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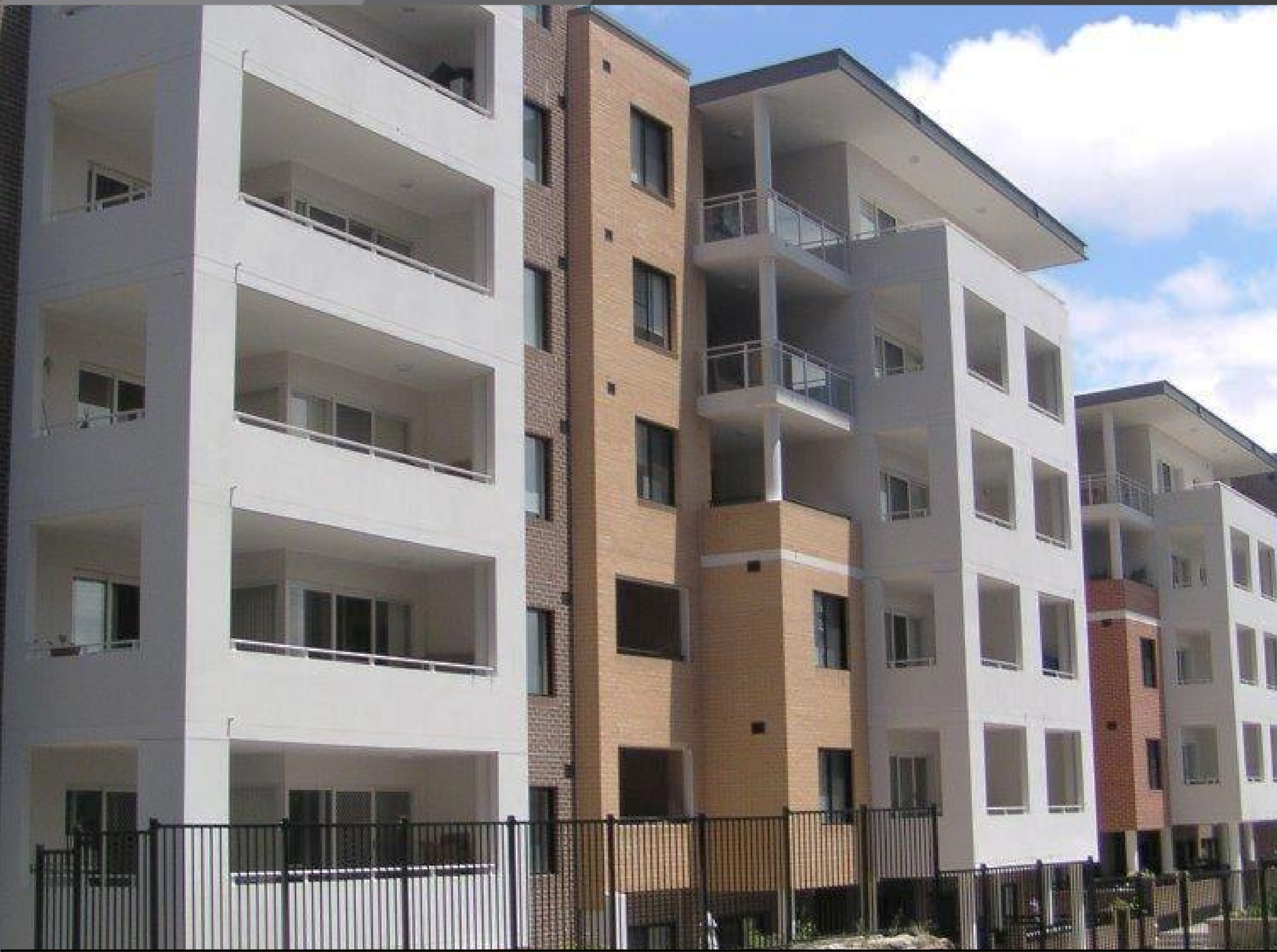

Next moves? Expanding affordable rental housing in Australia through institutional investment

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EXECUTIVE SUMMARY

This report presents the latest insights into new ways of financing much needed affordable rental housing in Australia, especially by attracting large scale institutional investors into the field. It builds on 2012/13 research led by the City Futures Research Centre (UNSW) into prospects for such a direction, as informed by a high level panel of industry experts and policy makers. To update that research, this report revisits our previous findings, reviews recent domestic and international housing investment developments, and summarises insights and experiences generated from a new round of contacts with local experts.

Engaging super funds, sovereign wealth funds and other large debt and equity investors in financing affordable housing is an often-stated goal of governments looking for innovative ways to stimulate housing supply in straitened times. Advantages claimed for such an approach include: the potentially large volume of funds available; the scope for matching institutional investor requirements for steady cash flow returns (rather than capital gains prioritised by individual investors) to a rental product offer; and stimulation of a professionally managed and more stable rental tenure that can meet the rising need for affordable housing. While interest in this objective has been evident in Australia for some time (underpinning the introduction of the 2008 National Rental Affordability Scheme (NRAS), for example), it has yet to be achieved.

As highlighted in this report, Australia's lack of recent progress in this realm contrasts with that of the UK in the same period. There, a variety of strategies – including public subsidies, leveraging existing assets, aggregation vehicles (e.g. The Housing Finance Corporation) and government guarantees for capital market financing of both market and affordable rental products – have been successfully combined to drive a switch from public funding and mortgage financing (both in short supply following the Global Financial Crisis) to institutional financing of social, affordable and market rental housing forms.

Australian experts continue to cite four major barriers to affordable rental housing investment from large institutional players:

- Lower yields than for competing investment options
- A lack of industry knowledge of rental housing products and performance
- The small scale and fragmented nature of deals on offer, coupled with insufficient liquidity, and
- Changeable and uncertain or, in some instances, unsuitable government policy settings.

Overcoming these barriers will call for concerted government action on each. While successfully attracting finance industry interest and evoking development of several possible financing models, Australia's recent NRAS experience was problematic in that technical scheme design was ill-suited to institutional investor requirements, and the program's 2014 demise arrested mounting market momentum and heightened industry concerns about policy risk. As well, insufficient time was allowed for expected market responses to develop. More fundamentally now, without a subsidy or incentive of some form, competitive yields on lower rent residential assets are not achievable.

The recommendations arising from our latest investigation (listed below) propose a practicable way forward whereby Australian governments working closely with industry experts could re-engage with advancing a new investment market in residential rental that, we argue, would have major benefits for the Australian economy and society.

Recommendations

1. Given the economic and social importance of boosting efficiently and effectively managed rental housing supply, Governments across Australia should recognise the untapped potential for large scale institutional investment in this sector. They should give priority to stimulating a new financing model to realise this prospect.
2. A cross-sectoral Rental Investment Task Force of key stakeholders and experts with high level policy and financing credentials should be appointed to develop recommendations for achieving target levels of institutional investment in rental housing supply, including an element affordable to low and moderate income groups.
3. An eminent private sector leader should be appointed to head the Rental Investment Task Force.
4. To facilitate the supply of newly-constructed *affordable* rental housing, a new incentive framework designed specifically for institutional players (and replacing the National Rental Affordability Scheme) should be developed for introduction by 2017.
5. State Governments should assemble and offer an initial portfolio of suitable shovel ready sites for residential development by private and not-for-profit developers which, on letting, can be re-financed through large-scale institutional investment.
6. State governments should offer a land tax waiver for aggregated rental holdings meeting designated regulatory requirements for affordable rental.
7. Consideration should be given to the possible role of government guarantees in facilitating institutional investment in rental housing provision, to provide comfort to backers and, thus, to minimise cost of funds.
8. An independent specialist financial intermediary, such as an Australian Housing Finance Corporation, should be founded.
9. An existing or new agency should be resourced to collect, publish and maintain appropriate financial, asset and tenancy management information that will inform all industry parties about the state of the affordable housing industry and its development.
10. Tax reform options to support institutional investment in social infrastructure including affordable housing should be investigated.

1 INTRODUCTION

1.1 The need to grow affordable rental housing

In Australia, as in many other developed countries, there is mounting concern about the large and growing shortage of housing affordable for households on low to moderate incomes ('affordable housing').[1] The withdrawal of direct government investment in new supply, a long-term trend, necessitates greater reliance on the private sector. Australian experience has shown that the current private rental system, dominated by speculative small-scale individual investors, serves the top end of the rental market extremely well. However, the lower end of the rental market, where rental yields are relatively constant and secure over the long-term, is likely to be better served by institutions prioritising long-term stable income returns rather than unpredictable capital gains. Yet, the long-held aspiration to reconnect institutional finance with rental housing has remained elusive (Pawson & Milligan 2013).

Australia's affordable rental housing shortage has been exacerbated by a long-term decline in the share of social rental housing, interrupted only briefly between 2008 and 2012 due to Commonwealth Government initiatives in that period (see Milligan & Pinnegar 2010). Although only part of the affordable housing picture, at some 422,000 dwellings, overall social housing provision in 2013 (AIHW 2014) remained more than 100,000 below the level needed to keep pace with post-1996 household growth (National Housing Supply Council 2012). At the same time, while private rental provision has expanded ahead of the nation's growing population, the total number of private rental dwellings affordable for low income households has declined. In conjunction with the way that existing stock is allocated in the private rental market, this has resulted in the shortage of private rental dwellings *affordable and available to low income households* growing to some 270,000 by 2011, up from 150,000 in 1996 (Hulse et al. 2015).

Due to these trends, growing numbers of lower income households are being effectively pushed into poverty by unaffordable housing costs. Across Australia, the proportion of lower income renters paying rents equating to more than half of household incomes rose from 20% in 2007/08 to 25% in 2009/10. By 2009/10 60% were paying more than 30% of income in rent (National Housing Supply Council 2012). With rents having continued to run well ahead of general inflation for most of the past two decades, it seems highly unlikely that such trends will have reversed in more recent years. The costs borne by individual households due to poor housing affordability have been well documented.[2] One such cost is that, in their search for more affordable housing, lower income households are pushed further into middle and outer suburban locations in our major cities, increasingly remote from job-rich inner cities and CBDs (Randolph & Tice 2014; Pawson & Herath 2015).

Both unaffordable housing and poorly located affordable housing are problematic for residents because of the pressures they place on individual household budgets and time availability. They are also problematic for society as a whole since they impair both

[1] In this paper, affordable housing refers to rental housing that is priced within the means of low and moderate income households. This incudes but is not limited to social rental housing, which in Australia is targeted to high needs clients, and other forms of government supported and market rental housing.

[2] See, for example, Yates and Milligan 2007

national economic efficiency and competitiveness (Rawnsley & Spiller 2012) and risk further eroding the social contract around fairness and opportunity.

With declining budget capacity, governments face a difficult task in responding to such challenges. However, with appropriate government support there is a market opportunity for the finance sector to invest in rental housing. Thus, as discussed in greater depth in our 2013 reports (referenced below), a number of developments have recently created more favourable conditions for investment industry interest:

- The demographically-driven transition of some superannuation funds from the 'accumulation phase' to the 'pension phase' in which more reliable (if lower yielding) investments assume greater priority.
- The post-GFC finance sector recognition of the need to maximise portfolio diversification, especially through engagement with an investment class characterised by cycles differing from other types of asset.
- Investing institutions' appreciation that residential rental returns tend to rise in line with earnings, thus often matching funds' long-term liabilities.

If adequately underpinned by state assistance this could include affordable housing. This would involve facilitating large-scale institutional investment supported by government subsidies and/or credit enhancements in return for resulting tenancies being made available to qualifying households at below-market rents. This is, indeed, what the 2008 National Rental Affordability Scheme (NRAS) was intended to achieve. However, for reasons explored in this report, the Scheme's objectives were not fully realised.

Building on an already substantial body of research to which we have contributed, this report considers the changing prospects for securing large-scale, long-term financing of rental housing in general and affordable rental housing in particular.

1.2 Research purpose and methods

Both in Australia and elsewhere, the scope for institutional financing of (affordable) rental housing has been extensively discussed over the past 10-20 years. However, the specific starting point for the current study was the 2012 investigation on the topic progressed via an industry and policymaker panel facilitated by the current authors and funded by the Australian Housing and Urban Research Institute (AHURI). Two resulting reports were published (Milligan et al. 2013a, 2013b). Box 1 summarises the four major barriers to progress identified by this expert panel, together with the mitigating strategies and actions proposed at that time to address these. Unfortunately, despite strong backing from research participant stakeholders (including government officials), these have yet to evoke any substantial government response.

A follow up research project was conducted by City Futures researchers in 2014/15 to update our earlier findings in the light of significant post-2012 policy and market changes. This update benefited from a substantial contribution by Professor Peter Williams, one of the UK's leading experts on the subject.

In this report the findings of this 'follow up' project are presented in three main sections. First we highlight post-2012 developments in policy and market conditions and discuss their implications for the potential for enlarging institutional investment in rental housing. This includes an update on relevant UK developments. Second, we present the latest industry insights into ways to address the persisting critical domestic barriers to institutional investment. Finally, we discuss possible policy directions and detail recommendations.

The report draws on interviews and roundtables involving a wide range of industry stakeholders, policymakers and other experts. Participants included:

- Commonwealth and state (NSW and Victoria) government officials
- Finance industry professionals
- Expert consultants and lobbyists.

In all, 15 participants were involved via in-depth interviews and 39 attended roundtable events convened by the research team. In addition, the report is informed by a review of recently published policy and academic literature on housing finance.

BOX 1: FINDINGS OF 2012 INVESTIGATION INTO INSTITUTIONAL INVESTMENT IN AFFORDABLE HOUSING*

Key barriers	Strategies as proposed in 2012/13
Risk return ▪ Secure and predictable returns commensurate with alternative investment options are required. ▪ Basing return on rents not capital growth will be preferable to institutional investors. ▪ Risk and perceived risk increase yield requirements, which works against affordability.	▪ Encourage development of an infrastructure-style rental housing product with return determined solely by cash flows from rental revenue (avoids development risk). ▪ Offer a government equity component (e.g. land) ▪ Maintain a financial incentive (such as NRAS) to meet yield requirements and achieve affordability goals.
Novelty ▪ Pooled residential funds are an unknown asset class. Market growth will require development of a robust track record on the performance of rental assets, tenancy managers and pooled instruments.	▪ Embark on a proof-of-concept phase (2-3 years) to develop the investment market, with government support. ▪ Offer credit support (e.g. revenue guarantee) and manage tenancy risks to encourage industry start up and overcome major perceived risks.
Scale and liquidity ▪ Large investors require large and diversified deals in tradeable products. Deal sizes of \$50m to \$250m for an institution and at least \$500m p.a. in aggregate would be expected to create liquidity and establish a sustainable market.	▪ Consider specialised intermediaries to aggregate investment options. ▪ Support development of secondary market mechanisms–e.g. bonds, Real Estate Investment Trusts. ▪ Set rental supply targets (see below) to meet scale requirements – including both affordable (assisted) and market rental components. ▪ Assemble rental investment opportunities across jurisdictions (especially in view of small Australian market).
Policy risk ▪ Long-term, robust commitments are expected from government. The possibility of investors being left with an "orphaned asset" (an isolated type of investment vehicle with little hope of further investment or liquidity if government support ceased) was identified as a serious concern.	▪ Establish a long-term National Strategic Policy Framework for private investment in affordable housing. ▪ Appoint a high level cross sectoral Task Force to steer development of the strategy. ▪ Nominate annual affordable housing supply targets commensurate with housing needs and investor scale requirements and align commitments to government incentives with the targets.

*The investigation considered the key barriers to investment in rental housing and devised a package of responsive strategies. The 23 panel participants included senior public officials, banking and superannuation industry experts and housing industry specialists.

Source: Milligan et al. 2013a

POST-2012 INVESTMENT CONTEXT

2.1 Housing policy developments

For many years Australian governments have voiced interest in stimulating investment of larger scale private capital from new and diverse sources into affordable housing. In particular, the desire for involvement of larger financial institutions has been stressed.[3]

Since the 2012 AHURI study the policy context for housing investment has changed in several important ways with implications for investor appetite and decision making, as discussed below.

2.1.1 Cessation of the National Rental Affordability Scheme (NRAS)

NRAS was Australia's 2008 national ground-breaking program designed to incentivise private investment in newly constructed affordable rental housing through an annual tax credit offered to private investors for ten years. At introduction NRAS was marketed strongly as an incentive for institutional investors that, if effective, would be expanded to 100,000 affordable rental dwellings from its initial target of 50,000 after 2012/13.[4]

Conceptually, the scheme was loosely based on the long-established and successful US Low Income Housing Tax Credit program. Its specific features were adapted from the National Rental Affordability Incentive (NARI) model, developed outside of government by a coalition of housing industry and community sector organisations prior to the 2007 Federal Election.[5] As it emerged under the post-2007 Australian Government, however, NRAS departed from NARI in several major ways that arguably damaged its appeal to institutional investors, which we discuss further below (see Section 3.5 and Box 3).

At its inception, NRAS received broad-based backing from across the political spectrum. Scheme advocates recognised that to secure institutional investor commitment a medium to long-term approach would be essential.[6] In 2014, however, the program was capped at a maximum of about 38,000 affordable rental dwellings. By that time it had successfully stimulated nearly 22,000 new builds owned by small-scale investors (including family trusts and self-managed super funds) and not-for-profits, but it had yet to attract institutional finance (Australian Government 2014a; project interviews). However, several leading banks and superannuation funds had shown more than a passing interest in the scheme and claim to have developed workable models.[7] It is also understood (from

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[3] See for example, Housing Ministers Conference (2009) 'Implementing the National Housing Reforms: A Progress Report to the Council of Australian Governments from Commonwealth, State and Territory Housing Ministers'.

[4] Plibersek, T. (2008) National Rental Affordability Scheme Bill 2008, Second reading speech, House of Representatives Hansard, September 24

[5] The National Affordable Housing Summit operated from 2004-2011 (Milligan & Tiernan 2011). Detailed consultation, modelling and design activities were conducted by this group over several years prior to finalisation of the NARI proposal for public release in 2007. These consultations included extensive discussions with major financial institutions, developers and governments, as well as with housing providers, residents and academic experts.

[6] See, for example, the 2008 Senate Standing Committee on Community Affairs Inquiry into Bills to establish the scheme – viz. the National Rental Affordability Scheme Bill 2008 and the National Rental Affordability Scheme (Consequential Amendments) Bill 2008.

[7] Milligan et al. (2013a:30-36) describes the emerging investment market and prospective models partly stimulated by NRAS. One product, the GRAIL (Government Rental Affordability Indexed Linked) Income Fund, described in that report (p. 34) went to market in 2013 offering an indicative annual return to investors of CPI plus 5%. Marketing confirmed that this product suited super funds' preferences for an index-linked payment (for debt finance) and that they were attracted to an option that avoided property risk. However, negotiations with super funds broke down

industry sources) that funding applications by domestic and international institutional investors were among those in 'Round 5' – the May 2013 call for applications that was terminated due to budgetary cut-backs under the new Coalition Government following the September 2013 Federal election.

2.1.2 State government initiatives

New initiatives in the housing realm with potential to attract private finance at scale have emanated from individual states, notably Queensland and NSW.[8] In particular, the **Queensland Government's 'Logan renewal plan'** and prospective **NSW Premier's Innovation Initiative** have attracted industry scrutiny. The former involves transfer of the management of nearly 5,000 public housing dwellings in Logan City to a community housing provider (CHP) from mid-2015 and rolling redevelopment of some of the transferred sites to provide an additional 1,500 social and affordable rental dwellings. Originally, to attract investor interest, the Logan transfer was designated as the first of a 5-year program of transfers involving over 90% of public housing in Queensland (45,000 dwellings in addition to the Logan tranche) (Pawson et al. 2013). However, the 2015 change of government in Queensland may put this program in doubt. While private sector engagement with the Logan project was restrained[9] and financing of the redevelopment component is yet to be arranged, schemes of this type are recognised in the industry as offering some potential for institutional investors, not least because of the scale of the requirement underpinned by strong government backing.

The NSW Premier's Innovation Initiative concerns an Expression of Interest (EOI) process underway at the time of writing and (*inter alia*) calling for financing innovations to assist with social housing modernisation and new supply. Initiated by the NSW Department of Premier and Cabinet, this initiative is centred on 'sweating existing assets' rather than offering new government investment. Indeed, proponents were directed to propose innovations that represented no cost to government. Nevertheless, in what will be seen as an encouraging development from an industry perspective,[10] the NSW Government has signalled that it is:

> *…open to considering the provision of credit enhancements to assist with securing third party capital on competitive terms provided the application is considerate of the impact such credit enhancements would have on the State's balance sheet and/or credit rating.* (NSW Government 2014: 3).[11]

Importantly to considerations of scale and durability, in the evaluation of bids made under the Initiative, preference will be given to innovations capable of wider application – e.g. in other geographic locations or segments of the market (NSW Government 2014: 9).

2.1.3 National Disability Insurance Scheme

Beyond these specific state plans, the new National Disability Insurance Scheme (NDIS) may also offer potential for new investment

over the cost of intermediary fees (Interview investment intermediary).

[8] While this study did not cover Western Australia, under the WA Government's affordable housing framework there have been some promising developments. Of most relevance, is the exploration of alternative financing structures and investment products, such housing bonds and tradable instruments, with the potential to attract institutional investment.

[9] The winning bid team involved not-for-profit organisations only. One other competing bid remained at the end of the bid process.

[10] See also Milligan et al. (2013b: 16-19) and Lawson et al. (2014) for discussion of the role and potential for government guarantees

[11] The term 'credit enhancement' refers to ways that government can facilitate the commitment of private finance – e.g. through debt repayment guarantees or balance sheet support.

models. NDIS is an innovative seven-year funded national program (commenced in 2013) to provide individualised support for people with permanent and significant disability, their families and carers. Under the scheme, the housing needs of clients will be addressed through a combination of referrals to existing programs and services (such as public and community housing, rent assistance and NRAS dwellings), family investment and a dedicated stream of funding for accommodation, including retrofitting, that is scheduled to flow from 2015/16 and is expected to reach $700m per annum by 2018/19. There are aims to leverage this public funding (partly sourced from a levy on taxpayers) two to threefold by taking advantage of the cash flows it will generate (Bonyhady 2014). Family equity is likely to be a major source of private funds. However, pooling of housing payments to individuals to create scalable investment opportunities could create the conditions for attracting institutional investment. Further guidance on investment opportunities and options was expected in mid-2014 but has been deferred by the Commonwealth.

2.1.4 Commencement of national regulation of community housing organisations

Allocating management of affordable housing owned by both public and private investors to regulated arm's length not-for-profit organisations has been a growing international trend also ramping up in Australia (Pawson et al. 2013). In keeping with investment industry expectations, a National Regulatory System for Community Housing (NRSCH) began operating in 2014. This offers a uniform system of regulation of housing not-for-profits and facilitates their cross-jurisdictional operation.[12] Importantly for the institutional investment sector, regulation assists with giving assurance about, and reduces risk associated with, how residential assets are managed. Further involving finance industry representatives in the NRSCH's development will be desirable to ensure that the regulatory model continues to provide them with adequate assurance of high quality financial, property and tenancy management.

2.1.5 Prospective policy developments

There are a number of extant areas of policy development with the potential to impact on the attractiveness of institutional investment in rental housing.

One critical area concerns welfare reform and, in particular, the future of **Rent Assistance** payments (RA) to lower income tenants. RA boosts affordable housing revenue streams and hence underpins landlord returns. A February 2015 report of a major review of the welfare system ('the McClure review of Australia's welfare system') recommended wide ranging changes to welfare payments, including changes to RA, which will be considered by the Australian Government in the context of the 2015 Budget. Assessment of welfare payment changes from the perspective of how these could impact government ambitions for private investment in affordable housing will be crucial.

Another contemporary policy discussion with potential implications for the pathway for institutional investment in rental housing concerns the future designation of housing policy roles and responsibilities between the Commonwealth and the States and Territories. Along with other expenditure areas, this will be considered in the forthcoming **White Paper: Reform of the**

[12] Unfortunately, two jurisdictions (Victoria and Western Australia) are not currently participating in the NRSCH, although they have indicated an intention to operate compatible state-based systems.

Federation (Australian Government 2014b). Prospectively, the closely aligned **White Paper on the Reform of Australia's Tax System** will also have a vital bearing on future housing investment patterns. The release of the terms of reference for that review was imminent at the time of writing.

A set of six principles will guide decision making on the future of government housing assistance within the context of the White Paper on Federation. One of these principles, [13] 'national interest considerations' – such that 'where it is appropriate, a national approach is adopted in preference to diversity across jurisdictions' (Australian Government 2014b: 2) – will be especially relevant to the future of institutional investment. As evidenced previously and reiterated in this study, our research points strongly to the need to:

- Promote a national market for investment in a residential asset class, especially to achieve scale and spread risk, and
- Achieve (cross jurisdictional) policy consistency (especially taxation) to drive market efficiency.

Finally, due to report in mid-April 2015, the Australian Senate Economics References Committee Inquiry into Affordable Housing has been examining many aspects of affordable housing policy, including the role for 'innovative and responsible funding mechanisms that provide a stable and cost effective way of funding affordable rental and social housing, such as affordable housing supply bonds and an affordable housing finance corporation.'

[13] The other five guiding principles are: accountability for outcomes; subsidiarity; efficiency equity and effectiveness of service delivery; durability; and fiscal sustainability.

2.2 Market conditions

2.2.1 The changing context for housing investment

Since the 2012 study the economic context for housing investment has changed in several important ways likely to affect investor appetite and decision making.

House prices have increased steadily since 2012, particularly in the larger capital cities, and private residential commencements, driven primarily by approvals for higher density dwellings, have returned to levels not seen for well over a decade. In part, these outcomes reflect mortgage lending rates which, since 2012, have declined to 50-year lows. Since rental growth has been more muted, such trends have damaged rental returns, evoking fund manager concerns:

> *You pick up the paper every day and it tells you you've got the most expensive housing market in the world* (interview, investment manager super fund).

The associated acceleration of the rate of growth of credit to individual investors has led the Reserve Bank Governor to suggest that it 'should prompt a reasonable observer to ask the question whether some people might be starting to get just a little overexcited' and to contemplate 'focused action to help ensure sound standards ...that might lean into the price dynamic'.[14] Such an approach is seen as an attempt to stretch out the upswing rather than constrain construction activity (Stephens 2014: 5).

Debt-financed small landlord investment through self-managed super funds (SMSFs)

[14] At the end of 2014, the Australian Prudential Regulation Authority (APRA) announced its intention to increase its supervisory intensity of Authorised Deposit Taking Intermediaries (ADIs) in the area of mortgage lending with a particular focus on the very strong growth in investor lending.

has also grown at an unprecedented rate in response to changes that have enhanced the financial appeal of property investment and as a result of relaxed constraints on borrowing against superannuation accounts.[15] Such provisions put industry and retail super funds at a disadvantage because they cannot negatively gear their investments. Concerns about the growth of SMSF residential investments have led to calls for regulatory changes to limit the associated risks, recognising the capacity for house prices to fall as well as to rise. The 2014 Murray report on the financial system, for example, as well as calling for a removal of tax breaks that encouraged speculative investment in housing, recommended that all super funds be banned from borrowing (FSI 2014: 74).

Increased rental property investment is also likely to have contributed to a slow-down in real rental growth after a decade or more of relatively strong upward movement. This, in conjunction with house price inflation, has contributed to declining rental yields since 2012.

The slowdown in rental growth also is likely to have been influenced by the impact on lower income renter households of post-2012 below-trend economic growth and negative growth in real net national disposable income per capita. Unemployment has increased and wage growth has fallen, both of which have contributed to a decline in the growth in real household disposable incomes for lower income households. These have been exacerbated by reductions in some social security payments.

Discussions with industry participants suggest these economic trends are likely to have had little impact on their overall appetite for residential rental investment (although in part this is always relative to what returns might be achieved in other sectors). The recorded upsurge in rental investment by individuals (and SMSFs) reflects an increased demand for the larger multi-unit developments that are preferred by those who contract out the management of their investment property. The sensitivity of such investment in rental housing to anticipated capital gains, the probability that house price growth will eventually slow and the uncertainties surrounding tax and financing arrangements for such investment raise questions about its reliability as a source of funding into the future. The potential volatility of funding from individual investors and its observed failure to deliver affordable housing for lower income households highlights the need for a new source of funding less reliant on speculative motives. As reported below, there is growing finance industry recognition of the potential for institutional investors to provide such funding.

2.2.2 Lending for affordable housing in Australia

Unlike in other countries such as the UK, data on lending for affordable housing in Australia is hard to come by. [16] Lawson et al. (2014: 29-36) provide an overview of domestic lending arrangements current at the start of 2014. They reported growing lending into the affordable housing sector via the banking industry, involving the four large Australian banks and several second tier banking institutions. Nevertheless, sub-optimal and relatively immature lending practices – characterised by traditional bank debt at margins above standard mortgage interest rates, short loan terms (and hence mounting refinancing risk and cost) and one off,

[15] See, for example, RBA Financial Stability Review, September 2013: 54-57.

[16] For example, The Homes and Communities Agency publishes a quarterly survey setting out the amount of borrowing registered providers (not-for-profit housing associations) have taken and finance sources.

fragmented and lengthy fund raising processes – were the norm.

In October 2014, reputedly the largest deal for debt funding into the sector to date, which took three years to finalise, was announced by Westpac Institutional Bank: a $61m loan facility to SGCH Ltd, a large NSW-based community housing provider, for the development of 275 new homes. This deal involves the bank financing developments by a newly created special purpose vehicle (SPV) on a renewable three year term. The lending is cash flow and non-recourse based, and has backing from the NSW Land and Housing Corporation (LAHC).[17] The loan is also supported by security held over both existing and new assets vested in the SPV.

As reported in our previous study, (Milligan et al. 2013a: 35) a collective of eight larger Australian community housing providers (CHPs) is in continuing negotiation with a banking institution and an intermediary to develop a residential asset-backed bond for their industry. However, the termination of NRAS was a major setback for this initiative. Consequently, public housing asset transfers to CHP balance sheets and/or other forms of credit support will be essential pre-conditions for such an initiative (interview, banking intermediary official). Confirming that financing arrangements are crucial, Australia's leading CHPs have identified a lack of large-scale structured financing and associated institutional support as the main factors constraining their sector's potential to emulate international success in affordable housing production (Milligan et al. 2015).

[17] The terms of LAHC backing are set out in a tripartite deed of agreement. They include an orderly process for relocating tenants before any foreclosure move, which aims to address a key investor concern about reputational risk arising from eviction of tenants.

2.3 International experience

As many Western governments have reduced their direct investment in housing provision, additional measures have been widely adopted to reduce the impact of that change. These also complement other continuing forms of public policy support for affordable housing such as: rent assistance/housing benefit, government land provision, 'soft' public loans, guarantees, and planning policy support.

The primary and interconnected rationales for the widespread development of so-called 'innovative financing measures' are derived from aims to:

- Reduce direct public expenditure
- Mobilise the very evident capacity of the private market, increase the volume of funds available and promote fund-raising efficiency
- Create a long-term market in tradeable investment (liquidity) in residential assets
- Reduce the cost of funds through lowering risk profiles, real or perceived, and
- Create a competitive and sustainable market in residential investment (drawing on multiple – debt & equity – sources of funding, both national and international).

Longer term investment in rental housing by arm's length investors may also have flow-on benefits for investors and consumers, including fostering professional tenancy management firms and providing greater tenant stability (than occurs when investors are motivated partly by realisation of opportunistic capital gains) (Crook & Kemp 2011).

Some of the measures in this realm, such as the US Low Income Housing Tax Credit are long established and remain operational, proving their durability. Others are more recent having been designed specifically for the post-GFC financial environment. Previous AHURI-funded research provides a consolidated record of relevant international financing initiatives judged potentially adaptable to the Australian context.[18] In a recent international review of innovative financing of affordable housing, the Australian NRAS initiative was one of the six schemes selected as having potential applicability in the UK (Gibb et al. 2013). NRAS features highlighted as desirable included: the scale on offer; having a competitive subsidy (among different investor classes); and the flexibility engendered through allocations to both low and moderate income groups.

2.3.1 Recent UK developments

As highlighted in our previous study[19] and by Professor Williams in presentations made during his recent Australian visit, the UK in particular has seen mounting interest in generating an institutionally financed rental sector. A flurry of parliamentary, government, industry and academic reports attests to this[20] along with specific government initiatives,[21] as highlighted in Box 2. All of these reports, developed by a cross-section of stakeholders (substantially from the private sector), have a common focus on the need for institutional financing to stimulate new rental housing supply. This is seen as having the potential to provide substantial long-term housing funding, with a good match between inflation-linked rents and the payments due on the pensions these funders provide. Many such institutions already have exposure to UK housing via housing association bond finance and private placements and this is now being extended with equity investment (Milligan et al. 2013b). The expectation is that this will continue to grow.[22]

Industry-led initiatives

Largely independent of government moves to promote such investment (see Box 2), the past few years have seen a growing range of 'build to rent' projects involving collaborations between larger housing associations and institutional players to develop *market rental* accommodation at scale. Participating associations have included Genesis, L&Q Group, Notting Hill, Places for People, Sovereign and Thames Valley Housing (TVH). Prominent among investor partners have been Aviva, Legal and General and M&G Investments.[23]

[18] See especially Lawson et al. (2010; 2012; 2014); Lawson (2013) and Milligan et al. (2013b)
[19] See Milligan et al. (2013b:20-26)
[20] Prominent among recent independent reports promoting new financing options are:

- Lloyds Banking Group (2015) Report of the Lloyds Banking Group Commission on Housing
- Legal and General (2014) Let's House Britain, UK Housing Crisis Report 2014, Legal and General, London
- KPMG in partnership with Shelter (2014) Building the homes we need: A Programme for the 2015 Government; London: KPMG
- Scanlon, K., Whitehead, C., Williams, P. & Gibb, K. (2013) Building the Rented Sector in Scotland, Homes for Scotland, Edinburgh
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[21] A summary of UK government's initiatives can be found in Wilson (2014). As further background see Williams et al. (2011)

[22] In the most recent deal, Legal and General has announced its first investment in the UK Private Rental Sector (PRS) market and plans to become a major owner of rented accommodation; seeing it as an ideal new institutional asset class for long term investors, and with an appetite to invest up to £1bn in the sector. Legal & General Capital (LGC), the principal investment division of the Group, has acquired an initial £25m regeneration site at Walthamstow in London to build and rent over 300 flats.
[23] Projects involving these players are extensively reported in the UK journals 'Inside Housing' and 'Social Housing'. Among initiatives additional to collaborations involving institutional entities and housing associations has been the recent Countrywide/Hermes announcement of a PRS investment fund.

Launched in 2012 and planned to involve the development of 1,000 market rental homes in and around London over three years, Thames Valley Housing's Fizzy Living project is a collaboration between this West London-based housing association and the sovereign wealth fund of Abu Dhabi, projected as generating a 5% net yield.[24] All profits are earmarked to cross-subsidise affordable housing which remains TVH's main business (Reeves 2014).

Among the other housing association-institutional investor collaborative models, which are now proven concepts, is the arrangement where an association initially funds and develops a project, with an institutional entity being engaged to refinance the scheme upon practical completion, acquiring the freehold property equity but leasing it back to the association which then functions as the long term manager (see Pawson & Milligan 2013).

It should be emphasised that the collaborations cited above relate to market rental products rather than affordable housing. While possibly benefiting from scale efficiencies in procurement and/or management, they are essentially unsubsidised projects, developed without any significant government assistance. Adapting models of the kinds referenced above to generate *affordable housing* would of course normally require significant government subsidy and/or credit enhancement.[25] However, they highlight the potential to separate ownership from management and help providers to avoid locking up capital which can be usefully employed undertaking more development.

Given their very large size and financially robust status, the UK housing associations engaged in market rental schemes are also incomparable with Australia's still fairly small and typically asset-poor community housing organisations (true of even the largest operators). However, while lacking the asset-backed capacity to raise development finance enjoyed by such UK counterparts, Australian CHPs are developing a strong housing management track record, potentially equipping them to play the scheme management role in equivalent collaborations. Indeed, post 2012 several of the larger CHPs entered into 'fee-for-service' management arrangements with NRAS investors (Milligan et al. 2015).

The UK 'build to rent' projects in which housing associations play a leading role are, it must be acknowledged, of indirect rather than direct relevance to affordable housing provision in Australia. The recent emergence of such projects nevertheless demonstrates the practical feasibility of institutionally financed new build rental housing developed at scale (e.g. in terms of generating acceptable rates of return), as well as illustrating the real appetite for such involvement among diverse types of institutional entities.

[24] Source: Riding the wave? Grant, profit and the future of housing associations in England; the case of Fizzy Living; UNSW seminar presentation by Peter Williams, 22 October 2014

[25] 2013 changes to NRAS rules had triggered the emergence of for-profit / not-for-profit collaborations supplying affordable housing in Australia but their further development has been impeded by the cancellation of that scheme (Milligan et al. 2015: 25).

BOX 2: RECENT UK POLICY AND INDUSTRY INITIATIVES TO ATTRACT PRIVATE INVESTMENT IN AFFORDABLE HOUSING

Initiative	Purpose	Impact
UK private rental and affordable housing debt guarantees 2013	Under the UK-wide Housing Guarantee Schemes, the UK Government provides a guarantee to support debt raised by borrowers to develop additional affordable and market rental housing. There are separate guarantee schemes for affordable housing and market rental projects. The maximum value of guarantees across both schemes is £10billion, of which each has been allocated £3.5bn initially, with £3.0bn held in reserve. The schemes aim to attract investors seeking a stable long-term return on debt finance without exposure to residential property risk. In 2013 a delivery partner, The Housing Finance Corporation Limited (THFC) was appointed as operational manager of the Affordable Housing Guarantee Program (AGHP). Effectively that scheme is using the government's fiscal credibility to reduce the cost of borrowing for housing providers	Announced In January 2014, the first deal involved £500m investment, secured through an agreement with the European Investment Bank, to deliver up to 4,300 new affordable rental homes[26] Conditions included: ▪ Minimum loan size £5million. ▪ Minimum property security value not less than 115% of the loan on an Existing Use Value-Social Housing (EUV-SH) basis. ▪ Net Annual Income from charged security not less than 100% of annual interest payable on the loan. ▪ An annual administration fee equal to 0.10% (indexed) of the loan amount. Subsequently an inaugural AGHP £208m government-guaranteed bond issuance achieved a margin of 37 bps for a further 13 associations with an all-in cost of funds 3.764% (3.93% with fees) and with a 28 year term. This was competitive with other government backed funding although some UK Housing Associations are able to raise funds without guarantee for similar rates.
UK Housing Association bond issues	UK housing associations have since 1988 raised funds by taking on bank debt and by issuing bonds that typically are bought by institutional investors. Bond financing – typically priced at a margin over the 10 year gilt rate – has expanded post-GFC as a consequence of banks retreating from the long-term debt market	Total bond issuance for 2010-11 was less than £1 bn. In 2011-12 this figure rose to £1.5 bn. In 2014 the Homes and Communities Agency (HCA) reported that the sector's borrowing facilities in Q3, 2014 totalled £74.5bn, 75% of which was bank loans, thus suggesting bond issuance plus private placements now stood at £18.6bn. New facilities arranged in the quarter totalled £1.7bn with capital market funding, including private placements, contributing 73% of the new funding in the quarter.[27]

[26] Fund recipients included Devon & Cornwall Housing Limited (£85 million/887 homes), Hexagon Housing Association £12.5 million/74 homes ; First Wessex £88 million/589 homes; Great Places,£50 million/674 homes; Wales and West Housing, £25 million/251 homes; Adactus, £27 million/344 homes; Home group £61 million/642 homes; and Paradigm £65 million/594 homes.

[27] HCA Quarterly surveys

Initiative	Purpose	Impact
London Housing Bank	Reflecting the shift in responsibility for government housing funding from central government to the Greater London Authority in 2014, details were released of a proposed London Housing Bank. The Bank aimed to gear up on the finance provided and facilitate the purchase of market homes off-plan and to incentivise developments by offering funding guarantees. Future funding would come from a range of sources, including the public sector and, potentially, institutional investors. Under a funding prospectus published in September 2014 the GLA made a £200m loan available for intermediate rent to lever in a further £466m of investment. In a second round a further £180m loan was made available for shared ownership with the aim of raising £1.2bn.	The two rounds of funding aim to support 4,000 intermediate rental and 4,000 shared ownership homes. Early indications are positive in terms of this getting off the ground and, for example, bidding for the London Housing Bank funding for the 'Intermediate Rent' product is open until early May. Funding allocations will be announced later in the year.
National Housing Trust (NHT) Scotland 2010	The Scottish Government, with support from the Scottish Futures Trust (SFT), developed the original NHT model for councils and developers. This leveraged private sector funding and council borrowing to deliver homes for intermediate rent (i.e. with rents pitched between social housing and market levels). Limited Liability Partnerships (LLPs) were set up to do this and purchase the homes produced paying between 65% and 70% of an agreed purchase price to the developer up-front. This was funded by participating councils offering loans to the LLPs in their area. The remaining 30% to 35% of the purchase price was contributed by the developer as a mixture of loan funding and equity investment.	By 2014 agreements had been struck with 15 developers for the delivery of over 1,250 homes across 10 council areas. Almost 800 homes have been completed, with more in the pipeline.

2.3.2 Other developments of interest

There have also been developments in sectors other than housing with potential applicability. By far the largest such activity in both the UK and Australia is the government-led, privately financed boom in infrastructure partnerships, especially for transport. Such projects are often based on government investing directly into a government-owned SPV initially and selling off later to private financiers on the basis of demonstrated cash flows generated by the completed facility. Our latest industry consultations reaffirmed that forms of infrastructure provision offering long-term revenue can be readily financed by the institutional sector.

This position informed the recommendation in our previous report that rental housing could be presented as an infrastructure-styled investment that can offer an acceptable risk-adjusted investor return from rental revenue (Milligan et al. 2013a: 8). As yet, however, the more powerful argument has been for building investment in transport infrastructure, like roads and ports. Accordingly, government recognition of affordable rental housing supply as infrastructure remains to be seen.

Another recently strong international policy trend in housing finance has been greater use of government guarantees to attract preferred private investment. As set out in Box 2 above, UK governments (England and Scotland) have shown the way recently in innovating around guarantees for provision of private and affordable rental housing supply. Lawson (2013) reviews the case for guarantees and outlines the ways that various forms of guarantees have been used to back affordable housing financing in seven countries.

There have also been fund raising developments in the local government sector that could establish a precedent for the affordable housing sector, if the latter could emulate the quality and scale of assets and cash flows that pertain in the former. Local government led initiatives include:

- The **UK Municipal Bond Agency**.[28] This is an independent company owned by local government shareholders that aims to reduce the financing costs of local governments through aggregating capital market funds (by issuing bonds) and sourcing other finance, such as from banks, pension funds or insurance companies, and offering a first loss guarantee. Initial fund raising efforts are underway. Councils and their local Housing Associations are expected to be able to use a share of the funds raised for housing developments. Pooling of lending requirements by this means helps to create the scale that is needed to attract institutional investment.
- A similar model is the **New Zealand Local Government Funding Agency.** Established in 2012 this had issued NZ$3.7 billion in loans to municipal members by end FY 2014 when loan costs had reached 15 basis points above the government bond rate.
- A 2014 Auckland City Council announced a plan to support fund raising specifically for affordable housing supply through pooling investor funds and offering a NZ$6 million equity funding commitment. While initially aimed at philanthropic investors, the **Auckland Housing Bond** has demonstration potential. An arms-length not-for-profit

[28] This builds on the much longer running Swedish Kommunivest set up in 1986

fund-raising agency is being established for the purpose.

- The Victorian Local Government Funding Vehicle (LGFV). Established with 30 local council members, 2014 saw their launch of a $200 million bond to be sold to a mix of domestic and international investors. This will enable participating councils to replace some of their traditional bank borrowings with lower cost debt capital markets' funding. A national collective financing authority for local government has been recommended for Australia.

3 INDUSTRY INSIGHTS POST-2012

Investment experts participating in this study emphasised the continuing significance of the four key barriers to institutional appetite for investing in rental housing that were identified in our 2012 investigation (see Box 1). Equally, however, there was growing recognition of the problems caused by poor housing affordability. While those from industry superannuation funds and major banks indicated ongoing interest in the issue and associated opportunities, several also emphasised fatigue and frustration in dealings with government, and some previously enthusiastic and optimistic informants declining to participate in this study. The industry mood is summed up by the following comments:

> *This really started about a year ago …some of our funds are very close to their members who are now telling them that housing has become a big problem* (interview, industry peak body).

> *We've spent time getting to know who the affordable housing businesses are and how the regulation works around these entities …With NRAS gone, we're still talking to people about how we might [make an investment in rental housing] but are we working on any [possible models]? – No… It's been a bit of a frustrating ride really because we've spent quite a bit of time on this…*(interview, industry superannuation fund investment manager).

> *The private sector is still willing to do equity and the banks are still willing to do debt on the right conditions* (interview, senior banking official).

Below we summarise prevailing views on the main industry-perceived barriers and possible ways of overcoming these as they emerged from our latest round of interviews and meetings.

3.1 Risk return equation

Institutional investors are seeking yields comparable with other asset classes (such as commercial real estate investment trusts, residential mortgage-backed securities) and offering predictable (guaranteed) long-term returns. Extensive industry modelling stimulated by NRAS has demonstrated that, to meet affordability goals, risk-adjusted returns required by institutional investors (to match other investment options) cannot be met without a financial incentive to boost returns and some form of credit enhancement to commensurately reduce risk.

> *The government change regarding NRAS has severely impaired some of the strategies we were looking at …There has to be an incentive, whether it's along the lines of NRAS or otherwise, there has to be some incentive and there has to be a market [for tradeable debt]* (interview, industry superannuation fund investment manager).

The reluctance of institutional investors to take residential development or property risk was also reiterated, along with a viewpoint that the superannuation industry may already be overexposed to property, such as through equities held in development companies and (mortgage-issuing) banks.

> *From an equity point of view the question of an appropriate return for the level of risk is far, far more acute than in relation to debt* (interview, industry superannuation fund investment manager).

This is an on-going difficulty where affordable housing is perceived by investors as a property asset, rather than as a cash flow profile. Thus, as first advocated in our 2012 research, structuring rental housing investment on the basis of infrastructure financing principles – matching cash flow from revenue to a fund's liabilities over a defined period – should be promoted as the preferred way forward because this will best convey the lower risk and, thus, lower return nature of the product.

This has specific implications for how government policy is shaped to support ***both*** the construction and operating phases of affordable housing provision, as explained in more detail in our previous research (Milligan et al. 2013a: 45-47). In summary, the strategy needs to involve government actions to de-risk construction (such as site assembly and planning support and, perhaps, a revolving construction fund for not-for-profit developers) and, following investor take-out of a portfolio of completed properties, some form of subsidy support and possibly revenue guarantee to lower investor yield expectations. Once a market in residential rental dwellings develops and becomes more competitive, government could step back from some of these provisions.

3.2 Scale

While several participating institutional investors recognised the attraction of a debt product with yield based entirely on rental return, problems related to deal size remain.

> *Getting scale is also crucial. We wouldn't do anything for less than $150 million and as part of diversification while at the same time managing any reputational risk* (interview, industry superannuation fund investment manager).

> *The Deal size needs to be $50m to $75m for an individual large investor and each one doesn't want to own more than 10% of the fund. Thus a $1billion investment opportunity would be a good starting point* (interview director, investment intermediary).

For scalable deals to achieve adequate returns, governments also need to offer more policy consistency, especially as regards taxation settings.

> *A significant outstanding issue is streamlining and standardising tax treatment. All [organisation's] schemes have tax avoidance structures which require individual rulings* (interview, senior banking official).

> *A key issue for large-scale investors is jurisdictional differences in, and the cost of, state taxes [stamp duty and land tax]* (interview, director investment intermediary).

Achievement of investor interest and scale will also be assisted by promoting liquidity. A forthcoming AHURI report will confirm the domestic industry's desire for effective residential property investment vehicles designed to suit Australian investment conditions (Newell et al. 2015).

3.3 Lack of market information

The advent of NRAS resulted in significantly increased attention being given by trustees, fund managers, investment intermediaries and ratings agencies to affordable housing as an investment option. However, while progress on ‘getting to know’ the affordable housing industry was evident, novelty barriers persisted:

> *The prospect of rental housing investment is hard for investors to get their heads around because of the greater complexity involved in managing an asset seen as ‘fragmented’ by comparison with a large commercial or retail building* (interview, industry superannuation fund investment manager).

Developing adequate market information is one key to overcoming the novelty factor. In this regard, an internationally active institution compared the Australian market situation unfavourably with that of the UK:

> *The long running experience with The Housing Finance Corporation (UK) as aggregator has meant there is a wealth of information on performance of [residential] assets there* (interview institutional banking sector).

3.4 Policy risk

Changeability and inconsistency of government policy continue to be major concerns for large investors, as underscored by industry dismay at the abandonment, rather than continuation and refinement, of NRAS.[29]

NDIS and state-based initiatives described earlier were seen as offering some potential to maintain momentum following the loss of NRAS. However, one informant described how their efforts to develop a product under the NDIS had also faltered because the incoming Coalition Government had limited client packages to 12-months, which resulted in too much risk around future revenue streams (Interview senior manager institutional banking sector). Several participants were also critical of the long delay in the release of the NDIS housing finance options paper (first mooted for late 2013 and but still unpublished over 15 months later), reflecting a mood of weakened trust in government (and hence greater risk).

For any initiative of this kind where government wants a major market response, the pervasive view was that government should propose a framework and then work closely and methodically with industry players to understand their requirements and to hone workable options. While only in its early days, the NSW Premier’s Initiative, discussed above, may offer such an approach. However, within the constraints imposed by the need for commercial confidentiality, an ‘open book’ obligation for funded projects would be desirable. This could help to establish investor requirements (e.g. their risk/return appetite); support the development of industry information and performance data; increase understanding across government and the industry of practical requirements for affordable housing procurement and long term management; and disclose the most cost effective options for government support (Milligan et al. 2013a: 11).

3.5 Specific lessons from NRAS

The NRAS experience has provided important specific lessons about avoidable missteps in the design, implementation and administration of a major government

[29] See, for example, Property Council of Australia ‘Don't throw the NRAS baby out with the bathwater’, April 28, 2014.

initiative aiming to attract institutional investment.[30]

Its 2008 enabling legislation made it clear that NRAS was intended to create a new residential asset class for large-scale investors.[31] In Box 3 we analyse policy design, implementation and administrative factors that our research suggests were major contributors to the institutional sector's restrained engagement with the scheme (thus limiting industry 'ownership' of the program) before its 2014 demise.

Crucial among the shortcomings was the policymaker failure to heed industry and expert advice that the scheme required a major shift in thinking and action by governments, non-profit organisations and private investors that would need several years and a staged approach to achieve.[32] Alongside this, the scheme experienced major administrative failings from the Canberra-based welfare bureaucracy that was ill-equipped to deliver on its objectives especially in the timeframe allowed. These included a serious lack of institutional finance knowledge and bureaucratic reticence to engage with the industry (Milligan & Tiernan 2011).

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[30] While beyond government's control, it is also important to note that the implementation timeline for NRAS was severely disrupted by the advent of the 2007 GFC and the ensuing credit crunch.

[31] See for example, the Treasurer's Second Reading Speech, National Rental Affordability Scheme (Consequential Amendments) Bill 2008.

[32] Interview Julian Disney, Chair, National Affordable Housing Summit 2004-2011

BOX 3: NRAS AND INSTITUTIONAL INVESTMENT

Opportunities and strengths	Threats and weaknesses
Scale and liquidity The size of the scheme (10-year incentives for 50,000 new rental dwellings) offered potential for deals at scale. Development of a secondary market in NRAS (to achieve liquidity) was envisaged by scheme advocates.	The NRAS bidding process involved calls for site specific housing provision. Except for Bid Round 4 which specified deals of 1,000 dwellings, NRAS was not structured to readily enable scalable deals – whereby large investors could finance large amounts of housing at diverse sites to meet specified criteria over several years. A further adverse consequence of the tender model used was that small investors dominated the bidding, increasing administrative load and delaying decision-making. Insufficient time was allowed for a market in NRAS to develop. Appropriate enabling and regulatory arrangements for such a market were slow to develop. In the meantime initial trading in NRAS allocations that developed was characterised by some as rorting, damaging the public reputation of the scheme.
Risk return The aim of the subsidy was to boost the return for investors such that affordable housing would offer returns comparable with alternate investment options.	Major super funds were disadvantaged compared to individual investors and SMSFs which could receive the NRAS subsidy on top of 'negative gearing' benefits. The NRAS 'tax credit' model did not match the tax regime of institutional investors. Products for packaging the scheme to suit institutional investors took significant time and resources to develop and 'sell'. Differences in the ways that state jurisdictions designed and implemented NRAS and differences in state property tax regimes reduced potential scale efficiencies and increased investor costs. Supplementary state support – such as through government land allocations, site assembly, planning system support, tax concessions or infrastructure provision – did not eventuate at the scale envisaged. Leakage of fees to self-appointed intermediaries reduced potential returns to investors and value for money for government. Institutional investors unfamiliar with the performance of residential assets required robust performance information. Indexation of the annual NRAS incentive by the rental price index, not the better known CPI, added to uncertainty.
Novelty NRAS was intended to create the conditions for a new domestic residential asset class that would be attractive to institutional investors.	There was insufficient effort to promote and tailor NRAS to institutional investors; government officials were apparently reluctant to market the scheme to the institutional sector. Proposed use of a high level independent expert advisory group to inform early development of the scheme was not taken up. While the superannuation industry undertook extensive due diligence of its own, this took time and thus had yet to bear fruit at the time of scheme closure. Perceived risk of tenant evictions was nominated by the industry as a major hurdle that was not adequately addressed.
Policy risk The Rudd Labor Government signalled it would continue with NRAS after the first 50,000 dwellings were supplied. Support from the then Coalition Opposition was indicated.	Super funds were concerned about deciding to invest in a new asset class utilising NRAS, if this were to turn out as a one-off venture with no predictable trail of subsequent investments. The abrupt cessation of NRAS has vindicated this concern and set back trust in government. There were inconsistencies between states in NRAS-related policy, tax and regulatory environments that added to complexity and cost.

Sources: Interviews; Milligan & Tiernan (2011).

4 WAY FORWARD

Overall since 2012, Australia has seen a step change in finance sector awareness of the affordable housing industry; its structures, functions and remit. This was largely stimulated by the ambition and scale of NRAS but also to some extent by state government redevelopment proposals involving public housing land contributions or public private partnerships. Several major institutions have expended considerable time and money on industry familiarisation, product development, feasibility studies and education of industry players (such as trustees and fund managers). As reflected in this research, the general industry viewpoint remains, as we concluded in 2013, that large-scale institutional investment in a residential asset class is both highly desirable and feasible (Milligan et al. 2013a). As international experience attests, a switch to large scale institutional financing can and should work given the right conditions. However, bringing this to fruition in Australia will require governments to specifically address the fundamental barriers discussed in this and our earlier research.

At the same time, the Australian economy is badly in need of assurance that the residential construction revival, which has helped to shield the economy from the end of the mining boom, will be maintained. This view arises particularly in light of uncertainties about the future of many of the factors that have contributed to this revival, notably:

- Post-2011 rapid house price inflation, widely considered unsustainable
- Ongoing record-low interest rates
- Tax concessions encouraging negative gearing and rapid expansion of contributions to superannuation funds, and
- Regulations affecting borrowing for rental investment both within and outside of SMSFs.

In labour market terms, the recent housebuilding revival seen in some parts of the country has compensated for the downturn in mining and the longer-term decline of manufacturing. The potential exists for a much more substantial and sustained growth in housing-related employment and activity if we could overcome the perennial problem of the volatility in the current sources of investment. As argued by the Governor of the Reserve Bank:

> *A high level of construction, maintained for a longer period of time, is vastly preferable to a very sharp boom and bust cycle. That alternative outcome might give us a higher peak in the near term, but then a slump in the housing sector at a time when the fall in mining investment is still occurring. A sustained period of strong construction will be more helpful from the point of view of encouraging growth in non-mining activity – and also, surely, from a wider perspective: housing our growing population in an affordable manner (Stephens 2014: 5).*

As shown by the success of the economic stimulus provided by the Australian Government's 2008 Social Housing Initiative, the availability of shovel-ready projects when there is a slump and a commitment to ensure there is adequate funding, as well as the political will to use planning powers to enable these projects to go ahead, provides an obvious solution to the desire for a sustained period of strong construction.

Nevertheless, in developing a mature Australian institutional investment market in affordable housing there is still a very long way to go. For their part, Australian governments must now spur recovery from recent reputational damage inflicted on the nascent affordable housing asset class, and take a stronger and much better-informed part in stimulating private funding of affordable housing. A much more solid and enduring bi-partisan policy platform and significantly improved public administration will be required as part of the mix for private financial institutions to commit to further engagement and, ultimately, to make defensible investment decisions in this realm. While national government leadership would be highly desirable, tightly coordinated state actions (in order to provide necessary scale and market diversity) could possibly substitute in the absence of such commitment.

If a strategy to engage institutional investors in supplying rental housing is pursued, not only will future generations of lower income households benefit from having well-located, stable and affordable housing but governments will have succeeded in catalysing a sustainable new model of rental housing provision. The model envisaged has the potential to attract capital markets funding at scale and to bring ongoing benefits to the construction industry while, at the same time, being less reliant on budget outlays and tax expenditures than past or current approaches. Professional management of rental housing will also be stimulated.

4.1 Recommendations

Stakeholder interviews conducted for this research project have affirmed that the directions laid down by the 2012 expert panel remain at the heart of what will be required to evoke large-scale institutional financing of rental housing in Australia. In this final section, we revisit the core recommendations of that panel (See Milligan et al. 2013a: 9-11 and Box 1 in this paper) and adapt and update those to take account of the subsequent policy and market developments, including the lessons arising from the NRAS experience and advances in overseas practice as outlined in the body of the paper.

1. **Given the economic and social importance of boosting efficiently and effectively managed rental housing supply, Governments across Australia should recognise the untapped potential for large scale institutional investment in this sector. They should give priority to stimulating a new financing model to realise this prospect.**

Without doubt institutional investment is more likely if there is strong and consistent government leadership in this area, preferably coordinated at a national level. While a number of funds recognise the case for investing in housing, they need to be confident that the appropriate policy stance is going to remain in place for a sustained period and that government will work with the industry to underpin the development of this new market. Achieving scale and national policy consistency will be critical to support the kinds of risk mitigation that institutional players are seeking in what is essentially a small and unproven domestic market. The prospective White Papers on Reform of the Federation and Reform of Australia’s Tax System offer immediate opportunities to recognise the national interest in achieving a transformative breakthrough in financing affordable rental housing.

2. **A cross-sectoral Rental Investment Task Force of key stakeholders and experts with high level policy and financing credentials should be appointed to develop recommendations for achieving target levels of institutional investment in rental housing supply, including an**

element of rentals affordable to low and moderate income groups.

Thinking and activity around institutional engagement in Australian housing provision remains in its early stages – the arrival of NRAS and individual states have advanced the agenda but there is much further to go. There continues to be a strong case for bringing together a time-limited high level task force to consolidate what has been learned to date across the country, to engage with the nascent fund appetite to invest in housing and to frame a way forward. Such a high level task force would need to be backed by a **specialised high profile senior officials group** which can then progress the detail of this in collaboration with both the finance industry and the housing sector. Crucially, because of the complex and cross-cutting nature of the issues and challenges, this group should be located in a central agency of government (e.g. Treasury), not in a welfare department.

3. **An eminent private sector leader should be appointed to head the Rental Investment Task Force.**

Identifying a respected and dedicated high profile individual to lead the task force and champion the case for institutions to develop rental housing portfolios remains highly desirable to help resolve political and industry barriers and widen support for appropriate action, in a similar way to how championing of the NDIS occurred.

4. **To facilitate the supply of newly-constructed *affordable* rental housing, a new incentive framework designed specifically for institutional players (and replacing the National Rental Affordability Scheme) should be developed for introduction by 2017**

The Rental Investment Task Force should be charged with developing design guidelines for a new incentive suited to the institutional sector to be introduced from 2017. This would be designed specifically to reduce the returns required by institutional investors to levels commensurate with the development of a competitive market in affordable rental provision. At the same time, the rental housing investment officials group (see above) should give specific consideration to how the costs of such an incentive could be offset through adjustments elsewhere - e.g. through limitation of negative gearing provisions or landlord capital gains tax concessions.

5. **State Governments should assemble and offer an initial portfolio of suitable shovel ready sites for residential development by private and not-for-profit developers which, on letting, can be re-financed through large-scale institutional investment.**

The aim of this demonstration should be to create scalable opportunities for institutional investors and build confidence in the future of this asset class. The preferred starting model would be for government or not-for-profits to retain ownership of the land and to on-sell to institutional investors the cash flows from rental revenues for an agreed term (10 -20 years). Site assembly should not be limited to public housing areas. Developments should include but not be limited to affordable housing. Packaging opportunities across (at least two) jurisdictions would increase the scale and attractiveness of any offer – as diversified deals worth around a $1billion will be required. Joint efforts should also be made to reduce cross-jurisdictional differences (in planning and tax policy for instance) that add to costs.

6. **State governments should offer a land tax waiver for aggregated rental holdings meeting designated regulatory requirements for affordable rental.**

Providing a land tax concession for aggregated affordable rental portfolios – consistent with the concession currently available to small investors – will level the playing field for, and reduce the costs of, institutional financing.

7. **Consideration should be given to the possible role of government guarantees in facilitating institutional investment in rental housing provision, to provide comfort to backers and, thus, to minimise cost of funds.**

By international standards, deals for financing affordable housing in Australia have been too expensive so far. Key contributory factors include revenue risk and, related to this concern or otherwise, default hazard. The Senior Officials Group in consultation with the Rental Investment Task Force should be tasked with specifying how affordable housing rental revenue streams could be underpinned. This includes giving consideration to how such revenue flows could be 'guaranteed' for a limited period to reduce investment risk and perceptions of risk, (thereby lowering the cost of funds), pending the evolution of an established market in this asset class. This issue should also be identified as a key matter in forthcoming deliberations on welfare reform. Additionally, the Group should also be asked to evaluate the possible benefits and costs to government contingent on implementation of a rental investment debt guarantee mechanism.

8. **An independent specialist financial intermediary, such as an Australian Housing Finance Corporation, should be founded.**

As argued in more detail in Lawson et al. (2014), the purposes for such an intermediary include: growing specialised institutional knowledge of finance market requirements; building trusted relationships between housing providers and investors; aggregating the borrowing requirements of diverse housing providers; administering contestable allocation processes; and providing quality information on investment performance. Such a development would emulate successful international practice as, for example, demonstrated by The Housing Finance Corporation, the UK's long-established not-for-profit institution playing this role.

9. **An existing or new agency should be resourced to collect, publish and maintain appropriate financial, asset and tenancy management information that will inform all industry parties about the state of the affordable housing industry and its development.**

Up-to-date information on financial deal terms, asset portfolios and tenancy performance is essential to inform the industry about this new investment class and to overcome perceived risks and novelty barriers. Reinstating analysis of housing market supply and demand (for example, as provided by the former National Housing Supply Council between 2008 and 2013) would also help to bolster investor interest. Collection and publication of such data under interim arrangements should commence as soon as possible with a view to reallocating the responsibility as the institutional context for the new market becomes established.

10. Tax reform options to support institutional investment in social infrastructure, including affordable housing, should be investigated.

Beyond specific tax changes discussed above and in the context to the White Paper on Tax Reform, there is a case for a broader investigation into the implications of tax arrangements for institutions and what changes are desirable to encourage socially directed investments, such as affordable housing. Pending longer term reform, an initial aim could be to level the playing field with the tax settings benefitting individual investors and SMSFs through negative gearing.

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