Joint Submission to the Council on Federal Financial Relations Affordable Housing Working Group

Social Ventures Australia and Macquarie Group Limited

18 March 2016

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Executive Summary

Macquarie Group Limited (**Macquarie**) and Social Ventures Australia (**SVA**) are pleased to make a joint submission to the Council on Federal Financial Relations Affordable Housing Working Group (**the Working Group**).

We agree there is an urgent need in Australia for a new, viable and scalable financing model to assist with the supply of social and affordable housing (**SAH**) supported by a complementary strategy to promote additional SAH construction. Compared with overseas jurisdictions including the United Kingdom and United States, the scale and sophistication of SAH finance in Australia is limited. In the UK, not-for-profit housing associations have leveraged over two million SAH dwellings transferred from the public sector to secure £62 billion[1] in outstanding bank loans and bond issues. By comparison, Australia's largest not-for-profit community housing providers (**CHP**s) each typically own around 2,000-3,000 dwellings securing bank loans of between $15 to $50 million per CHP, often on suboptimal terms.[2] The sector has tremendous potential to use private sector financing to help bridge the gap in supply.

As the Affordable Housing Working Group: Issues Paper (**the Issues Paper**) notes, there are significant barriers to generating interest in the private sector for the provision of finance for SAH in Australia. From our analysis and discussions with sector participants – including community services and housing providers in Australia and overseas, regulators, capital markets experts and intermediaries – we believe several key improvements will help facilitate private sector financing including generation of scale, adequacy of returns, confirmed pipelines of demand and regulatory reform and consolidation of the CHP sector.

It is our view that with these improvements, 'Model 1' of the Issues Paper, a funding aggregator, would best facilitate private sector debt finance for suppliers of large-scale housing developments, including new and existing CHPs, and any new real estate investment trusts (**REIT**s) (for example under 'Model 2' of the Issues Paper) and special purpose vehicles (**SPV**s) established to encourage supply. Our submission focuses primarily on the framework required to create an Australian Housing Finance Aggregator and the evidence for why we believe this is the best option in a fiscally constrained environment.

The Issues Paper also includes 'Model 4'; a model for private finance via impact investing and Social Impact Bonds (**SIB**s). While SIBs are complementary to other housing initiatives, they would be unlikely to lead to large-scale development of new affordable housing by themselves. In our experience, impact investing incorporates a much wider variety of mechanisms designed to attract private capital to solve social problems. Different types of impact investment can make a contribution to improving outcomes for people in need of affordable and adequate housing. SIBs can generate savings to governments and be an effective mechanism to better align service spending with desired outcomes for clients, as well as accurately quantifying and measuring those outcomes.

SVA and Macquarie have substantial international experience and would welcome the opportunity to work with Government to assist in the supply of SAH. More information about both SVA and Macquarie is detailed in the Appendix.

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1. Andrew Heyward, '*Investing in Social Housing: A Guide to the Development of the Affordable Housing Sector*', 13 February 2013, pg 9, http://www.thfcorp.com/investing/investing-in-social-housing.pdf
2. For example, see 2015 Annual Reports for:

   BlueCHP: http://bluechp.com.au/uploads/other/BlueCHP_AR_2015_web.pdf

   Bridge Housing: https://www.bridgehousing.org.au/data/pdfs/annualreports/BridgeHousing_AnnualReport2015-Web.pdf

   Mission Australia Housing: https://www.missionaustralia.com.au/publications/annual-reports/annual-report-2015/doc_download/422-housingannual-report-2015

   St George Community Housing: http://www.sgch.com.au/wp-content/uploads/2015/11/SGCH-Annual-Report-2015_Screen.pdf

Meeting the Social and Affordable Housing Challenge

As the Issues Paper identifies, Australia faces a significant challenge with the availability of housing that is both affordable and appropriate, with significant detrimental impacts for households on low incomes.

The Australian Housing and Urban Research Institute (**AHURI**) calculated Australia's shortfall in affordable and available private rentals for low income earners at almost 400,000 properties in 2011, up from 225,000 in 2006.[3] This means many low income earners cannot afford to rent a place to live; and for those who do, a majority experience insecurity due to rental stress.[4]

The reasons for the shortfall are two-fold: first, an absolute shortage of affordable accommodation for those in the bottom 20 per cent of income earners; second, a shortage of *available* affordable accommodation for those in the bottom 40 per cent of income earners due to higher income earners occupying in the lower-cost end of the rental market.[5] Social housing waiting lists are also lengthy and increasing, amounting to nearly 50 per cent of existing social housing stock in Australia.[6]

Australia needs to generate more than one kind of below-market stock, and the financing solutions which fund them must be flexible enough to cater for this diversity.

The disparity between supply and demand represents only part of the social and financial challenge. Existing social housing is often nearing the end of its useful life and repair and maintenance costs are accordingly much higher than with newer stock. The 2013 NSW Auditor-General's Report on public housing reported that the NSW Land and Housing Corporation (**LAHC**), which owns 85 per cent of NSW's social housing stock, has a repairs and maintenance shortfall estimated to be $330 million.[7]

Housing is often not in the right location (that is, isolated from growing job markets and transport hubs) and unfit for purpose (both in accessible design and allocation for families and singles who have different needs). Existing stock is often in locations which increase social exclusion[8] while decades-old policies have entrenched disadvantage in specific locations.[9]

The human cost is significant. Lack of stable and appropriate housing has had a significant impact on affected individuals and families, who are likely to fare much worse than the general population on a range

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3. Hulse, K., Reynolds, M. and Yates, J. (2014) *Changes in the supply of affordable housing in the private rental sector for lower income households, 2006–11*, AHURI Final Report No. 235, Australian Housing and Urban Research Institute Limited, Melbourne, pg 2.
4. Australian Institute of Health and Welfare 2014. *Housing assistance in Australia 2014*. Cat. No. HOU 275. Canberra: AIHW, pg 67.
5. NHSC (National Housing Supply Council) 2012, *Housing Supply and Affordability - Key Indicators 2012*, Commonwealth of Australia, Canberra, pp47-9, accessed at http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2012/NHSC/Downloads/PDF/housing_supply_affordability_report.ashx; Australian Institute of Health and Welfare 2014. *Housing assistance in Australia 2014*. Cat. No. HOU 275. Canberra: AIHW, pg 23; Hulse, K., Reynolds, M. and Yates, J. (2014) *Changes in the supply of affordable housing in the private rental sector for lower income households, 2006–11*, AHURI Final Report No. 235, Australian Housing and Urban Research Institute Limited, Melbourne.
6. Waiting list of 197,500, current supply of social dwellings 403,767. Source: Productivity Commission 2016, *Report on Government Services 2016 Chapter 17*.
7. NSW Auditor-General's Report *'Making the best use of public housing*', 30 June 2013, pg 18 accessed: https://www.audit.nsw.gov.au/ArticleDocuments/280/01_Public_Housing_Full_Report.pdf.aspx?Embed=Y
8. See further data in resources on Australians for Affordable Housing website: http://housingstressed.org.au/resources/.
9. New South Wales Parliament Legislative Council Select Committee on Social, Public and Affordable Housing, *Social, public and affordable housing* (2014) pg 175: http://www.parliament.nsw.gov.au/prod/parlment/committee.nsf/0/12b4da4578015782ca257d4d00120ffe/$FILE/Report%20on%20Social,%20public%20and%20affordable%20housing%20-%20September%202014.pdf

of health and social indicators such as mental illness and unemployment. This in turn has broader social and economic costs to the community in lost productivity and increased welfare costs.

Improving housing outcomes for low income earners requires a multifaceted approach. This includes:

— improving supply of housing stock across the housing continuum (to deal with both absolute and relative shortages);

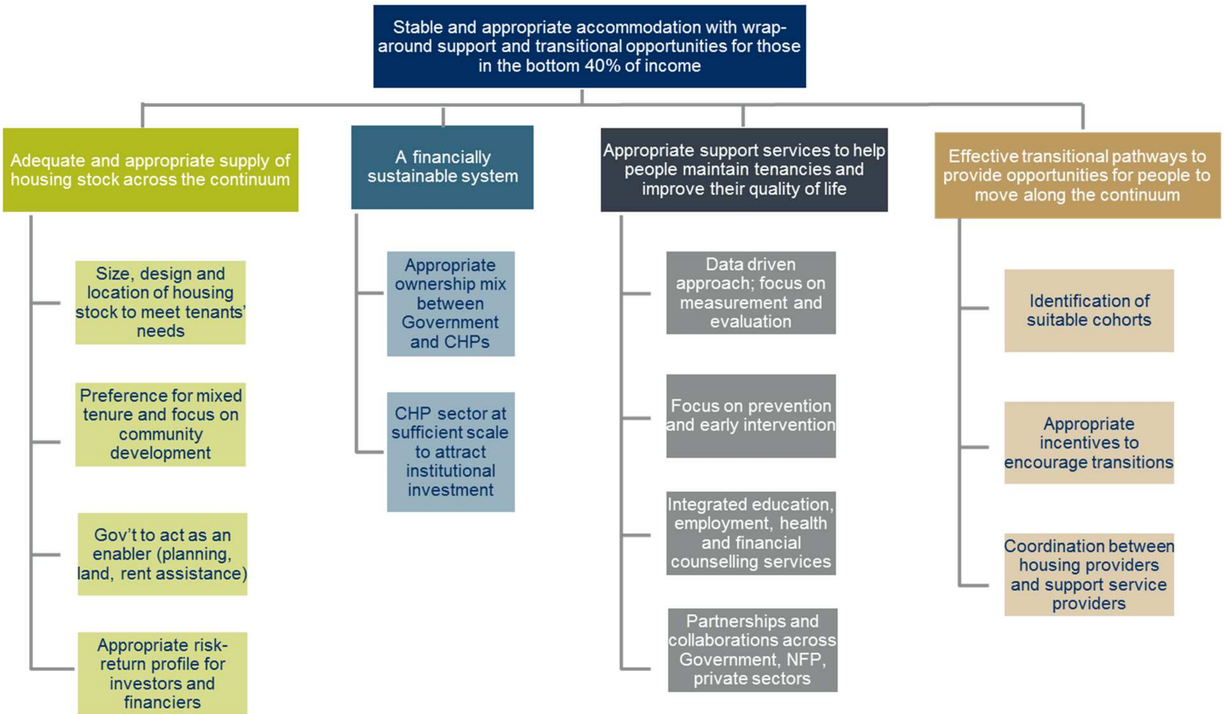
— sustainable and reliable funding for SAH;

— integrated and targeted support services for those who need them; and

— opportunities for social mobility and to move along the housing continuum where appropriate.

Figure 1 below is a graphical summary of these interrelated drivers.

Figure 1: Improving Housing Outcomes - The Housing Driver Tree[10]



While it is beyond the scope of this submission to explore these in detail, it is essential to consider the interaction between the different initiatives required to improve housing outcomes.

By supporting mechanisms to attract private capital into SAH, Commonwealth, State and Territory Governments can:

— have a significant impact on supply;

— assist redevelopment of existing estates where there is concentrated disadvantage to generate mixed tenure developments;

10. Social Ventures Australia, *Improving Housing Outcomes - The Housing Driver Tree*, 2016.

— improve the scale of Australian SAH suppliers to deliver on further stock expansions; and

— put the SAH system on a more sustainable financial footing.

By increasing supply at different points in the market, it will also improve opportunities for transitions, and reduce rental stress and risk of eviction.

Table 1: Levers to stimulate investment in SAH[11]

LEVER	DETAILS / EXAMPLES	CWTH / STATE RESPONSIBILITIY	IMPACT
Construction / development costs	• Innovative design / build concepts – e.g. modular housing • Large scale development capability of SAH suppliers to reduce project costs	N/A	LOW
Financing costs	• Interest rate subsidy • Government support to instill investor confidence	Cwth	MEDIUM
Financing terms	• Long dated financing tenor up to 15-20 years (funding certainty for borrowers) • Lower debt servicing hurdles (where prudent) • Lower interest rates	Cwth / State	MEDIUM
Management rights transfer	• Leverage rental income stream to develop new stock • Limited by maintenance liabilities on existing stock	State	MEDIUM
Planning regulations	• Inclusionary zoning – 10-15% based on LGA needs assessment • S.94 contributions waived for SAH supplier residential development projects	State	MEDIUM
Income support	• CRA moved to floating mechanism linked to market rent	Cwth	MEDIUM/ HIGH
Tax incentive	• Replacement mechanism for NRAS • Tax credit for new SAH	Cwth	HIGH
Land costs	• Partnership between NFP, land banks and CHPs/ REITs/SPVs – alignment mission and purpose • Land gifted or leased at peppercorn rent from the State	State	HIGH
Land / stock ownership transfer	• Title transfer of social housing to CHPs/REITs/SPVs with leverage commitments • Medium-long term leases (20-30yrs) of social housing to CHPs with land swap	State	HIGH

There are a number of ways Governments can attract greater private capital into new SAH supply. The optimum policy setting will involve a combination of mutually reinforcing initiatives at both State and Commonwealth levels of Government. For example, NSW has begun this process with large scale mixed tenure redevelopments (Communities Plus), support for rental income (Social and Affordable Housing Fund) and would ideally include planning changes to underpin confidence in the pipeline of new stock.

11. Social Ventures Australia, *Levers to stimulate investment in SAH*, 2016.

The Commonwealth is very well placed to improve both financing costs and terms through an aggregator, and it is our view this is a cost-effective intervention in a fiscally constrained environment. Tax incentives and changes to income support will have a large impact and cannot be overlooked – but also come at greater cost.

Finance for the SAH sector

Private sector financing for SAH in Australia is limited in both scale and sophistication. While a number of international jurisdictions have implemented successful measures to encourage private funding of affordable housing, finance in Australia is limited mostly to short-term corporate debt facilities for the relatively small not-for-profit CHP sector. It is expensive and inefficient, reflecting a reticence by financiers to commit time and resources to what they perceive to be a small, financially unsophisticated, economically unviable, and esoteric market segment.

Loans are issued at very low ratio to a property's market value (a misnomer, given social housing income flows are dependent on social tenant income and have no nexus with market values). Discussions with sector participants indicate interest is typically charged between 6% and 8% per annum, and loan terms tend to be less than five years; a suboptimal mismatch for assets with relatively steady, stable income flows for a useful life of up to 40 years.

Funding at lower interest rates and for longer terms will allow CHPs to harness greater leverage, and use the leverage to develop a greater number of dwellings.

An Australian Housing Finance Aggregator

We believe the housing aggregator model provides the greatest potential for generating private sector debt finance to generate additional SAH stock in Australia in a manner that is efficient for Government. Accordingly, our submission will focus on a proposed structure for this model, following the criteria outlined in the Issues Paper.

While this model could significantly reduce the cost of borrowing for SAH suppliers (in particular CHPs) and as a result enable greater funding for the sector, its degree of success will depend on the ability of State and Commonwealth Governments to address the challenges outlined in subsection (f) of this section.

a) Provide a detailed outline of the proposed model, what outcomes it would deliver, and how the proposed model overcomes barriers to investment, reinforced by supporting evidence.

As the Issues Paper notes, The Housing Finance Corporation (**THFC**) in the UK demonstrates the successful role an aggregator can play in stimulating SAH finance. The THFC is the foremost aggregating funder to UK housing associations. It has held an A+ credit rating since 2003[12] and as at 31 March 2015, has outstanding loans exceeding £4.15 billion in value.[13]

As an example of its success, in a 2013 paper[14] listing all public UK housing bond issues between January 2011 and January 2013, the THFC secured close to £500 million in funding (at an average tranche size of £99.3 million) for smaller-scale housing associations at spreads of between 99 and 205 basis points (**bps**) above government bonds, constituting over 10% of all public UK housing bond issues in that period. As we outline later in subsection (a), these spreads are less than half those typically incurred by Australian CHPs at present for their debt funding.

Policymakers could follow the THFC's lead, by establishing an aggregator entity that:

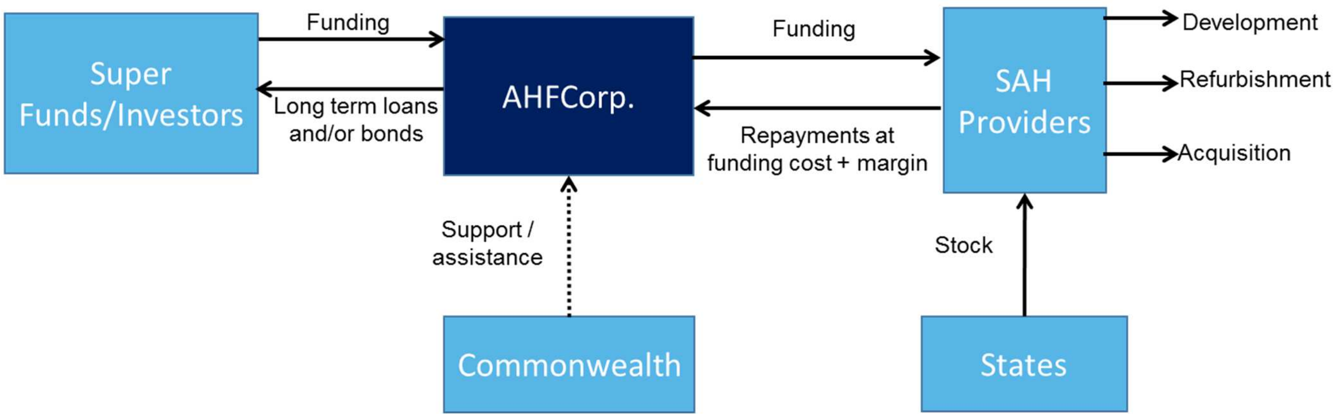
- aggregates funding needs for housing suppliers (including CHPs, REITs and SPVs);
- undertakes credit assessment of these entities;
- sources periodic tranches of debt from institutional investors in its own name;
- ensures continuous compliance with covenants to ensure SAH suppliers are solvent and able to pay their obligations with right to procure rectification of compliance breaches;
- sources SAH supplier repayments via free cash flows from secured properties; and
- on-lends debt to SAH suppliers at cost of debt plus margin to cover costs, with borrowers subject to covenants and their repayment obligations secured either via:
  - a fixed and floating charge over the SAH suppliers as a whole;
  - a mortgage over particular SAH supplier assets selected on the basis of their revenue profile; or

12. THFC Annual Report for year ending 31 March 2015: http://www.thfcorp.com/accounts/2015/THFC%20Ltd%202015.pdf
13. Ibid.
14. Heywood, Andrew: '*Investing in Social Housing:, A guide to the development of the affordable housing sector*', 13 February 2013, http://www.thfcorp.com/investing/investing-in-social-housing.pdf

— where necessary, a power to replace non-performing SAH suppliers with better-run providers by way of transfer of housing stock from the non-performer to the other, thereby minimising disruption to the SAH tenant.

A diagram of the proposed structure appears as **Figure 2** below.

Figure 2: Proposed aggregator model



Ideally, the aggregator would be a not-for-profit entity that has access to both sector and financial expertise and resources. For the purposes of this submission, we will call this entity the 'Affordable Housing Finance Aggregator' (**AHFA**).

AHFA would require management and administrative support from a financial sector participant, including:

— credit assessment;

— loan origination to suppliers of SAH;

— ongoing loan maintenance, including collection and monitoring;

— raising debt capital from and managing payments to suppliers of debt capital to AHFA; and

— periodic reporting and compliance, both to debt funding providers to AHFA and the entities to which AHFA lends.

AHFA would also benefit from a partner with both financial and social sector expertise to provide the following services:

— opportunity identification and business development;

— deep sector knowledge to help tailor financing packages to the needs of borrowers;

— measurement and evaluation of AHFA including ongoing cost benefit analysis for Commonwealth and social impact; and

— engagement with other key stakeholders including State Governments, peak bodies, and commercial lenders.

This model would overcome barriers to investment by:

— ensuring high credit quality of AHFA debt funding recipients through AHFA's thorough credit assessment process;

— generating debt finance better-suited to the longer term timeframe SAH requires; and

— pooling debt funding to a sufficiently large scale to enhance the economic feasibility of private sector debt finance to SAH suppliers, thereby allowing finance to be accessed by SAH suppliers (in particular CHPs) at a considerably lower rate than that currently available (as outlined later in this subsection).

As a consequence, the funding costs CHPs face in Australia could be substantially reduced, enabling them to unlock a greater level of equity in existing stock to fund further supply via:

— construction, development or acquisition of new dwellings; and

— extending the useful life of existing dwellings via repairs and maintenance, including renovation to make stock more suitable for purpose.

Our analysis of the sector indicates that cost of funding for CHPs via existing debt facilities typically entails interest charges of around 6%pa to 8%pa (around 400 to 600 bps) above 5 year Australian government bonds) at Loan to Value Ratios (**LVRs**) of around 20% to 25%. By comparison, the THFC has sourced debt at spreads of between 100 to 250 bps over equivalent UK government bonds.

An example of this model's ability to improve the financial position of CHPs and generate further supply is outlined in section 3(e) of this submission.

b) Outline what roles would be played by investors, governments, the not-for-profit sector and others

To establish and successfully implement the AHFA model, there are a number of key participants across the Government and non-government sectors. Their roles and responsibilities are summarised below.

(i) Commonwealth Government

THFC's low-cost funding is in part due to the UK sector's strong regulatory oversight by Government. Ratings agencies have previously formed a favourable view of debt issued by the sector in the UK due to robust regulation and regulatory frameworks, including powers to intervene when housing associations are in financial distress by forcing mergers or transfers of stock.[15] This has helped reduce cost of debt to the sector. A number of institutional investors have indicated to us that this is a critical gap in the current Australian SAH landscape.

Over the shorter term, the administrative cost of the Government increasing regulatory oversight could be minimised by providing the AHFA with powers of intervention for poorly-performing borrowers, thereby providing de facto regulation of CHPs who utilise the aggregator until funding to the sector increases in scale and sophistication.

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15. See for example Fitch Ratings '*English Registered Social Housing Providers: Strongly Government-Monitored and Regulated Sector*', 25 May 2012; Moody's Investors Service '*English Housing Associations*', 22 September 2010.

Over the long term, we suggest regulatory oversight of the sector via a regulator akin to the UK's HCA. A strong regulator would benefit the sector over the long term, and its cost of administration could potentially be manageable due to the comparatively small number of CHPs likely to be required to regulate if consolidation of the CHP sector occurs.

(ii) State Governments

As outlined in the preceding section 'Meeting the Social and Affordable Housing Challenge', there are numerous levers State Governments have at their disposal to help facilitate the development of new SAH stock. In order of scale of impact and likely impact on the success of the AHFA, they are:

— land title / stock transfer;

— planning amendments including inclusionary zoning;

— infrastructure planning decisions, including regulations mandating provision of minimum levels of SAH in new developments; and

— management right transfer over longer periods.

There are a number of State Government initiatives currently underway that would be complementary to the establishment of the AFHA. These include but are not limited to the Social and Affordable Housing Fund (NSW), the Communities Plus Program (NSW), the Connected Living Initiative (WA) and the Renewal SA transfer program (SA). The AFHA would be uniquely positioned to support these initiatives with the supply of appropriate capital into the sector.

(iii) Investors

Feedback from investors indicates a strong institutional investor appetite for long term secure and stable returns, particularly in the current low interest rate environment. Critical to attracting institutional investor interest in this sector is a need to identify and structure an investment product that is comparable to assets with which the investor is familiar. This includes but is not limited to:

— investments backed by AAA Government credit rating;

— rated securities by rating agencies such as Standard & Poor's and Moody's;

— liquidity in the form of tradeable securities (development of a secondary market); and

— appropriate risk adjusted returns.

Based on discussions with a number of institutional investors and industry super funds, there appears to be a significant latent supply of capital where the above characteristics exist. In particular, industry superannuation funds would be well-suited investors, due to the return profile and an appetite for applying funds to achieve positive social outcomes. SVA has recently announced a $30m mandate with HESTA, which highlights the appetite for superannuation funds to deploy capital into this market where the attributes of the transaction align with the fund's mandate.

(iv) SAH suppliers

While it is envisioned AHFA will lend to CHPs, REITs and SPVs, it is likely CHPs would be the initial target borrowers for the AFHA.

There are currently hundreds of CHPs nationwide, of which 25 are classified as Tier 1 providers. Based on the UK experience, consolidation of a currently fragmented CHP sector at both Commonwealth and state levels could assist in improving the scale and effectiveness of the sector. The UK experience indicates that fewer housing providers with larger portfolios (20,000 dwellings or more) would generate increased efficiencies and management expertise to fully capitalise on the benefits of the AFHA. Concurrently, the transfer of stock from State Governments would also bolster the scale and capacity of CHPs. Both changes should be supported by a consistent national framework as detailed earlier in this section.

c) Consider the short-term versus long-term aspects of government support when designing the operational aspects of a proposal, including how the model may become independent of government over time.

Initially, the Government may need to provide the model with a level of support to allay potential risk concerns of participants, in particular institutional investors.

Any Government support would be a finite short-term measure during the initial three to five years of AHFA's operation. This could take a number of different forms including financial support for AHFA, AHFA-originated debt issues or the SAH suppliers to whom AHFA will on-lend. Ultimately, the Government may elect to implement measures of support which impose the most reasonable burdens on it. Once the aggregator model has established a funding pipeline and developed a sufficient investment track record such that a market-based borrowing program emerges, the support measures can ideally be removed.

Furthermore, consideration could be given by State and Commonwealth Governments in agreeing to implement planning controls requiring the inclusion of social and affordable dwellings for larger developments.

d) Outline key operational design elements and implementation options of the model, including whether the proposal can be trialled, and if successful scaled up.

The key operational design elements are outlined in subsection (a) and (b) above and are readily implementable by existing financial institutions.

Proof of concept

AHURI cited internal research at the Working Group Roundtable in Sydney which indicated that the word 'pilot' or 'trial' should be avoided given the negative signals it sends to the market related to the perceived short term nature of an initiative or project. We agree with this sentiment and suggest a proof of concept initiative. This would provide the market with the necessary confidence that the Commonwealth's preferred model can be framed as the beginning of a larger, scaled program. This is important for a number of reasons, not least in providing institutional investors with the certainty of a pipeline of opportunities, at scale, in the future, to ensure they engage and commit resources to the proof of concept initiative.

Key design elements of the AHFA proof of concept phase include:

— quick to market – fast-track deployment of capital and evaluation of proof of concept to confirm scalability and effectiveness of model (initial allocation to be deployed within two years of Commonwealth Government agreement);

— leveraging the expertise of a proven funds manager along with a social sector/financing partner to provide a distribution network and scale, along with knowledge and experience of the housing sector;

— operations/management to be run on a cost recovery basis during proof of concept phase; and

— borrowers likely to be (but not limited to) Tier 1 CHPs (but may also be REITs and/or SPVs).

Table 2: Summary of proposed proof of concept

Initial capital raising / funds under management	$200m
Implementation timing (from signed documentation to financial close)	6 months
Investment period	18 months
Average deal size	$30m-$40m
Social impact (new social and affordable dwellings)	800 new dwellings[16]

e) Outline how the model minimises capital costs and maximises income so as to reduce the need for ongoing government involvement and assistance, while continuing to provide low cost rental housing for those on low incomes.

To best demonstrate how this model improves financial outcomes for CHPs, we have provided a hypothetical example.

Assume a large-scale Australian CHP currently has an existing interest-only debt facility on the following terms:

— $60 million with an interest rate of 7 per cent pa;

— secured against all its housing stock (market value $250 million); and

— for simplicity, interest is serviced by all free cash flows from that housing stock (that is, $4,200,000 in net rent matching interest costs of 7 per cent x $60 million).

Assume that as an alternative the CHP can access funding via an aggregator at 3.50% per annum (approximately equivalent to 10-year Australian Government bonds plus 100bps), of which 3.10% is the cost of debt issuance and 0.40% is aggregator margin to recoup costs and provide a reasonable profit margin.[17]

Compared to its original debt facility, under the aggregator model the CHP can either:

(a) halve its servicing cost to $2.1 million, meaning $2.1 million in extra available funding for the development of new SAH stock or repairs and maintenance on existing stock; or

(b) maintain the $4.2 million servicing cost but use it to instead obtain $120 million in funding (that is, $4.2 million ÷ 3.5% pa interest cost) rather than $60 million ($4.2 million ÷ 7.0% pa). This is because the free cash flows ($4.2 million) can now service double the debt compared to the initial facility.

Assuming conservatively that the cost per new dwelling is $400,000 (including land),[18] this means at least 150 new dwellings can now be acquired or developed. Assuming the existing stock worth $250 million is

16. Assumes $250,000 cost to build with land provided by State Government.

17. Including (but not limited to) cost of establishment, staffing, origination of loans, debt capital raising, funds management, legal and professional fees, information technology infrastructure, marketing and reporting.

18. Estimate based on total value of property held divided by dwellings owned for CHPs from 2015 annual financial reports from BlueCHP, St George Community Housing and Bridge Housing. URLs for all four are listed in footnote 4.

similarly worth $400,000 per dwelling (or 625 existing dwellings), SAH supply has increased 24% (150 new dwellings in addition to 625 existing).

While highly simplified for ease of understanding, this example demonstrates how competitive funding sourced via aggregator can benefit CHPs without impacting the cost of SAH for those on low incomes.

f) Explain how any major barriers to implementation, such as those outlined previously, can be addressed including what funding, policy, legislative and regulatory support would be required.

Barrier 1: Generation of scale

The current scale of SAH against which funding could be secured is insufficient. In both Australia and overseas jurisdictions, public sector entities will not consider private sector borrowing due to its adverse impact on public sector finances.

Solution: Increased non-government housing stock via either transfer from public sector to SAH suppliers, or new development should address this hurdle. In the medium term, additional supply could also be mandated through planning laws.

In the United Kingdom, large-scale voluntary transfers of public sector housing stock to not-for-profit, private sector housing associations (**HA**s, akin to Australia's community housing providers) have taken place since the 1980s. Between 1983 and 2013, 1.3 million dwellings were transferred to HAs,[19] enabling them to obtain finance secured against these dwellings to generate further supply. Presently, HAs have approximately £62 billion in outstanding bank lending and bond issues.[20]

The scale of the sector in the United Kingdom has ensured financiers are willing to expend time and effort modelling the sector's risk. Coupled with strong government regulation, it has enabled provision of finance to the sector at low, competitive rates.

In our discussions with the SAH sector, we understand at least one major financial institution had generated a credit model and approved the origination of loans to CHPs, only to cease this business line due to insufficient client appetite. However, recent initiatives at State Government level to facilitate an increased transfer of stock will likely increase appetite.

Barrier 2: Adequacy of returns

Social housing currently struggles to generate positive net yields. Rent for social housing is fixed at a portion of tenant income and entirely independent of a dwelling's market value. The overwhelming majority of social housing tenants primarily source their income from government support, meaning that while payments are stable and secure, they are often insufficient to service funding for further development or maintenance. Feedback from sector participants indicates that free cash flows are occasionally generated from tenants who remain in social housing even when their financial situation improves. In NSW, 13% of tenants pay rent equal to 80% to 100% of market.[21] While affordable housing (as distinct from social

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19. See footnote 14.

20. Ibid.

21. FACS, '*Social Housing in NSW Discussion Paper*', Nov 2014: http://www.facs.nsw.gov.au/__data/assets/file/0009/303030/Social-Housing-in-NSW_Discussion-Paper.pdf

housing) generates more favourable rental income, it is nonetheless suboptimal compared to market dwellings.

Solution: Income enhancements increase a dwelling's free cash flows and accordingly increase the level of funding that dwelling's free cash flows can secure. As an example, transfer of stock from public sector to private will entitle tenants to Commonwealth Rent Assistance. Additionally, subsidies to bridge the gap between social and market rents could be adopted, similar to that currently utilised in New Zealand and that in effect to be implemented via the recently-announced NSW Social and Affordable Housing Fund. While not essential to an aggregator's success, income enhancements (coupled with stronger financial discipline) will enable the SAH sector to harness a greater level of funding from the private sector.

Barrier 3: Ongoing transactional pipeline

It will be challenging to attract substantial private sector funding for SAH unless participants are assured of a viable, long term pipeline of demand for finance.

Solution: Government support for the sector at a broader level is required; measures such as transfer of stock to the non-government sector from State Government entities, mandated construction of SAH under planning regulations, and CHP sector reform will foster increased CHP appetite for funding and accordingly a regular pipeline of activity will assist. State Government inclusionary zoning policies for new developments would also increase confidence in the pipeline.

Barrier 4: Sector/Regulatory reform

At present, Australia has hundreds of CHPs operating on a small scale, very few of which meet the requirements for highest 'Tier 1' classification in terms of scale and scope of activity. In NSW for example, there are 16 'Tier 1' CHPs; financiers have indicated the ideal number is closer to 3 to 5 at scale.[22]

Solution: We believe consolidation of CHPs can improve their operational efficiency and effectiveness; well-run CHPs will benefit both tenants and financiers. This could be encouraged via provision of incentives for voluntary mergers (such as agreed transfer of public stock to merged entities).

Additionally, there is a benefit in developing measures to strengthen current government regulation of CHPs with a regulator akin to the United Kingdom's Homes and Communities Agency, via either extension of the National Regulatory System for Community Housing (**NRSCH**)'s regulatory oversight, or the establishment of a new regulator. As mentioned previously, granting of stronger intervention powers for the aggregator can help reduce the regulatory burden and annual cost on any sector regulator established by Government, particular in the initial stages of the aggregator's implementation.

Nationwide, robust regulation of CHPs will also improve financier confidence that, should a borrower CHPs experience financial distress, a regulator will be capable of intervening to minimise risk of default and any adverse publicity arising from the replacement of defaulting CHPs.

22. Jon Ross, National Housing Conference 2015 presentation *'Moving from Talk to Action: Institutional investment in affordable housing'*, http://www.nhc.edu.au/wp-content/uploads/2015/11/TS6-Jon-Ross.pdf

Barrier 5: Public sentiment toward private sector involvement in the delivery of public goods
Private sector involvement in a traditionally public-sector enterprise can attract negative public sentiment. Financiers have previously expressed concern about a need to evict of tenants when enforcing security against CHPs.[23]

Solution: The preferred solution entails two forms of Government assistance. The first is a mechanism for enforcement of security which does not affect a dwelling's existing tenancy arrangement. One example is tripartite agreements between financier, SAH supplier and Government whereby the Government agrees to intervene and transfer stock to another SAH supplier on default by the incumbent SAH supplier. This measure will provide added comfort for financiers as well as minimise the impact on tenants of circumstances beyond their control.

The second would be an active CHP sector regulator with the ability to intervene in the event of defaults, for example by compelling a CHP in likely financial distress to restructure or merge with another CHP. Active regulation is a key trait of the sector in the UK, where the HCA with vested with these powers.

As there has been a long-term stagnation of SAH supply, public and community sector confidence in private sector involvement will undoubtedly be increased when the number of tenants on low incomes who are adequately and affordably housed increases as stock numbers rise and waiting lists decline.

g) Provide an estimate of the implementation costs.

Once the level of finance on-lent reaches sufficient scale, we believe an aggregator margin of between 40 to 50bps can enable the aggregator to be financially viable.

However, in the early period while the model is introduced, the limited current scope of funding coupled with establishment costs means a minimum floor payment from Government will be required to ensure expenditure is recouped. This minimum floor would need to cover:

— development of credit assessment models for the Australian market;

— implementation of new IT systems and infrastructure;

— legal fees to establish a scaleable, robust documentation process;

— ongoing loan maintenance, monitoring and collections;

— cost of issuing debt capital to institutional investors;

— leasing of commercial premises;

— auditing and reporting; and

— staffing for all of the above.

23. Westpac Group, '*Submission to the NSW Government's Discussion Paper on Social Housing in NSW*', 20 February 2015, pp 6-7.

Extrapolating NSW housing data, we estimate CHPs currently hold over $4 billion of social housing stock nationally,[24] whereas the public sector alone holds in excess of $100 billion.[25] While there is tremendous scope for growth in CHP-held dwellings against which to secure funding, at present the revenue generated from on-lending to a sector of this size would be insufficient to justify the risks and expenditure associated with establishing an aggregator in Australia without direct Government support. A minimum revenue floor for the aggregator to be covered by Government for an initial period would address this issue.

h) Take into account the constrained overall fiscal environment across the Commonwealth and states and territories.

We acknowledge current fiscal constraints faced by Commonwealth, State and Territory Governments and believe this model, even with a floor on minimum revenue to the aggregator, will require minimal Government expenditure directly. We also believe initial costs to reform the sector and improve regulatory oversight over a smaller number of CHPs are unlikely to place a substantial fiscal burden on the Commonwealth Government in the long term. Additionally, an introduction of planning regulations mandating that large scale developments have a set level of SAH dwellings will similarly reduce Government costs by generating private sector supply.

However, the speed at which the aggregator delivers finance for new supply will be impacted by other policy measures, which have costs independent of the aggregator.

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24. In NSW in 2014, CHPs (excluding Aboriginal CHPs) held 4% of the state's approximately 150,000 social housing. LAHC owned approximately 126,000 (85%) of social housing, valued at $34 billion. Extrapolating this data indicates the total value of the sector in NSW was approximately $40 billion in 2014, of which CHPs owned $1.6 billion in housing. With NSW social housing accounting for over one-third of social housing nationally, we conservatively estimate the total value of social housing in Australia held by CHPs in 2014 to have been $1.6 billion ÷ 40% = $4 billion. Source: '*Social Housing in NSW Discussion Paper*', FACS, Nov 2014: http://www.facs.nsw.gov.au/__data/assets/file/0009/303030/Social-Housing-in-NSW_Discussion-Paper.pdf

25. Source: 2015 Annual Reports for:
    Family & Community Services (NSW): http://www.facs.nsw.gov.au/__data/assets/file/0016/341611/3592_FACS_AR_2014-15_Financial-statements_web.pdf
    Department of Health and Human Services (VIC): http://dhhs.vic.gov.au/wp-content/uploads/2015/10/DHHS-Annual-report-2014-15.pdf
    Housing Authority (WA): http://www.housing.wa.gov.au/HousingDocuments/housing_authority_annual_report_2014_15.pdf
    Department of Housing and Public Works (QLD): http://www.hpw.qld.gov.au/SiteCollectionDocuments/HPWAnnualReport2014-15PartB.pdf
    South Australian Housing Trust (SA): https://renewalsa.sa.gov.au/renewalsa/cms/wp-content/uploads/2014/05/2014-15-SAHT-Annual-Report-A13956654.pdf
    Department of Health and Human Services (TAS): https://www.dhhs.tas.gov.au/__data/assets/pdf_file/0005/204395/DHHS_Annual_Report_2014-15.pdf

Alternative financing models

In addition to the housing aggregator model, the Issues Paper has considered three other alternative financing models that may be suitable within the affordable housing context. We believe each of these models could play a supporting role in addressing the challenges of financing new affordable housing stock, however we believe the housing aggregator model optimises the desired outcomes for the Federal Government and the communities it is seeking to support. We explore the merits of two of these models below.

a) Real estate investment trusts (REITs)

At a basic level, REITs give investors access to property assets that may otherwise be out of reach of investors, such as large scale commercial properties. REITs are designed to generate wealth in two ways: they provide exposure to the value of the real estate assets that the trust owns and the accompanying capital growth, and rental income. Conventionally, a fund manager is appointed and is responsible for all administration, improvements, maintenance and rent collection.

Within the social and affordable housing context, a REIT structure would enable the pooling of social and affordable housing assets at scale. Benefits would include attracting institutional investors to such a vehicle, delivering a more efficient lifecycle management program of the assets (and therefore lower ongoing capital costs) and improve development and property management capability by outsourcing these functions to a private sector participant.

However, this model has significant challenges, including:

— heavily dependent on State Governments to contribute land and/or stock in the form of either title transfer or long term leasehold arrangements (which would represent part or all of the equity contribution into the REIT);

— in order to build up the asset base of the REIT, there would be a much longer lead time to establish a REIT at scale and optimise its effectiveness as a financing vehicle;

— without further demand side reform of rent settings including CRA, a REIT would not be able to provide returns on equity at market expectations and could limit debt levels the REIT could sustain (contingent on rental yields and capital growth assumptions) and;

— inhibits the development and growth of the CHP sector. A number of the larger Tier 1 providers are currently building their property management and development capability in addition to their core business which is tenancy management. A REIT would likely result in the CHP sector simply being a sub-contractor to the REIT in its capacity as a tenancy manager of the assets.

While the REIT model may therefore be a complex vehicle to bring private equity into the provision of SAH, we note that if the Government choses to pursue this option it could be done in conjunction with advancing a debt aggregator which would be able to provide debt finance to the REIT.

b) Impact investing and social impact bonds (SIBs)

Impact investing, broadly defined, is the allocation of capital with the dual expectation of a financial market return commensurate with the underlying risk combined with a demonstrable social return (or social impact) on the investment.

SVA's background in impact investing suggests that there is no shortage of capital ready to be invested in "impact" assets. This has been the experience on single asset raisings SVA has undertaken including the Goodstart buy-out of the ABC Learning Centres in 2009, where $22.5 million of 'social notes' was raised from a range of impact investors and Australia's first social impact bond, Newpin, which was oversubscribed for the $7 million capital raise. This has also been SVA's experience in raising funds under management, with Hesta recently announcing a $30 million investment management agreement with SVA with an additional line of sight to approximately another $100 million from other industry super funds over the coming 12 months. SVA's experience is supported by the recent Impact Investor Survey which indicated that across a range of institutional investors there is latent supply of up to $18 billion of impact capital.[26]

We believe impact investing is complementary to the previously discussed financing models – the aggregator model and REITs. SVA and Macquarie believe both vehicles would improve the flow of impact investment into the social and affordable housing sector, with a clear preference for the aggregator model.

SIBs are an innovative and newly developed financing vehicle, which forms part of the broader impact investing landscape, alongside more traditional investment types such as debt and equity. The SIB market in Australia is still nascent, with only two SIBs that have reached financial close ($17 million in total), compared to the UK and US markets where more than 50 SIBs under development or in operation.

SIBs finance social service programs through a combination of outcome-based payments and market discipline. Returns to investors are contingent on pre-determined social outcome(s) being achieved that generate cashable savings to Government of which a portion of these savings are returned to investors. Investor returns to Newpin investors over the 2014-15 financial year were 8.9 per cent pa which is very competitive in the current market.

The growing interest in, and attractiveness of, SIBs to a wide range of stakeholders is based on the following attributes:

- value for money for fiscally constrained Governments;
- focus on preventative interventions that are notoriously difficult to fund;
- funding certainty over longer timeframes for service providers;
- access to private capital;
- risk-sharing mechanism amongst the contracting parties (Government, service provider and investors); and
- improved measurement and evaluation and governance around Government procurement including a strong focus on outcomes.

SIBs will likely play an important, albeit niche, role within the social and affordable housing landscape. To date, SIBs have generally been small scale (below $30 million) and have provided working capital for the intervention program in a targeted area of need. Given the scale of capital required for the housing sector (well in excess of $1 billion) and therefore the direct cost savings to Government that must be attributable to such an investment, it is unlikely that a SIB would be a suitable financing model at scale to address this challenge.

26. Dembek, K et al, '*Impact Investing Australia: 2016 Investor Report*', March 2016.

There are however examples within Australia where SIB models are under development to address both the stock shortfall and the working capital for a program addressing youth homelessness. SVA is currently in a consortium with St George Community Housing (CHP) and UnitingCare (Service Provider) and is in negotiations with the NSW Government as the preferred tenderer for a vulnerable young person's SIB seeking to develop a Youth Foyer model.

Youth Foyer is based on a proven model from the UK in which vulnerable young people are provided a dwelling akin to student accommodation with intensive and aspirational support surrounding the young person. Every young person is provided access to education and employment opportunities with a strong focus on transitioning the young person into stable accommodation at the end of the program. Incorporated into the operating costs of the program is a market based rent, which unlocks private capital into the property transaction (the model assumes a new build of 70-80 beds, purpose built for Youth Foyer).

Modelling undertaken by the consortium indicates that savings attributable to the Commonwealth Government at 2.5x the size of the bond would accrue over the term of the bond through the reduction of Newstart and CRA. For example, a $10m SIB would generate ~$25m of savings attributable to the Federal Government. This figure is in addition to the savings modelled to the NSW Government.

Such a model is an example of how a SIB structure can facilitate additional social or affordable housing stock over and above the larger-scale supply that would transpire from an aggregator model. In addition, it demonstrates a potential ancillary role for the Commonwealth Government to play by supporting the development of the SIB market where there are clear and measurable cost savings to the Commonwealth.

Appendix – About Macquarie Group and Social Ventures Australia

About Macquarie Group

Macquarie Group Limited (**Macquarie**) is a global financial services provider with offices in 28 countries.

Our breadth of expertise covers advisory and capital markets, trading and hedging, funds management, asset finance, financing, research and retail financial services. The diversity of our operations, combined with a strong capital position and robust risk management framework, has contributed to our 46-year record of unbroken profitability.

Our funds management business, Macquarie Asset Management (**MAM**), is a full-service asset manager offering a diverse range of capabilities and products including infrastructure and real asset management. As at 30 December 2015, MAM had $487 billion in assets under management.

MAM is the world's leading global alternative asset manager specialising in infrastructure, real estate, agriculture and energy. It has been awarded the world's largest infrastructure asset manager three years running.[27] With a client base primarily comprising institutional investors and governments, MAM has more than 50 infrastructure funds with assets under management in excess of $121 billion.[28]

Macquarie has a strong interest in improving SAH outcomes. Our philanthropic arm, the Macquarie Group Foundation, is one of Australia's largest and oldest corporate benefactors. In 2015 the Foundation and Macquarie staff contributed $A24.2 million to over 1,300 community organisations worldwide, including a multi-year operational expenditure grant to SVA to develop social impact bonds in Australia.

We have significant expertise in delivering solutions for the SAH sector, including:

— in Australia, originating an investment product delivering income to participants in the National Rental Affordability Scheme; and

— in the United Kingdom, arranging infrastructure debt security issuances for the development of SAH by not-for-profit housing associations.

Macquarie has extensive resources, access to capital, and experience with transaction, real estate and asset management.

About Social Ventures Australia

SVA is a non-profit organisation established in 2002 by The Benevolent Society, The Smith Family, WorkVentures and the AMP Foundation.

SVA works to reduce disadvantage in Australia by offering funding, investment and advice. It has a proud history of fostering social innovation in Australia. Its social impact investing arm has facilitated the implementation of innovative financial models to generate social outcomes coupled with financial returns for investors. To date, SVA has arranged more than $200 million in investment funding across housing,

27. Towers Watson Global Alternatives Surveys 2013 (published July 2013), 2014 (published July 2014) and 2015 (published July 2015), measured by assets under management.

28. Based on proportionate enterprise value, calculated as proportionate net debt and equity value at 30 June 2014 for the majority of assets.

early learning, employment-driven social enterprises and social impact bonds, including the Newpin Social Benefit Bond, Australia's first SIB.

In our first 12 years:

— we generated over $50 million of investment from philanthropists, trust and foundations and Government into the social sector;
— we arranged a $165 million of investment into early childhood learning to fund the non-profit consortium buyout of ABC Learning Centres to create Goodstart, providing 15% of Australia's early childhood places;
— we worked with over 80 social ventures like Beacon Foundation, Ganbina, STREAT and AIME, and distributed more than $20 million to support their work;
— we leveraged private investment to match Commonwealth Government funding into the $9m SVA Social Impact Fund to support innovative social enterprises;
— we partnered with UnitingCare Burnside on Australia's first Social Benefit Bond with the NSW Government, the Newpin SBB;
— we were the lead partner of a consortium providing advice and support to the WA Government to deliver the $10 million Social Enterprise Fund;
— in 2015, SVA announced a second social impact fund – the Social Impact Investment Trust – with Health Employees Superannuation Trust Australia. The fund which is initially $30m is focussed on social and affordable housing; and
— we delivered over 550 consulting engagements for over 300 clients to strengthen the non-profit sector.

More information is available at www.socialventures.com.au