiss EGW requires annual reporting but it also undertakes an independent risk assessment and ranks each of its 406 members each year. The French guarantee is much more focused on strengthening capacity of financially weaker members through intensive support to organisations excluded from traditional LA guarantees and thus access to CDC finance. It offers financial management training and also actively intervenes to

improve the balance sheets of weaker social landlords, though asset re-organisation, favourable loans and grants. In Ireland, the activities of the HFA are now extended to Voluntary Housing Bodies as well as local governments, and it is developing its professional capacity to assess risks in this sector alongside moves for greater sector regulation.

Many schemes also have an ongoing compliance role to ensure that the loans guaranteed continue to serve their intended purpose, checking applications of rent caps, tenancy and tenure. In addition to affordability and quality, the Swiss scheme also places strong emphasises ecological sustainability.

Beyond monitoring and mentoring, ranking and certifying most guarantee schemes pool smaller demand for funds. The most outstanding examples of this are the EGW and THFC. In turn they are able to arrange the issuance of bonds. In the Swiss case, bonds attract a federal government guarantee lowering the perception of risks and generating yields equivalent to the very low Swiss government bond rate. Given that rents are tied to financing costs in this country, lower interest rates have a real benefit to sitting tenants.

Purchasers of bonds are predominantly insurance companies and pension funds. However, loans guaranteed by the Dutch WSW are largely supplied by the two largest public sector banks in that country.

Given differences in ownership, role and size of the sector being served, the human resources required by the intermediaries and guaranteeing bodies vary accordingly. Where schemes are self-financing, their operating costs also affect the pass-on benefit of the guarantee. The leanest operation is the Swiss EGW, where no staff member is employed. Rather a voluntary but expert board and auditing committee supervise risk assessment, certification and bond issuance processes. However, the actual administration of these tasks is undertaken by a private legal firm and independent financial specialists.

Most schemes only provide guarantees to approved and or registered social housing providers to build and renovate a range of rental, share equity and ownership housing services. The obvious exceptions are the Scottish National Trust, which focuses on local governments in joint ventures and the new UK scheme for private rental landlords. Both schemes appear to be the most fluid in their requirements and affordability demands.

Typically, the target group for guaranteed loans is either tightly prescribed or outlined in terms of performance benchmarks and cost rent mechanisms. The French scheme has the tightest definition of loans which can be backed, as Decreed by the government, with about a dozen loan programs of the CDC ranging serving low income home owners to the homeless. The large Dutch scheme is narrowing its range of investments to rental housing for specified income groups, as a result of EU directives and government policy.

The key organisational features of the reviewed guaranteed schemes in selected European countries are provided in Table 9 below.



**Table 9: Guarantee ownership, roles, resources and targets for selected European schemes**

<b>Illustration</b>	<b>Established</b>	<b>Status and Ownership</b>	<b>Roles</b>	<b>Staffing and resources</b>	<b>Existence and Definition of the target group for guarantee loans</b>
Dutch Social Housing Guarantee Fund WSW	1983	Foundation with an independent management structure. Guarantee is threefold: debt free properties of the sector, capital of the WSW and backstop of central and local government.	Guarantees lenders to housing corporations. Cash flow analysis and monitoring of HCs. Provides guarantee certificates to lenders of approved borrowers.	54 staff, governed by a board, including peak bodies, experts.	New construction, renovation and refurbishment, of housing for rent by registered housing corporations within a certain price range.
Swiss Federal Government Guarantee on Limited Profit Housing Bonds EGW	1991	Co-operative (406 members), members fee 200 CHF, established by peak bodies of limited profit sector, with government support and representation. Guarantee provided by Federal Government.	Pools lending demands of members, arranges independent risk assessment, annual risk ranking of each member, raises funds secured by properties and Federal Guarantee.	0 staff, professional board meets four times a year, contracted private firm and legal services company acts as trustee and lead bank arranges issuance by commission.	Members of EGW submit annual reports to inform their ranking. Financed developments must comply with sector's own charter and Federal standards for affordability, ecology and sustainability to be eligible for housing assistance.
French HLM Guarantee Fund CGLLS	2001	Publicly owned and administered, supervised by the Minister for Housing, Finance and the Economy.	Strengthening financial capacity and skills of part of the HLM sector, including re-organisation, providing guarantees, loans and grants. Provision of a guarantee requires written risk analysis, both in terms of the financial health of the organization and the balance of the transaction.	29 staff members  Governed by a board including peak housing bodies, government, qualified experts and national urban policy director.	Registered HLMs, joint venture companies and government approved organisations who provide housing for disadvantaged persons using specified loans sourced from the CDC.

<b>Illustration</b>	<b>Established</b>	<b>Status and Ownership</b>	<b>Roles</b>	<b>Staffing and resources</b>	<b>Existence and Definition of the target group for guarantee loans</b>
Ireland Housing Finance Agency HFA	1982 Local government 2012 VHBs	Publicly owned company backed by Government guarantee.	Raises funds, receives applications for loans, certifies housing associations for lending due diligence, credit risk assessment and monitoring.	11 staff, Directors appointed by Irish Ministers, Credit Committee, independent financial assessment.	Home ownership, shared ownership, rental finance. Local government and Credited voluntary housing bodies.
Scottish National Housing Trust	2010	Scottish government owned backing Local Authority and since 2013 RSL investment in housing joint ventures.	Provides a limited debt guarantee to lenders to LAs and HAs. Rental properties are sold after five to ten years (possibly to a HA). To meet EU state aid rule, guarantee is withdrawn if rents rise above defined limits.	Estimated 2–3 staff, forms part of larger Scottish Futures Trust, which is governed by a board appointed by Scottish Ministers and serviced by an audit committee.	Evolving and variable. New rental housing at near market rents (80%) via joint ventures involving private sector local authorities and or housing associations. Guarantee only covers loans of LAs and HAs.
UK Affordable and Private Rented Housing Guarantee Schemes	2013	Initiated by UK government (DCLG, HCA), backed by HM Treasury. THFC licenced to issue guarantees.	THFC to aggregate loan demands, raise funds, allocate loans to vetted borrowers and provide guarantees. Linked to grant aided and revolving fund schemes (for 30–40% of development costs).	Issuer and licenced guarantor roles absorbed into THFC. Too early to assess resourcing impacts.	Investment finance for large newly completed private rental and affordable rental (or HA ownership schemes), minimum threshold £10 million PRS £5 million HA. Other co-financing subsidy requirements may apply.

## 4.2 Financing impact of the guarantee

Most guarantee schemes reviewed above were established in response to weak or absent investor interest and declining direct public investments. In this context, social housing providers have necessarily relied on a specialist intermediary and a guarantee to pool and represent their needs and market to investors.

These mechanisms have greatly expanded credit options, sometimes creating entirely new investor markets and based on successful experience reduced required yields, loan interest costs and lengthened loan terms.

Purchasers of social housing bonds include major pension funds and insurance companies (Switzerland and the UK), public sector banks (the Netherlands) and, where the banking sector has all but collapsed, international financial institutions (IMF and EIB) and governments (Ireland).

The WSW purports to have reduced interest rates by 1–1.5 per cent below the going equivalent mortgage rate. The loans derived from EGW bonds, closely match the very low Swiss government 10-year bond rates (CECODHAS/HSBC/Gay Guggenheim, 2011) and are consistently 1 per cent below market alternatives (SECO 2010).

Typically, loan applications are based on traditional lending criteria, such as the existence and quality of collateral, loan to value ratio, cash flow and interest rate cover. As financial intermediaries the WSW and EGW mediate the lending volumes of housing associations, setting required equity, loan to value ratios, requiring regular valuations, interest rate cover, amortisation rates and debt free covenants. The WSW for example, assesses the amount housing corporations can borrow each year and provides guarantees only within these limits.

Generally, the cost of issuing bonds is deducted from the loan amount provided to the borrower, as in Switzerland, the Netherlands, Ireland and the UK. In France a progressive system lightens the burden for deeply social investments made by the CDC loans in social and very low income housing.

Where a cost is incurred providing a guarantee or where a fund must be accumulated to support it, a premium is generally added on top of loan interest payments. The basis for calculation varies significantly from a cash flow of the organisation and rent revenue to a percentage of the cost of capital associated with the loan. The French CGLLS progressively charges a fee depending on the purpose of the loans backed (lower for very social housing and investment in homelessness services). The Dutch WSW charges a quarterly risk premium, which contributes to the fund it maintains as the second layer of its guarantee. In the case of Ireland a guarantee premium is not charged. In Switzerland, funds sufficient to cover one year payment of interest are added to the loans issued from the EGW, as a first line of protection.

These characteristics are summarised in Table 10 below.

**Table 10: Guarantee implications: fees, loan terms and conditions, market impact on borrowing selected European schemes**

<b>Illustration</b>	<b>Fees paid and basis for setting fee</b>	<b>Terms and conditions of typical loans guaranteed</b>	<b>Market alternatives</b>	<b>Interest discount to borrower compared to alternatives</b>	<b>LTV with Gtee (%)</b>	<b>LTV without Gtee (%)</b>
Dutch Social Housing Guarantee Fund backed by the sector and government WSW	Borrowers pay a quarterly risk premium to the WSW.	Variable rate structure 2–50 year terms. During the crises, loans terms and conditions deteriorated.	Limited, lending dominated by two public sector banks 86 per cent. Coverage: 96 per cent of housing corporations make use of the WSW guarantee.	The average spread on new contracts in 2012 was around 96 basis points above the swap rate (2011: 65 basis points). Interest discount estimated to be 1.5 per cent for similar mortgages, but comparison difficult.	WSW provides an annual assessment of amount that can be borrowed.	Only 4 per cent no guarantee, not comparable.
Swiss Federal Government Guarantee on Limited Profit Housing Bonds EGW	Pre-bond fees deducted from loan amount. A premium sufficient to generate one year of interest payments is added to loan interest.	5–15 years, may be fixed with defined terms. Rates tied to investments in specific properties, first port of call, rates and terms vary according market situation and needs of the borrower.	Increasing participation of commercial banks, as familiarity increases and mortgage rates decline.	Very closely matches market rates for government bond issues plus fees, average 2.8 per cent between 1994–2013 on 10-year bonds currently below 2 per cent.	80 per cent (10% must be amortising), guarantee must be linked to a mortgage on a property.	Market has been limited without guarantee.
French HLM Guarantee Fund CGLLS	CGLLS funded by an indirect tenant fee (1.4% rent), landlord fee based on cash flow, guarantee fees, between 0–2 per cent depending on target group and nature of the loan, charged on disbursement of the loan.	The CDC offers tightly regulated loan terms and conditions for specified housing services and programs. All CDC loans must have a government guarantee. Sometimes, guarantee is provided where the debt it is secured by a legal first mortgage or other collateral on unencumbered HLM properties.	HLMs coming to the CGLLS can only obtain CDC loans with a government guarantee. They only seek a CGLLS guarantee, when local governments refuse or are unable to provide.	No discount and no market alternative, CDC must have a guarantee and interest rate is set for housing services. CGLLS typically applies to financially weaker HLMs, unable to obtain a LG guarantee.	The interest rate and terms are established by the CDC.	No market without guarantee.

<b>Illustration</b>	<b>Fees paid and basis for setting fee</b>	<b>Terms and conditions of typical loans guaranteed</b>	<b>Market alternatives</b>	<b>Interest discount to borrower compared to alternatives</b>	<b>LTV with Gtee (%)</b>	<b>LTV without Gtee (%)</b>
Irish Housing Finance Agency HFA	Self- financing company, loan margin covers costs. Margin for loan costs 0.035 per cent.	Provides loans up to 35 years, Variable rate structure, matching ECB rates pre-crisis, which are passed on to LA borrowers. VHB rates currently 3.25 per cent, 1.75 per cent for LA loans. Recently more expensive fixed rate negotiated for VHBs (6.5%).	Commercial market does not serve VHBs and lending to LAs is typically 2 per cent higher than HFA rate.	At least 2 per cent for LA home loans, no commercial alternative for VHBs.	70–80 per cent NPV based on cash flow of project.	Approximately 50 per cent NPV if they could borrow.
Scottish government's National Housing Trust for RLSS	NA	NA	Depressed development. Market weak for development of rental housing, necessitating joint ventures.	NA	NA	NA
UK Affordable and Private Rented Housing Guarantee Schemes.	Private rental borrowers expected to cover costs of arranging guarantee, expected losses, cost of capital associated with the guarantee are payable with each interest payment.	Determined by the market. Guarantee requires ongoing maintenance of LTV and ICR. Monitoring reports. Covenants for long-term debt. Security up to 30 years against organisation assets, as in regular borrowing. Relates to an initiative for a revolving fund for private rental construction.	Market for retail lending very weak. Stronger RSLs have been able to issue their own bonds and raise institutional finance. Smaller RSLs combine their borrowing needs via a financial intermediary such as THFC.	Aims to provide long-term investment finance (up to 30 years) at a small margin above British gilts.	80 per cent LTV Interest cover 1.2:1 Requires 20 per cent own equity, combined with revolving loans. Requires 5 yearly valuations.	NEW

### 4.3 Accounting for the guarantee and accrediting a rating

Government accounting requirements and day to day practice on the guarantees varies considerably depending on the structure and ownership of the guarantee. For example, if it is sector owned or independent from government, a wholly owned subsidiary or limited liability partnership.

At the time of writing this issue was very much a 'hot topic' as government's strove to design structures which would have the least impact on government budgets. For this reason, up to date information is not easily accessible on this topic online and hence the issue was followed up via more intensive key expert interviews.

The breadth of definition for government debt has important implications for how guarantees are accounted for. All governments in this era of fiscal austerity and low economic growth are keen to reduce their liabilities.

The 'independent' sector owned WSW is required to maintain a minimum fund of 0.25 per cent of guaranteed capital and must report to the government annually on maintenance and operation of this fund. The Swiss government sets limits on the EGW co-operative bond issues and only a parliamentary decree can increase it. The French government approves the CGLLS budget and statements and closely ensures compliance in this government owned enterprise, as a SFI it must also comply with Basel III reserve requirements.

Information on government debt is collated by Eurostat and the European Central Bank to assess General Government debt (known as GG Debt or Maastricht debt). In recent years Eurostat has broadened its definition of GG debt, which not only includes national debt but also the borrowings of all entities classified as 'within Government' such as Non-Commercial State-Sponsored Bodies (NCSSBs), local authorities, and Housing Finance Agencies (DoF 2013).

The HFA is a wholly owned public limited company; it provides information on its assets and liabilities to the central statistical office for Department of Finance and central budgets office statistics unit. The Department of Finance monitors HFA debt and must be consulted if any changes are proposed. The sanction of the Minister for Finance is required for increases in the debt limits or any other policy changes. In contrast the WSW is a privately owned organisation, which reports on important policy matters affecting the governments back stop role, such as the 0.25 per cent coverage of debt obligations requirement.

Turning now to external official credit ratings, the three most established schemes for attracting lower cost larger volume private finance are indeed independently rated: the Dutch WSW (Aaa), Swiss EGW (AAA) equivalent to their governments and UK THFC, when considered without the recently introduced guarantee scheme is A+/Stable/A-1, lower than the UK governments rating (AAA/Stable/A-1+).

Their rating reports, cited in this review, provide an interesting perspective on the factors which are considered important to investors in determining credit worthiness, which can be summarised as:

- First and foremost the credit worthiness of the government.
- Secondly, the strength of relationship between government and social housing sector.
- The importance of housing providers in delivering government social and economic policy.

- A demonstrable and stable long-term commitment to this relationship and policy by government.
- The financial management capacity of the issuing housing finance intermediary.
- The ongoing monitoring process for assessing applications by borrowers.
- The scale of the obligations relative to the scale of governments revenue base and taxation powers.

None of the European guarantee schemes reported a call on the guarantee due to default. Over the past decade and since the 2008 crises the WSW, EGW and THFC have maintained 0 per cent default rates on the loans they have issued and/or backed for over the past 20 years. However the WSW is currently facing challenges due to the actions of one member (due to an early call on a loan back by derivatives), leading to strengthening of the monitoring of associations using these financial instruments. The THFC which will soon administer the UK guarantee schemes has also maintained a 20-year default free record. The CGLLS, which serves the needs of financially troubled HLMs, aims to eradicate the risk of default through subsidies, capacity building and re-organisation. It currently has a 0 per cent default rate, since 2008, but this has been as high as 4 per cent in the past.

These issues are summarised in Table 11 below.

**Table 11: Accounting for the guarantee: Official rating, accounting norms, call conditions and default rate, selected European schemes**

<b>Illustration</b>	<b>Rating (Official) or internal assessment</b>	<b>Accounting norms for contingent liability and Required budget reporting</b>	<b>Conditions under which guarantee may be called</b>	<b>Default rate on guaranteed loans</b>
Dutch Social Housing Guarantee Fund backed by the sector and government WSW	AAA/Negative/A-1+ Standard and Poor's) same as the Dutch government.	WSW capital must not fall below 0.25 per cent of guaranteed capital. Legal agreements between guarantee partners. Requires annual reporting to Central and Local Government. Being independent and sector-owned, debt of WSW is not government debt and consequently not reported. The risk is considered 0 per cent and therefore not noted in the national accounts.	Only when the resources of the sector and the central fund are exhausted. Recent stress test (Vestia, €2.4 billion) did not affect government back stop guarantee and was resolved internally by Vestia and the sector.	0 per cent
Swiss Federal Government Guarantee on Limited Profit Housing Bonds EGW	AAA (ZKB) same as Swiss government.	Provision of guarantees government by Swiss law and Stock Exchange directives. Under housing legislation, government periodically sets credit facility limit on EGW issues (currently CHF 1.4 billion). This is reported in the annex to annual budget and state accounts. Until mid-1990s no provisions for any potential claim were made in annual budget. Now a lump sum is included in the budget but has never been called on since 2003. Complies with Swiss standard accounting for government guarantee.	EGW accumulates reserves tagged to each obligation sufficient to cover 1 year of bond coupons and allow time to re-organise debt before any call on the guarantee. Precise wording is outlined in the bond prospectus: 'The Swiss Confederation provides a federal guarantee to ensure this borrowing requirement and is solely liable under Article 496 Swiss Code of Obligations with the PE'.	0 per cent since 2003.
French HLM Guarantee Fund CGLLS	No rating.	Government approves CGLLS budget, financial statements, assistance to the HLM sector, ensures compliance governing the operation of the CGLLS.	When the borrower defaults, the CGLLS agrees to meet payment deadlines at the request of the lender.	0 per cent since 2008 but has been higher in the past (4%).
Ireland—Housing Finance Agency	Same as Irish Government for short term market P2	HFA provides audited reports annually and reports on a quarterly and half yearly basis also. Loans are currently accounted	No guarantee for VHBs. Property is the sole security for the loan. In practice, another VHB would be sought to take over	0 per cent Guarantee applies to LAs, but not yet



<b>Illustration</b>	<b>Rating (Official) or internal assessment</b>	<b>Accounting norms for contingent liability and Required budget reporting</b>	<b>Conditions under which guarantee may be called</b>	<b>Default rate on guaranteed loans</b>
HFA	(Moody's).	for as government borrowings, under Eurostat 2007 requirements for GG Debt, including government owned companies.	the loan obligations.	tested for VHBs.
Scottish government's National Housing Trust for RLSs	Not rated.	Scottish government has no borrowing powers, LAs have prudential limits. Scheme uses LLP arrangements to meet public accounting standards. Estimated costs of guarantee about GBP 2800 per property. Funds are set aside annually in the Government's Departmental Expenditure Limit (DEL) budget to make provision for any in-year guarantee expenditure. If there is no call on these funds they can be spent on other things at year's end.	Subject to Facility Agreement <sup>61</sup> between Developer (a Limited Liability Partnership) and the lending and Local Authority. Cover default due to losses to LAs and LLPs due to inadequate rent revenue or insufficient sale proceeds. Limited by inclusion of developer equity (30%).	0 per cent but relatively new.
UK Affordable and Private Rented Housing Guarantee Schemes.	Without guarantee THFC has been A+/Stable/A-1. Current scheme not yet rated.	Policy evolving. Potentially revolving fund accounted for as loan assets rather than expenses. Lending capped at £10 billion. LLP may distance government from guaranteed borrowing. At most on accounts as small contingent liability.	Recourse limited to project assets and contributed capital.	Estimated to be 0 per cent on the basis of previous THFC RSL bonds issued with 100 per cent repayment record.

<sup>61</sup> Standard format can be downloaded from <http://www.scottishfuturestrust.org.uk/publications/facility-agreement/>.

## **5 INFORMING THE RESEARCH AND DEVELOPMENT OF AN AUSTRALIAN SOCIAL HOUSING GUARANTEE**

The following findings from this international review inform our subsequent Australian research effort to design an appropriate mechanism to attract lower cost longer term finance for the Australian social and affordable housing sector.

### **5.1 Agreed principles, long-term mandate, facility agreement**

From the outset, agreed principles for investment eligible for government guarantee need to be defined by government and agreed by peak bodies to ensure appropriate targeting of implicit public subsidies and provide a clear signal of commitment to investors and borrowers for specific housing supply outcomes.

The government guarantee, being an implicit subsidy on the cost of finance, should only go to eligible organisations operating according to not-for-profit principles and providing affordable rental housing for defined household incomes. In Australia, this implies registered providers required by government to offer below market housing services and operating a not-for-profit business model. Economic advantage should not be provided where this is not the case, to promote efficiency and fair competition for an implicit subsidy.

Once these principles are agreed there should follow clear government mandate for guaranteed obligations. In the interests of prudence, this agreement should set the amount of obligations the government is willing to back as well as the conditions for borrowers applying for funds and their use. Agreement on the limit should be based on the principles above, defined supply targets and the current and potential borrowing demands of the social housing sector. It can also be used to facilitate a regular pipeline of investment, which is necessary to meet these supply targets, which in turn will consolidate and sustain provider capacity and maintain active investor interest. The government can set a ceiling of the guaranteed bonds and also pace the amount issued. Once any ceiling has been reached, a new ceiling can be proposed informed by demand, sector performance and market conditions. Such a process would ensure greater market certainty and build long-term investor commitment.

### **5.2 Lowering risk of investment and avoiding any potential call on the guarantee**

A vital aspect of many schemes is the measures used to reduce the likelihood of the guarantee ever being called. The following steps are widely used to help lower the risk and provide the returns required by investors.

First and foremost, the borrowers must be well managed, reporting appropriately and independently monitored. Accounts should be able to demonstrate whether their businesses are stable and critical conditions supportive. No cases reviewed intentionally guaranteed organisations likely to fail (otherwise the debt would soon be wholly assumed by the government). In all cases only once risks were sufficiently minimal, was a government guarantee provided.

Secondly, it is important to inform investors of the nature of the guarantee and the 'back stop' role played by the government. However, it should be noted that this component of the guarantee is likely to be the main factor influencing the rating of the bonds, as in the Switzerland, the Netherlands and the US.

### **5.3 Informing investors and marketing the bonds**

Interest in well rated assets (AAA) has substantially increased with the Basel III solvency ratios, requiring financial institutions to hold a higher proportion of quality reserves. Well rated government bonds or their equivalent are in strong demand and lower yield longer term bonds are of greatest interest to insurance and pension funds. They are also interesting investors in the housing sector, as they prefer long-term bonds to suite their policy holder's needs.

In the start-up phase, pro-active government supported efforts need to be made to inform relevant investors of the nature of social housing loans as a new asset class and build good investor relations. This requires an active strategy of marketing amongst asset consultants and relevant stakeholders, for example a sponsored 'road show' in the initial period and possibly regular marketing there-after.

### **5.4 Expert financial intermediary**

Investors are unlikely to have specialist technical and legal capacity to service the social housing sector, and hence in most cases the establishment of a financial intermediary is required. This intermediary has the capacity to assess risks and certify financial metrics eligible for guarantee. Given the scale of the borrowing demands, a resourcing structure and task allocation similar to the EGW could be appropriate, drawing on a mix of public, not-for-profit and private sector expertise.

Considerable progress has been made in Australia in preparation for the piloting of the National Housing Company and various other intermediaries (see Milligan et al. 2013 and relevant section of Lawson et al. forthcoming). The key is to ensure that costs of intermediation and issuance, in terms administration fees and commissions, do not outweigh the benefits. Non-profit delivery models, either by government, a non-profit organisation or existing non-profit industry fund or co-operative bank, would be the least expensive route. More detailed research on this issue will refine Australian proposals in the Final Report.

### **5.5 Pooling demands and regularity of bond issues**

The size of the organisations is not definitive for their financial management efficiency and effectiveness, but the size of the bond issue is. However, this amount appears to be less than the \$200 million estimated by Milligan et al. (2013). For example, EGW bond issues have varied from CHF 23 to CHF 123 million, gradually attracting and sustaining strong demand from pension funds. While the scale of the borrowing needs to be sufficient to attract institutional investors, this can be achieved by pooling multiple smaller borrowing demands. Such a strategy can reduce the costs of procuring finance individually and of course, provide access to the wholesale market. The cost of issuance is then shared between participating borrowers and added as a premium on the loans.

Pooling mechanisms can work effectively but regularity of issue is also important. Investors require issues to be regular and predictable, thereby developing a liquid market for the bonds. This requirement could dovetail with a long-term housing program with annual supply targets.

### **5.6 Structure of the guarantee**

In the event of default, loss sharing arrangements need to be clear and agreed in advance. As with the WSW, the guarantee can be conceived as a series of layers or lines of defence against any default and subsequent call on the government.

Firstly, organisations must be accountable to a body that has real power to intervene and enforce compliance, where an organisation is failing to comply or needs assistance or re-organisation to comply. High calibre and professional expertise in the financial management of not-for-profit organisations is very important, both inside these organisations and those regulating them. This requires adherence to clear and appropriate commercial benchmarks for solvency ratios, interest rate cover and equity to be eligible for any guarantee.

Further, equity or equity-like components of guaranteed schemes are also important and include indefinite public loans or other (tenant, landlord, government provided) equity. Properties which are guaranteed need to be well located, maintained in good quality and offered in highly rentable locations, thereby diminishing likelihood of vacancy and voids and protecting their capital value. The guarantee may be tied to a mortgage on an unencumbered property. Through subordination, the guaranteed bonds can be ranked higher than government equity in the project, thus senior loans have first call on repayment. The equity of the borrower can be considered the first line of defence of the guarantee.

As in the Netherlands and Switzerland, a guarantee fee can also be used to build up a reserve fund proportional to the obligations guaranteed. This can also be conceived as the government guarantee's second line of defence. In Switzerland the fee is sufficient to cover interest payments for a minimum of one year and is in addition to any issuance fee.

Alternatively, governments can act as an insurer, by pricing the risk and charging fees, thereby accumulating a fund, as in the Netherlands with the CFV. Alternatively, they must account for unfunded risks in their public accounts as contingent liabilities and set aside an acceptable proportion of the guarantee obligations in reserve. If governments intend to regularly support organisations to meet their repayment obligations, the government is in effect taking responsibility for the loan obligations and they need be accounted for as such in the government budget.

## **5.7 Conclusion: a well-managed guarantee has limited impact on government budgets**

As demonstrated by all the schemes reviewed in this study, a zero default rate has been sustained and no call has yet been made on the government guarantees. This is largely due to the supportive role of government in bolstering the equity position of housing providers and their revenue stream (co-financing, supporting low income tenants) and the financial management and monitoring regimes guiding housing sector organisations (auditing and compliance). A sustainable and sound business model is first and foremost the strongest line of defence protecting any government guarantee, growing supply capacity amongst providers and easing access to lower cost larger volumes of investment.

This report has critically appraised different approaches to guaranteeing investment with a focus on social and affordable rental housing in order to inform the development and implementation of a model appropriate to Australian conditions. Building on the findings of this review, the following phase of our research will examine the:

- Borrowing needs and capacity of the Australian social and affordable housing sector.
- Expectations and requirements of appropriate bond investors (being pension funds, insurance companies and retailers of fixed income securities) for any potential social housing bond with guarantee.

- Australian norms and practice with regards to the use of government guarantees.
- Options for an appropriate and palatable SHG, refined to address Australian social housing finance needs and conforming to international best practice.

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## APPENDICES

### Appendix 1: List of contributors and interviewees\*

**Table A1: Contributors and interviewees**

<b>Name</b>	<b>Title and Organisation</b>	<b>Country</b>
Mr. Stuart Broom	Specialist, European PPP Expertise Centre, European Investment Bank	Europe
Ms. Catherine Aubey-Berthelot*	Director General, French Mutual Fund for Guarantees of Social Housing (CGLLS) and staff*	France
Mr. Jean-Pierre Schaeffer*	Special Adviser to the National Council of Cities and former Chief Economist for the CDC	France
Dr. Michelle Norris*	Chair of the Board, Housing Finance Agency	Ireland
Mr. Barry O'Leary*	Chief Executive Officer, Housing Finance Agency Plc	Ireland
Mr. Brad Gilbert*	Head of Financial Innovation at the Scottish Government	Scotland
Dr. Peter Gurtner*	Chair EGW, Swiss Bond Issuing Co-operative*	Switzerland
Mr. Dario Laterza*	Issuance, Debt Capital Markets, Zürcher Kantonal Bank	Switzerland
Mr. Victor Schaap*	Director of Housing Markets, department of Housing Corporations, Ministry of Internal Affairs	The Netherlands
Mr. Erik Terheggen*	Manager of Policy and legal affairs, Social Housing Guarantee Fund (WSW)	The Netherlands
Mr. Stephen Stringer*	Deputy Director, Expanding the Rented Sector Programme, Department for Communities and Local Government	UK
Dr. Peter Williams	Director, Cambridge Centre for Housing and Planning Research	UK
Mr. Piers Williamson*	CEO, The Housing Finance Corporation	UK

## Appendix 2: A note about bonds

Social housing provision typically involves public and increasingly private sources of capital. For private investors, a well regulated social housing sector, with a sound business model, quality housing stock and stable revenue stream can be an attractive form of investment. Bonds can be based on obligations from rent revenue, sales, lease payments or other obligations and issued as a tradeable product amongst institutional investors. Bonds may be issued by a specialist financial intermediary, such as a housing finance agency, which pools the borrowing demands of numerous housing services, to raise finance at an efficient scale appropriate for institutional investment.

As mentioned above, there are a variety of bonds that may be issued by a financial intermediary implying different types of payments as summarised in the Table A2 below.

**Table A2: Types of Bonds and their different payment characteristics**

Type of bond	Payment characteristics
General Obligation Bonds	GO bonds are backed by the full faith and credit of the issuing (borrowing) government. This means that the government is obliged to use its taxation powers for the timely payment of principal and interest to the bondholder. Given the low risk, these bonds have the lowest yield and therefore can offer the cheapest form of finance. In Australia, these bonds are issued by the AOFM.
Revenue Bonds	RB are secured only by the earnings of revenue producing enterprises such as a mortgage loan or a portfolio of loans. The enterprise could be a housing association managing residential housing project. They do not rely upon the taxing power of third party for repayment and must be self-supporting with respect to their fees. These bonds carry a higher interest rate in the market place because they are viewed as being less secure than GO bonds. Such bonds are issued by the Housing Finance Corporation in the UK.
Limited Obligation Bonds	LOB are payable from and secured only by a pledge of the proceeds derived from specified revenues only, usually the revenues from the facility for which the bond was originally issued. These bonds may carry a higher interest rate than GOBs, where this revenue stream is less secure than general taxation powers of government. Such bonds may relate to a specific piece of infrastructure, such as toll road or portfolio of dwellings.
Moral Obligation Bonds	General Obligation Bonds, Limited Obligation Bonds or Revenue Bonds which have legally pledged security that is weak or untested. A government which is not the Issuer but has a strong credit rating approves the bond issue (through a general statute or specific action) and agrees to consider appropriating funds to cover any shortfall of pledged revenues needed to pay bond debt service. Although the government does not 'legally' obligate itself to appropriate funds, its agreement to consider appropriating funds is treated as a 'moral' obligation to do so, and this 'moral' obligation is considered the primary credit for the bonds.
Lease Secured Bonds	Bonds are secured with lease payments from the entity that uses the facility, such as a housing association. The rental stream and interest rate determine the size of the issue. They are issued by a 'shell' Issuer (often a newly created trust or non-profit corporation with no real assets), payable from and secured by a pledge of a fixed dollar contract (usually a lease agreement) with a political subdivision, such as a housing finance agency of government, where the government has the ability to levy taxes and exercise eminent domain powers. The credit for such Bonds is the credit of the political subdivision lessee, not the 'shell' Issuer.

Source: Rock 2007, p.6, Elmer 2013<sup>62</sup>

<sup>62</sup><http://www.lincolnst.edu/subcenters/teaching-fiscal-dimensions-of-planning/materials/elmer-bonds.pdf>

### **Appendix 3: Swiss Bond Issuing Co-operative terms and conditions**

Market conditions amongst investors and borrowers are decisive for the rise and fall of actual loan terms and conditions. EGW bonds are usually between six and 10 or even 15 years, the longer the bonds maturity the higher the interest rate and hence the cost of borrowing.

Duration, above- or under-par issuances and volumes are determined by the situation in the capital market and the needs of the borrower. The interest rate depends on the going SWAP rate for bonds and the going rates for borrowers with the highest credit rating (AAA). The issue price is negotiated by the lead bank, reasonably with an agio which allows the borrower to finance part of the issuing and administering costs which are divided amongst the housing associations involved.

Currently, the EGW issues five to 15-year low yield low risk bonds, which are covered by a Federal guarantee. Funds raised allow for lower cost fixed interest loans over a fixed term. Interest rates are comparatively very low in Switzerland. The cost of raising public finance is also very low, even costless, with Swiss government 10 year bonds averaging 2.8 per cent between 1994 and 2013, but declining to below zero in April 2013. These conditions and the existence of a government guarantee are reflected in the cost of EGW loans as illustrated by the most recent 10 and 15-year bond issues, bearing interest of 0.875 per cent and 1.375 per cent respectively at the date of issue (February 2013, No.44 and 45). The key dimensions of Issue 45 are provided in Table A3 below.

**Table A3: Key dimensions of EGW Bond Issue Series 45**

<b>EGW Bond Issue Series 45<sup>63</sup></b>	
Loan Amount	CHF 123,800,000.00
Interest rate	1.375%
Issue price	101.423%
Period	2013–2028
Issuance costs	
Commission decision 1.250%	CHF 1,547,500.00
Management fees CCL 1.100%	CHF 1,361,800.00
Issuing fee 0.010%	CHF 12,380.00
Provisions for losses on interest 0.150%	CHF 185,700.00
Out of Pocket	CHF 25,000.00
Coupon cashing commission (15) 0.150%	CHF 185,700.00
Title cashing commission 0.010%	CHF 12,380.00
Total issuance costs for the duration of	CHF 3,330,460.00
Emissions for the entire costs	2.690%
All inclusive costs (all-in costs) as calculating the Zurich Cantonal Bank	1.468%
Payment	
Issuance costs	2.690%
Agio	- 1.423%
Issue costs, net	1.267%

Source: EWG, 27 February, 2013

For series 45 the total of the issuance costs (as shown above 2.69% of the bond amount) includes all outlays during the duration of the bond. These include the costs of takeover, management costs of the loans, emission fees, provision for interest losses, out of pocket expenses, coupon debt collection, title collection commission and underwriting costs. That means that one 15th must be added to the annual interest rate of 1.375 per cent which in turn explains in principle the difference between the interest rate and the all-in-costs.<sup>64</sup>

<sup>63</sup> When reading the table above, the issue of CHF 123.6 million EGW bonds, refers to the total amount of funds raised by issue 45 with a 1.375 annual interest rate for a duration from 2013–28. The interest rate is the fixed annual payment to bond investors in 5000 CHF tranches.

<sup>64</sup> While this is the norm in principal, in this series the bonds have been issued 1.423 per cent above pari generating a corresponding agio which helps to cover part of the overall issuing costs. For the example above, the issuing costs of 2.69 per cent of the bond amount can be reduced by the proceeds of the agio (1.423%) leaving net issuing costs of 1.267 per cent of which one 15th is to be carried yearly by the borrowers proportionally to the amount of their quotas. These costs are added to the cost of loans issued to housing associations by EGW.

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