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How might bond finance expand affordable housing in Australia?

HOUSING SUPPLY BONDS HAVE BEEN SUCCESSFUL OVERSEAS IN FINANCING AFFORDABLE HOUSING. WITH THE RIGHT APPROACH, A SIMILAR SCHEME CAN BE IMPLEMENTED IN AUSTRALIA.

KEY POINTS

- Housing Supply Bonds (HSBs) are designed to reduce the cost of funding available for community housing providers (CHPs), and thus enhance their capacity to increase the supply of affordable housing.
- Housing Supply Bond would be targeted at super fund managers, retail investors and governments.
- Based on the research, modelling the average cost of funds to lend to CHPs would be 4.7 per cent, considerably lower than current costs of around 8.2 per cent.
- A specialist financial intermediary (or intermediaries) would need to be created. It would issue HSBs to different investor market segments and loan the funds raised to CHPs for buying or developing new affordable housing.
- Governments would have an important regulatory role ensuring loans are targeted appropriately.
- Success of the scheme depends on investors having certainty that government will continue to support HSBs long term.

This bulletin is based on research conducted by ***Dr Julie Lawson*** *at AHURI Research Centre—RMIT University,* ***Associate Professor Vivienne Milligan*** *at AHURI Research Centre—the University of New South Wales and* ***Associate Professor Judy Yates*** *at AHURI Research Centre—the University of Sydney. The project explored using bond finance—in particular the Austrian model of Housing Construction Convertible Bonds—to expand stocks of affordable housing in Australia.*

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CONTEXT

Despite innovations such as the National Rental Affordability Scheme (NRAS), finance remains a major challenge for all governments aiming to expand the affordable housing sector. In order to attract private investment, institutional development and new subsidy arrangements are needed. The research explored the feasibility of housing supply bonds as a means of doing so, and looked at what would be required to implement such a strategy in Australia.

RESEARCH METHOD

The research involved a literature review, an Austrian case study and 25 stakeholder interviews in Sydney, Canberra and Melbourne. The interviews with institutional investors, regulators, public finance specialists, housing providers and public policy officials provided understanding of industry requirements for a bond suitable for the Australian market.

Subsequently, a HSB model was presented and refined at an industry workshop composed of expert advisers, industry stakeholders and academics.

KEY FINDINGS

Aim of the Housing Supply Bond

The HSB would need to be a straight forward, low-risk, low-yield and long-term instrument in order to offer suitably cheap funds for borrowers such as CHPs.

Housing Supply Bonds are designed to reduce the cost of funding available for CHPs below that currently available from the private sector and, thereby, to enhance their capacity to increase the supply of affordable housing. The HSB proposal incorporates a combination of public funding (providing direct subsidy) and private bond finance indirectly subsidised through tax incentives and government guarantees.

Three types of Housing Supply Bond

Three forms of HSBs are proposed for the target markets:

1. The AAA Housing Supply Bond is for super fund managers. It is a fixed interest, long-term (up to 10 years) bond, which would require a government guarantee.
2. The Tax Smart Housing Supply Bond is for retail investors. It is a fixed term, fixed interest (or indexed), lower yield and long-term bond with an appropriate tax incentive that generates a competitive after tax yield.
3. The NAHA (National Affordable Housing Agreement) Growth Bond is for governments. It is a zero interest bond that converts a direct grant into a long-term revolving loan.

Rate of return

In mid-2011, HSBs would have had to yield around 8–9 per cent to attract self-managed retirement funds. Any lower yield would have to be offset by either a tax concession advantage (substantial enough to lift yields to an adequate level of return) or by a high rating, reflecting a low risk. This is why enhancements (e.g. government guarantees or tax incentives) are required to reduce risk and improve HSB yields.

The HSB proposal was modelled using an assumed scheme to raise $7 billion to finance 20 000 dwellings. On the basis of what retail and institutional investors required, the bonds were allocated 70 per cent to AAA bonds, 20 per cent to Tax Smart bonds and 10 per cent to NAHA growth bonds. As a result, the average cost of funds available for on-lending to CHPs was 4.7 per cent, considerably lower than the then current costs of around 8.2 per cent. An additional allowance would need to be made for costs incurred by the financial intermediary in raising and distributing these funds.

Financial intermediary

A specialist financial intermediary (or intermediaries) would issue HSBs to the different segments of investors, and would then loan funds raised to CHPs to buy or develop new affordable housing.

The financial intermediary would issue bonds (in discrete groups or tranches) through a special purpose vehicle (SPV) that would isolate the assets and income streams associated with each tranche and hold them in trust to provide comfort for the investors.

The financial intermediary would perform the following services:

- Link suppliers of capital with appropriate investment opportunities.
- Create aggregation benefits and efficiencies through lower transaction and search costs.
- Develop further efficiencies through specialised knowledge of the industry.
- Ensure a pipeline of projects and funds.
- Inform and educate investors and providers about risk and returns.

The intermediary could also:

- Assist in making providers investment ready.
- Provide access to funds for smaller players—helps maintain diversity.
- Contribute stability to housing and finance systems via counter cyclical activity.

Regulatory arrangements

Appropriate regulation is required to ensure that defined policy goals and targets are met. The raising of funds and their allocation to affordable housing providers must be transparent.

The financial intermediary would be regulated by two key agencies—the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA). ASIC would be responsible for regulating bond issuance and any licensed trustees. APRA would be responsible for ensuring the capital adequacy of any specialist intermediary and the proposed social housing guarantee fund.

Governments would have an important regulatory role ensuring funds raised are only allocated to registered organisations providing housing services; the housing is of a certain standard and not above a certain cost; and rent limits are placed on housing services provided.

Statutory legislation will also be required to establish the legal and regulatory structure for affordable housing providers and cover any tax reforms needed, such as allowing charitable not–for–profit housing providers to retain profits for an agreed time period (e.g. 10 years) before they must be reinvested in developing new housing.

Other government support

Success of the scheme depends on investors having certainty that government will continue to support HSBs long term.

The viability of HSBs could also be enhanced by planning reforms that promote affordable housing through inclusionary zoning, density bonuses and policies providing explicit affordability goals for urban renewal strategies and government land banking activities.

POLICY IMPLICATIONS

Before implementing a HSB, policy-makers need to know whether investors are comfortable with them and if they are cost-effective. A review of regulatory requirements applying to a financial intermediary and cost estimates for establishing and operating the entity (whether stand alone or located with an existing institution) would also be required.

Policy-makers need to consider the most appropriate authority to monitor financial and other regulatory requirements that govern not-for-profit CHPs. A national regulatory system for CHPs could be established.

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FURTHER INFORMATION

This bulletin is based on AHURI project 30652, *Housing Supply Bonds: a suitable instrument to channel investment towards affordable housing in Australia?*

Reports, event presentations and media coverage from this project can be found on the AHURI website: www.ahuri.edu.au or by contacting AHURI Limited on +61 3 9660 2300.

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