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# HousingWORKS

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# Private finance: a fair weather friend?



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**Sweeping like a whirlwind from the sub-prime mortgage belt of America, the Global Financial Crisis (GFC) brought banks – and in some cases countries – to the brink of collapse. Reformed banker turned housing researcher Tony Gilmour asks where this leaves moves to introduce private finance into the Australian affordable housing sector.**

Affordable housing is a capital intensive business. In countries with a large social housing stock such as England and the Netherlands, refurbishment of existing homes built several decades ago is a major headache. In the US and Australia, with a social housing stock of around 5%, the emphasis is more on increasing affordable housing supply – though both countries have their fair share of crumbling public housing estates.

The need for major affordable housing investment, at a time when governments were looking to moderate overall spending, led to a growth of private finance initiatives from the 1980s. Countries adopted different flavours and combinations, according to taste. These, however, can be broken down into three basic types: debt, equity supported by tax incentives and cross-subsidy from commercial projects. None of the approaches worked particularly well during the GFC, though some worked better than others. The examples in this article are mainly from England and the US, both countries that have been particularly zealous in their use of private finance to support the expansion of not-for-profit (community housing) providers.

## Debt

The use of medium term bank loans to finance social housing is not surprising given the use of mortgages to facilitate owner occupation. Social landlords can leverage their rent-roll to pay interest and capital, particularly in countries like England where there is strong government support of tenant income through the housing benefit.

Since England introduced private finance in 1988, mainly in the form of commercial loans to housing associations, the funding model of



Institutional equity at work: tax credit financed multi-family homes in Santa Rosa, California.

the sector has been transformed. Lenders currently provide a staggering £50 billion (\$90 billion) of facilities for associations. Traditional loans are supplemented by a small volume of bonds, with the not-for-profit Housing Finance Corporation syndicating £1.9 billion (\$3.4 billion) of bond lending to 188 associations. These initiatives have allowed governments to progressively reduce the level of grant support such that in 2009, for the first time, it fell below the level of private finance.

Despite a slow start, English banks and building societies soon became comfortable with the relatively low risk posed by housing associations. By 2008, some 85% of the lending market was dominated by 5 major institutions – Lloyds, Barclays, Nationwide, Santander/Abbey and Royal Bank of Scotland (RBS).

Although in the early 1990s margins charged by banks on top of their cost of funds were typically between 1.5% and 2%, these had fallen through competition to around 0.25% by the mid 2000s. Just before the GFC, English housing associations could borrow at the same rates as the country's top businesses. They became 'rate tarts', touting their business between lenders to get the best deal.

The party ended with the GFC. Several banks struggled to survive – customers queued outside the beleaguered Northern Rock to demand their money back. One of my former employers,

RBS, the world's fifth biggest bank, was rescued by the government which now owns 85% of it. The banks' tight liquidity led to a period of several months during 2008 when many of the sector's lenders stopped making new loans. This has been followed by a period when considerably higher margins are being charged on new and re-negotiated loans, back up to 2%.

Although perhaps too early to judge, the debt model used in England to help support housing associations has been more resilient during the GFC than might have been expected. Borrowing margins have increased, though probably returned to more realistic levels. Ironically public ownership of part of the banking system has been key in keeping loans flowing – RBS is under political pressure to support its customers in hard times. Despite the introduction of private finance to English housing associations, public subsidies such as the housing benefit remain strong. And, when the going got tough, government stepped in to prevent housing associations failing.

### Equity supported by tax breaks

Perhaps not surprisingly, it is the US that has pushed furthest the use of private finance. Typical affordable housing projects are financed 20% by grants, 40% by bank loans and 40% by equity through Low Income Housing Tax Credits (LIHTC).

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The LIHTC scheme was introduced in 1986 and has been remarkably popular under both Republican and Democratic governments. In return for providing new affordable units with rents set at 30% of local salary levels, investors receive tax credits over 10 years which can be used to reduce their tax bill. US tax credits are sold in the market at a discount – initially affordable housing developers received only 10 cents in the dollar, though by the mid 2000s the figure had risen to 90 cents. Despite their complexity, and loss of subsidy through high professional fees, LIHTC schemes have successfully delivered around 1.7 million affordable homes since 1986. This compares with a total US public housing stock of 1.2 million built over the last 70 years.

The GFC caused considerable disruption in the US for affordable housing developers. Not only were debt markets hit – like in England – but also

LIHTC equity. Some 80% of tax credits had been purchased by commercial banks and Fannie Mae and Freddie Mac. With these institutions making heavy losses, tax credits lost their appeal. The price of credits plummeted, leaving funding gaps for projects arranged during 2007 and 2008.

The US Government came to the rescue in February 2009 with a subsidy to fill the financing gap for affordable housing developers, allowing new construction to start again. However, a recent report by the Harvard Joint Center for Housing Studies suggests that even in late 2009 the tax credit market remained seriously depressed and that the entire LIHTC scheme may need to be overhauled.

### Cross-subsidy

Though not strictly a form of private finance, several not-for-profit housing providers in England, the US and Australia have used profits on market rate property development to help support affordable housing rental. Particularly in England, the government has taken a relaxed view on these schemes as they reduce the level of public grants and help create mixed-income, mixed-tenure communities. Some housing associations are said to have over half their new developments devoted to market sales and shared ownership.

The downturn in English property markets during the last 18 months has hit hard the associations relying on cross-subsidy. Several have had to write-down their asset values, leading to a breach of the terms of their commercial loan agreements. Prime Minister Gordon Brown spent £2.8 billion (\$5.0 billion) by

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the end of 2008 to re-capitalise housing associations, often those that had speculated most with private development and land-banking.

### Thoughts for Australia

Countries such as England and the US which have introduced private finance have made major strides in improving the condition of their social housing and building new affordable stock since the mid 1980s. These achievements would probably not have been possible if they had relied on government grants alone. Market forces have improved the quality of new housing schemes, by awarding funds to providers who can best demonstrate sustainable environmental design and social mix.

The GFC, however, has indicated the limits of free market capitalism. In both England and the US the private finance system for affordable housing had to be rescued by old-fashioned government spending. When times are good, private finance flows freely to support new affordable housing. In a recession, governments need to pump-prime to maintain the affordable housing sector. Compare this with

recent debacles in Sydney involving the failure of infrastructure public-private partnerships. When the Lane Cove and Cross City tunnel projects collapsed, private investors lost their money. When affordable housing schemes in the US and England faced problems, investors were protected. So much for the transfer of risk to the private sector.

Australia is a lucky country. Our recession was shallower and finance system more robust than other developed countries. Private finance has started to be introduced into affordable housing production, though in a modest way. Several larger community housing providers have bank loans, though grants are likely to cover perhaps three quarters of capital costs. The National Rental Affordability Scheme (NRAS) looks like America's LIHTC, though appearances are deceptive. Distribution of NRAS incentives is more managed than marketised, and most allocations to date have been to not-for-profit organisations. Institutional investment in NRAS has been encouraged, particularly in round three, though little has materialised.

Private finance is a fair weather friend. When the economy is strong, it still requires public under-pinning through support of tenant income, capital grants and tax breaks. When the economy collapses, governments must step-in to prevent the failure of housing providers leading to the eviction of low-income tenants. Introducing a sustainable level of private finance will bring market disciplines; relying on it too much will lead to excessive risk taking. We may have started the private finance journey late in Australia, though at least we have a chance to get the balance right.