Property Council of Australia
ABN 13 00847 4422

Level 1, 11 Barrack Street
Sydney NSW 2000

T. +61 2 9033 1900
E. info@propertycouncil.com.au

propertycouncil.com.au
@propertycouncil

14th March 2016

Division Head
Social Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

To the Affordable Housing Working Group

Re: Affordable Housing Working Group: Issues Paper – Innovative Financing Models

The Property Council of Australia is pleased to provide a submission to the Working Group on its issues paper and innovative financing models for affordable housing delivery.

The Property Council is the peak body representing the interests of owners and investors in Australia's $670 billion investment industry.

Our members are long-haul investors in cities, so understand the case for improving their productivity, sustainability and liveability – and the essential role played by affordable housing.

While we welcome the government's focus on providing more affordable housing options, any discussion on this issue cannot ignore the fact that planning reform is urgently required across all jurisdictions to increase land supply and reduce affordability pressures for all Australians.

We recognise that planning issues are beyond the scope of the current Issues Paper. Therefore our submission points to possible solutions such as enabling and facilitating institutional investment and the United States' Low Income Housing Tax Credit model. Both would enable the private sector to deliver more affordable housing without compromising affordability for the whole market; however both require concerted action from all levels of government.

Please note: in responding to the Working Group's Issues Paper, we have done so in a collective sense. The structure of our submission reflects this.

Please contact me if you require further assistance and subject to availability; we would of course be happy to participate in any ongoing consultation with the Working Group and relevant Ministers or departmental representatives.

Yours sincerely

Glenn Byres
Chief of Policy and Housing

Submission on innovative financing and delivery of affordable housing

Council on Federal Financial Relations, Affordable Housing Working Group

March 2016

Contents

Contents

Executive Summary

Housing affordability is undeniably one of the highest priority issues for the community and for governments across Australia.

The challenge of delivering more housing, including at sub-market or affordable rates, or through public and social housing, is one that the constrained balance sheets of state and federal governments cannot meet alone.

There is no doubt that innovative solutions exist, not only for financing, but also for the delivery of housing at lower costs. The private sector can, and is eager to play a greater role in improving housing outcomes for all Australians.

But the approach to delivering more affordable housing, including public and social housing, needs to be cautious and recognise:

- That planning reform is urgently needed to improve land supply, location and affordability of housing across the board
- The need for risks and returns to be market based and acceptable relative to the returns from other investment classes if the private sector is expected to invest
- That changes to the regulatory and tax frameworks are needed to enable large scale institutional investment in housing
- The role of government incentives, including land contributions, in addressing the funding gap
- The need for greater capacity in the Community Housing Provider sector to manage housing assets
- The existing policy approaches in this area across the states and territories

While the models put forward in the Issues Paper have merit, private sector investment requires scale and certainty about a pipeline which they cannot generate – with the possible exception of the Bond Model.

We have put forward potential solutions in later sections of this submission, noting that further work is required to fully scope the economic benefits that are achievable.

There are many alternatives to the current approach to affordable housing delivery that can unleash private sector capacity, and we are happy to partner with governments to explore sensible solutions.

The property industry – an overview

Let property grow the economy

Property is the nation's largest industry and creates prosperity, jobs and strong communities.

Property is a major part of both the household balance sheet and the Australian economy.

Property:

- directly contributes **11.5 percent of economic activity** – or $182 billion to Australian GDP
- is the nation's second largest employer, **creating 1.1 million jobs** – which is more than mining and manufacturing combined
- helps provide **a wage to one in four Australians**
- pays **$72.2 billion in wages directly**, and another $119 billion in wages indirectly
- delivers 16 percent of the nation's tax revenue, with **$72 billion in taxes** paid to federal, state and local governments
- allows people to save for their retirement and reduce government's pension costs, with **14.1 million having a stake in property through their super funds**

It is crucial that policymakers work to support the industry given it is vital to Australia's economic fortunes.

About the Property Council

The Property Council champions the interests of more than 2200 member companies that represent the full spectrum of the industry, including those who invest, own, manage and develop property across all asset classes.

Our members are long-haul investors in cities - they have an inherent interest in seeing them prosper and an understanding of the policy settings needed to make them work.

Australia's affordable housing challenge

Housing affordability is one of the highest priorities for the community and it is important that federal policy makers adopt a position of national leadership on this issue.

Despite record levels of housing approvals, high levels of housing commencements and completions and record low interest rates, many Australians still suffer from unacceptable levels of housing stress.

Australia has one of the highest levels of population growth in the OECD, and the demographic composition of our society is also changing significantly, best demonstrated by Federal Government's Intergenerational Report IV. We need supply side settings which enable the production of the new housing needed to meet this growth and change.

The ability of supply to keep pace with demand, and in turn keep downward pressure on prices, depends on streamlined and efficient planning systems. While we recognise that this is beyond the scope of this particular Working Group, any discussion about housing affordability cannot ignore the desperate need for planning reform around Australia.

Similarly, in order to ensure our cities can meet future housing needs, governments and industry need clear and comprehensive insights into Australia's housing affordability and undersupply problems. We therefore strongly urge the Federal Government to reinstate the National Housing Supply Council or establish a similar function in a central agency to provide the critical data source government and industry need. Without this information, the extent of the policy failure cannot be fully investigated or addressed, and similarly the success of any policy solutions will not be fully understood either.

Our cities need housing that is affordable to rent or to buy, in locations that are well serviced with infrastructure – not just roads, but schools, childcare and hospitals – and close to employment opportunities.

The affordability challenge is twofold – first in terms of declining general affordability, and secondly in terms of the availability of housing for key workers (affordable housing) and for the socially disadvantaged (social or public housing).

The scale in the shortfall of affordable, social and public housing is significant. Governments on their own cannot fund the entire quantum needed to produce this type of housing, and therefore we welcome and support the initiative to consider private industry submissions on alternative funding models.

It is estimated that the affordable/social housing shortfall nationally is around 200,000 new dwellings. At an average construction cost of $500,000 per dwelling (including land), the potential size of the market alone as it stands today is over $100 billion. Governments need to recognise and accept that private capital will need to achieve market returns if it is to be mobilised in meeting this task.

Potential solutions for providing affordable housing

On the premise that they are able to achieve market returns, large private investors are increasingly willing to invest in affordable housing.

They clearly recognise of the underlying need for this type of housing, and they are prepared to invest as long as the risks and returns are market based and acceptable relative to the returns from other asset or investment classes.

This can only happen once the key obstacle of economic viability is resolved, and in some instances this can only be achieved through initiatives that will ultimately require incentives of some form from Federal and/or State Governments.

If affordable housing, including public and social housing, is to be delivered at scale, a number of additional services will need to be developed simultaneously.

One of the key issues identified by investors is the lack of large professional property and building management entities that could be engaged to manage a residential asset on their behalf. While they are crucial to the success of large-scale affordable housing delivery, the Community Housing Provider (CHP) sector in Australia does not currently have the capacity to meet the demands of institutional level investment in this space. We would strongly encourage greater opportunities for developers and investors to partner with CHPs in order to build that capacity, and ensure that the risks are appropriately distributed. Again, this is beyond the scope of this Working Group, but it must be borne in mind when considering alternative financing models.

The solution to increasing the supply of affordable and social housing in the quantum required will involve a number of substantive and coordinated actions from both Federal and State Governments.

A bi-partisan consensus and consistent policy settings will also be essential at the Federal level to provide certainty around a long term pipeline for investment.

Institutional investment

Despite Australia having one of the most mature markets for Office, Industrial and Retail Real Estate Investment Trusts (REITs), there is little to no institutional buy-in in residential REITs.

Most telling of all is that some of our larger superannuation funds are invested or looking to invest in mature residential REITs overseas (often called multi-family housing), which provide investors with institutional grade investment returns.

The primary barrier for development of a domestic REIT is the yield gap, which has previously kept institutional investors at bay. However, this gap can potentially be filled if policies are introduced to support supply, where Government works with industry and the community housing sector in key areas to provide affordable housing.

Currently, investment in residential properties relies almost entirely on mum and dad investors who receive a marginal rental return of approximately 3%.

These investors are unable to provide the scale or volume of investment that will be necessary to keep investment costs low and downward pressure on rents.

However, institutional investors, including superannuation funds, have the capital necessary to invest at scale, making it possible to provide supply and keep costs low.

Critically, there are no institutional grade investments much below an income return of 5% and most institutions would be unable to invest in assets that achieve lower returns.

Importantly, unless costs can be reduced to enable returns to reflect true institutional grade investments, it will be difficult to get affordable housing at scale.

There are numerous ways this can be encouraged but it will require innovative thinking and government's input to incentivise opportunities.

There are many ways in which institutional investors can invest in the residential market:

- Multi-family housing (aka “residential REIT”) – this can be low rise scale, or high rise apartment complexes
- Social housing (usually in partnership with government)
- Affordable housing / key worker accommodation (usually with government tax concessions)
- Student accommodation
- Retirement villages

Institutional investment can take the form of equity or debt:

- Equity options include listed REIT and unlisted wholesale fund
- Debt options include securitised debt vehicle and social housing bonds

As a result of engagement with our members, the Property Council has identified the following barriers which are currently limiting the opportunity and incentives for institutional investment in affordable housing.

In brief, they are:

- **Income yield**
    - Residential is the lowest yielding asset class. In order to compete with existing asset classes, a residential investment would need to provide yields in the range of 4.5% to 5% income yield, and 2% growth
    - Returns are primarily expected from income yield, not capital gain

- Investments must be viable and not rely on continuous government support if they are to attract long term investors – otherwise investors bear the risk of government policy changes

- In the context of (relatively) fixed rents, the following could improve yields:

    - Reductions in building costs - this could be achieved through innovation in construction materials and methods, and through increased flexibility in design requirements

    - Reductions or concessions to land costs

    - Changes to the tax system to provide greater investment imperative or concessions (with caveat that these changes must not be subject to reversal at the whim of political cycles)

- **Tax flow through treatment**

    - A structure similar to existing REITs, where there is tax flow through for the investment vehicle, would be most suitable

        - This may require changes to Division 6C of the tax rules to allow flow-through for residential REITs if returns are predominately from capital yield

- **Scale**

    - Investment scale is required in order to attract significant institutional investment, indicatively a minimum of $500m

        - For single sites, this presents significant challenges in terms of availability of land, planning and zoning requirements, and construction and access issues

        - Alternatives may include a number of sites, however the costs of construction and management will still be significant

        - Generally, low to medium rise developments are preferred, largely due to lower construction costs. The issue of appropriately located, zoned and serviced land remains a key blockage

        - Planning systems that include incentives or rewards for the investment in affordable housing are not common due to a lack of understanding of the scale needed to make an investment viable

- This is distinct from those jurisdictions where consent authorities use clumsy policy solutions such as affordable housing levies or inclusionary zoning. These measures are often counterproductive due to the rigidity with which they are applied and result in only small contributions to affordable housing stock at the cost of broader affordability across developments

- **Location of sites and quality of product**
    - In order to ensure yields, the location must be favourable, and likewise the quality delivered must be appropriate for the product
        - Complex planning requirements and building regulations combined with premiums for well-located land make projects challenging
        - Regulations which stifle innovation in construction make cost reductions difficult to achieve without compromising quality

- **Operation and management of assets**
    - Operational efficiencies will be achieved by reducing the fixed cost per unit of management, making large scale projects more attractive
    - Comparable management costs in Australia are typically double that in the US, largely due to a lack of scale and experience of existing providers

Critically, any government policy change or action that enables developers to obtain sites from government, gives concessions on taxes or fees for suitable developments, confirms tax flow through status for residential REITs, allows for faster development assessment, or improves the flexibility of planning regulations will all help reduce initial development costs and will tip the balance in favour of residential REITs being developed as a viable asset class.

Residential REITs represent a unique opportunity for the market to develop affordable housing at scale and government actions can be focussed directly on developments that provide a proportion of their development for affordable housing.

It allows the market to solve the almost intractable property problems that plague all modern governments.

Low Income Housing Tax Credit

The Low Income Housing Tax Credit (LIHTC) program has been operational in the US for almost 30 years, and has created 2.5 million rentals for low income households in that time.

The program operates as an indirect subsidy encouraging individual and corporate investors to invest in the development, acquisition, and rehabilitation of affordable rental housing.

Its longevity relates to the program being established in the Tax Reform Act 1986 which means the program largely avoids the appropriations process.

LIHTCs are calculated as a percentage of costs incurred in developing the affordable housing property, and are claimed annually over a 10-year period whilst the project operates with an affordable housing component.

The tax credit operates by providing equity equal to the present value of either 30 per cent (sometimes referred to as the 4 per cent credit) or 70 per cent (alternately referred to as the 9 per cent credit) of eligible costs of a low-income housing project, depending in part on whether tax-exempt bonds are used to finance the project.

To be eligible to qualify for a tax credit, either of the following requirements must be met:

- 40/60 test – The developer or project sponsor must provide 40 per cent or more of the units for renters earning no more than 60 per cent of the area's median income

or

- 20/50 test – The developer or project sponsor must provide 20 per cent of the units for renters earning 50 per cent or less of the area's median income

These units are subject to rent restrictions, where the maximum gross rent must be below 30 per cent of imputed income based on an area's median income.

As the tax credits are only available for affordable rental units, many project applications contain more than the percentages of affordable stock required above.

Decisions to develop and finance affordable housing using LIHTCs are based on local needs for housing and community development in each state, and tax credit allocations must be consistent with state housing priorities.

Each state is provided an allocation for competitive applications from developers/sponsors. The projects are often initiated by a community-based sponsor. All projects must have sufficient local demand to meet cash flow projections.

There is a secondary market of syndicators that on-sell the rights to tax credits to investors and support the project across a 10-15 year compliance period. The developers/sponsors receive the money up front and the investors are able to claim tax credits on their federal income tax returns.

The Property Council considers that a model based on the LIHTC could be implemented in Australia, and significantly improve the delivery of affordable housing.

It must be noted that the Federal Government will forgo a portion of future income tax revenues, however this will be offset by the reduction in expenditure on welfare or rent assistance measures that will be achieved, as well as the broader economic uplift that improving housing affordability will have.

The benefits of the LIHTC model include:

- The establishment of what is effectively a new industry
    - Large scale investment and professional development and management of assets, generating employment opportunities and long term supply of affordable housing stock

- Long term saving in Commonwealth Rent Assistance, benefitting the Federal Government
    - As social, public, and affordable housing tenants who would normally qualify for this assistance are able to access dwellings created through the already subsidised tax credit model, the cost of CRA payments would decline

- Potential savings in future capital gains tax discounts
    - The preference among institutional investors would be to adopt an income approach in their feasibilities, with no allowance for prospective capital gain on the asset

- Other long term savings to State and Territory budgets
    - Should new social and affordable housing be created at the scale required there are potential long term savings to government(s) in areas such as, but not limited to, homelessness services and programs, health expenditure and the annual maintenance and management of public housing assets

- Increased construction sector activity, and broader economic uplift
    - Increased construction activity contributes to economic activity and the generation of additional taxation revenues, benefitting both state and federal governments

Further economic modelling is required to better quantify the economic benefits that a LIHTC approach would bring to all levels of government, in order to offset the tax credit.

The Property Council is currently scoping research in this area, and will engage further with governments as it progresses.

Incentive models for housing supply

As noted in the introductory comments to this submission, any attempts to improve the provision of affordable housing in Australia must address the barriers to supply and affordability presented by planning systems around the country.

Despite the planning reform undertaken in various jurisdictions over the last decade, Australia has a significant lack of housing supply, both in terms of the volume of dwellings being delivered, but also the type and location of housing supply.

National Competition Policy (NCP) was instrumental in driving reforms in the 1990s that unlocked significant economic benefits for the country. Adopting a similar approach to drive reforms targeted at improving housing supply can improve affordability, create growth and generate jobs.

In November 2015, the Federal Government released its response to the National Competition Policy Review, indicating a willingness to consider payments to states and territories for reforms to planning and zoning that improve productivity and lead to economic growth.

Under a new competition style model, states and territories would receive incentive payments to reform their planning systems, turbocharge their housing supply pipelines, better utilise their own land holdings, and deliver innovative affordable housing solutions.

The Property Council is currently finalising research into the framework and model that would be required to use an incentive payments and competition policy approach to improve housing affordability outcomes.

We look forward to sharing the results publicly and working with governments around the country to deliver more affordable housing.

Other policy initiatives

Although the scope of this Issues Paper is limited to the consideration of financing models, there are a number of other policy approaches currently being taken by governments around the country to address this issue.

Whilst the Working Group is no doubt well versed in them, the following are policies that the Property Council and its members are generally supportive of:

- Government land sales for housing development
    - Opportunities exist to make better use of government land sales to deliver affordable housing, subject to requirements being made clear well before the sales and bidding process commences
- NSW Government initiatives
    - The Premier's Innovation Initiative – Social Housing Assets
    - Social and Affordable Housing Fund
    - Housing Acceleration Fund
- Keystart – WA
    - A shared equity and low deposit home loan provider for homebuyer unable to access finance in the private market

Contacts

Glenn Byres
Chief of Policy and Housing
Property Council of Australia
Phone: +61 2 9033 1952
Email: gbyres@propertycouncil.com.au

Andrew Mihno
Executive Director – International & Capital Markets
Property Council of Australia
Phone: +61 2 9033 1944
Email: amihno@propertycouncil.com.au

Katharina Surikow
Policy Manager – Housing
Property Council of Australia
Phone: +61 2 9033 1936
Email: ksurikow@propertycouncil.com.au