

Final Report

Financing affordable housing: a critical comparative review of the United Kingdom and Australia

authored by

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Peter Williams' contribution to this report is in his personal capacity as a housing researcher.

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EXECUTIVE SUMMARY

Governments in both the United Kingdom and Australia are committed to supporting housing systems that deliver affordable and appropriate housing to all their citizens. In both countries recent economic and social developments have challenged this policy goal. In particular, the increasing globalisation of economic activities and the liberalisation of national economies are forces that have largely removed housing from its historically protected, even cocooned position. The general neo-liberal turn in policy in both countries, re-defining the role of government, has placed constraints on traditional loan and tax sources of funding for areas like housing. This has led to a common interest in leveraging institutional debt and equity investment into the provision of affordable housing – and to a necessary concern for identifying and pulling the appropriate policy levers.

However, the institutional histories, methods and trajectories applied differ markedly between the UK and Australia. Housing policy in the former has undergone significant reform over the past 30 years, with major policy innovations like the Right to Buy granted to public tenants, large scale public housing stock transfers from local authorities to the housing associations, shared equity programs and town planning instruments, as well as liberalisation of the housing finance market, substantially changing the tenure distribution and ownership structure of British housing. Housing policy reform in Australia, by contrast, has been muted, largely confined to internal changes to the dominant social housing policy vehicle – the Commonwealth State Housing Agreement.

The key *research questions* addressed in this report are:

1. What is meant by ‘affordable housing’ in Australia and the United Kingdom? How has this changed in recent times? What impacts on policy are these changes having?
2. What are the scope, volume and impact of private investment in affordable housing in Britain, focused on the past 5 years?
3. What were the barriers to private investment in affordable housing and how were they overcome in the British case?
4. In particular:
 - what institutional reforms and capacity building were required in order to ensure greater private investor involvement? And what barriers/constraints still remain?
 - what public policy levers were necessary/successful in stimulating appropriate investment and supply responses?
5. What are the realistic future options and likely developments in private financing in Britain, in the light of forecast need?
6. What are the main similarities and differences in the conditions and opportunities for private funding in Australia, compared to Britain? To what extent do British approaches fit the Australian investment and policy climates?
7. What determines the successful implementation of stock transfers from local councils to the housing association sector? What factors block such transfers? What implications, if any, do the British experiences here have for Australia?

These questions are addressed in detail in the body of the report and the main conclusions summarised in chapter 6. Key findings are presented below.

Expansion of Private Finance in the United Kingdom

Starting from a position where government had a large equity stake in housing, private finance has successfully been introduced into the provision of social and affordable housing by a complex mix of arrangements for the construction of new stock and the transfer of existing stock from the local authority sector to the housing association (HA) sector. By 2001 the total housing association sector comprised around 1.6 million dwellings, almost half the size of the declining local authority public housing stock. The intervention of private finance has effectively transferred many households into owner occupation with the help of subsidy and 'stretched' the supply side subsidies available so that they can meet a larger proportion of unmet need.

Private investment (lending) in social housing:

- Exceeded £34 billion in 2003, in cumulative terms. Annual investment in this sector has declined in recent years but is still running at over £2 billion.
- Is provided by about 150 lenders, mainly large banks and building societies to housing associations of varying sizes.
- Is heavily directed towards mortgage lending; but a growing bond market is emerging for the debt of the larger housing associations (and syndicates of smaller associations).
- Sees risk keenly priced and rates lying only 30-50 basis points above the rate at which banks lend to each other. The low cost of finance is heavily dependent on the lenders' confidence in the established regulatory framework and central government's continuing commitment to the Social Housing Grant to the HAs and payment of housing benefit to low income tenants.
- In addition to funding 50-60 per cent of the cost of new HA construction, has financed the transfer of about 900,000 dwellings from local authorities to the HAs and some 2 million dwellings across the UK to sitting tenants under the Right to Buy legislation introduced in 1980. Both forms of transfer have generally depended on significant price discounts to reflect local market conditions and the state of the stock. The transfer-to-HA market is dominated by a small number of large lenders, typically providing finance in £50 million tranches or more.
- More recently, a number of shared equity/ownership schemes for low income people have been introduced through the HA sector, sometimes including HA equity, sometimes only involving loan facilitation supported by subsidy, with the residual finance provided by private mortgage lenders. To date, the total number of dwellings financed in these ways is less than 50,000.

The impact of the Right to Buy, shared equity and (very recent) schemes targeted at 'key workers' has, over the past two or three decades, substantially increased the number of lower income people entering owner occupation.

This expansion of private finance was encouraged by the following factors:

- As a pre-condition, local government owned almost a third of the total housing stock in the late 1970s. This provided the option for government to subsidise the transfer of ownership to tenants and housing associations, encouraging demand.
- Financial markets were progressively deregulated and liberalised during the 1970s and 1980s, providing the capacity of financial institutions to finance the transfers from the local government sector and to lend to the HAs for construction.
- The land use planning system was modified to increase local government powers to mandate affordable housing provision as an element in obtaining the right to develop or redevelop and to generate additional funding from landowners and developers that could be directed to affordable housing.
- The growth in (and near-certainty of) continued central government supply side subsidies to the HAs and demand side subsidies to low income households reduces the risks facing private lenders and institutions engaged in affordable housing provision.

Emerging Issues

The UK Government has, as noted above, supported the growth of low income home ownership through: the Right to Buy; the use of Social Housing Grant to fund shared equity through the HAs; and s.106 planning powers. Most recently, targeted support by way of direct grants to 'key workers' have been used to address labour market concerns in particular regions, notably the South-East. In each case, mortgage lenders finance the balance after the subsidy. This reduces the risk to both lenders and lower income purchasers.

The unanswered question remains, on the one hand, what are the sustainable limits to this general policy direction and, on the other hand, how much can subsidy support? In other words, will most low income home owners be able to sustain mortgage repayments when economic and employment conditions change and the property market turns down, and will those unable to access subsidy be enabled to achieve acceptable housing by other means?

More broadly, ***there are a number of changes in the market and institutional environments that may undermine the previously favourable climate for private investment in affordable housing in the UK.*** They include:

- The intention by central government to phase in a form of rent control, relating individual dwelling rents to local property values, in the HA sector. This restriction in the revenue raising powers of housing associations may increase the probability of financial distress in parts of the sector, increasing risks to lenders and resulting in rising mortgage rates in those areas.
- Current debates over reforming the regulatory system for the HA sector, including the issues of regional devolution and governance, likewise may cause lenders to reassess and price changing risks to the sector in the future. To the extent that the Housing Corporation as funding body 'picks winners' – i.e. favours larger, better performing HAs when allocating the total Social Housing Grant – this may result in the cost of finance rising for average and bad performers, increasing their likelihood of default and reinforcing the trend to concentration (mergers and alliances) in the sector.

There are, in other words, a number of real and potential threats to the regulator and some associations that may cause lenders to be more discriminating in allocating and pricing loans.

- The process of stock transfer from the local authority to HA sector has cooled. Some local authorities are looking to retain ownership of the stock but effectively out-source management to ALMOs – Arms Length Management Organisations. Greater public tenant resistance to wholesale transfers has led to a ‘downscaling’ to the estate level. Both trends reduce the volume of dwellings transferred and, hence, the private funding needed to effect transfer.

The private finance market for affordable housing in the UK has been strongly focused on debt. ***The government is just beginning to think about the question of how to introduce institutional equity finance into:***

- the private rented sector, where (unlike Australia) most of the poor do not live
- large scale urban regeneration, often in declining regions
- and private equity in shared equity and social rented housing

as well as to facilitate the growth of secondary markets that would reduce the costs of funding.

Barriers to private funding that have been overcome through institutional reform to date include:

- The highly regulated structure of social housing which was replaced by a framework that provided comfort to private lenders while increasing the social landlord’s freedom of decision and potential to increase financial and operating efficiencies (but note the comments above about the change to rent policy).
- The initial lack of understanding of the new market among private financiers – particularly as to the nature of housing associations – has been overcome, allowing for a wide range of institutions to fund housing and affordable housing, in particular. Financial markets lacked knowledge when introduced to the sector but at that time their investments were cushioned by the enormous equity built up in the social housing stock. Over time, as debt-to-asset ratios have increased, so too has market understanding and confidence.
- The lack of specialist financial and management expertise has been overcome, in part, by the general growth of this privatised market but also by the incentives provided by profitable opportunities.
- The problems associated with the poor quality and upkeep of some of the dwellings for transfer have been addressed by including these costs in the initial valuations and by appropriate targeting of the required subsidy.
- The small scale and fragmentation of the HA sector has been partly overcome by means of the large scale voluntary transfers, the concentration of subsidy among larger HAs and the trend towards mergers and syndicates.

Barriers still remaining include:

- The extent of demand for affordable housing (relative to supply) across regions and the multiple problems facing some inner city areas. These generate risks for lenders in locations where investment and regeneration could have major social benefits.
- The fragmentation of ownership in the relevant areas, including Right to Buy, increases the difficulty of initiating and achieving regeneration and in improving neighbourhoods in deprived or declining regions. This is exacerbated in the subsidy levels and rent policy makes the funding of construction and transfer a riskier proposition in some areas – i.e. those in which rents are low and likely to lag average growth.
- In spite of close regulation and the process of sector concentration, pockets of small scale and poor performance remain in the social housing sector.
- The likely future emergence of alternative lending opportunities, in the wake of Basel 2, may constrain the exposure lenders wish to maintain to this low risk/low return investment market.
- The continuing consolidation of this financial market, together with its natural maturation, will tend to limit the profitable investment opportunities there.
- The ever-present political risk related to rent and subsidy policies, regulatory arrangements and taxation arrangements.

The Australian Situation

Most of the barriers noted above characterise the situation in Australia to a much greater degree because of the very small scale and poorly developed institutional structure of the community housing sector. State governments, in particular, have generally been unwilling to transfer public housing stock to any degree. Social housing provision and the land use planning system are radically disconnected. There has been a failure in placing housing – especially affordable housing – on the political agenda. The real value of supply side subsidies to public housing have fallen consistently over the past decade, which coupled with the close targeting of available stock to people with very low incomes and multiple social disadvantages, has put the state housing authorities in a parlous financial situation, very poorly placed to expand provision to meet increasing demands.

To date there have been a number of small one-off projects in several states that leveraged some private funding to supplement government equity and/or recurrent subsidy commitments. These include:

- *City West Housing Company Pty. Ltd.* – a non-profit entity funded by the NSW and Federal Governments and private developer contributions, that is delivering around 600 medium density units targeted at low to moderate income households in Sydney's inner-west.
- *Brisbane Housing Company Pty. Ltd.* – an independent not-for-profit company, that aims to provide up to 600 dwellings by 2006 at less than 75 per cent of market rents in Brisbane's inner and middle suburbs. The Company is structured to be tax effective, leverage contributions from the not-for-profit and private sector, and access limited private debt finance.

- *City of Port Phillip (Melbourne)* – in conjunction with a community housing organisation (the Port Phillip Housing Association), has initiated a number of projects since the mid-1980s resulting in the provision of several hundred dwellings rented at levels substantially below market rents. These projects have relied on a range of Federal and state government funding programs and sometimes involved private developers in ways that have reduced development costs borne by Council.
- *Community Housing Canberra Ltd.* – a non-profit housing provider which has completed its first mixed social and private housing development with a private equity partner – City Edge, involving the redevelopment of a public housing site, with a proportion of the new dwellings being returned to the public housing authority and another proportion retained by CHC for rent at sub-market levels.

There have been a number of other small scale attempts across the states and territories to encourage affordable housing provision drawing on private funding sources (details are provided in section 5.5) but, to date, no successful large scale attempt has been made.

However, there has been a lively debate over the past few years as to how substantial volumes of private finance *could* be leveraged into this sector. The following approaches have been suggested.

- *The consortium model* – proposed by the Affordable Housing National Research Consortium, would entail a capped Commonwealth outlay subsidy to the states and territories enabling the latter to borrow and acquire dwellings for rent to low-moderate income households at income related (i.e. below market) rents.
- *A retail investment vehicle* – developed by Macquarie Bank, would pool retail equity investment for the acquisition of rental dwellings managed by a community housing organisation but would require substantial government subsidy to deliver the required return to investors.
- *Tax relief targeted to retail investors renting to community housing organisations* – would entail special tax benefits directed at private landlord-investors who rented their dwellings on long leases to community housing organisations or other non-profit providers for a minimum period of time, with the benefits to be split between the investor and provider in the form of lower than market rents.
- *A low income tax credit scheme* – similar to the US scheme, would (according to initial microsimulation modelling) target most of the benefit to landlords providing lower cost rental dwellings, encouraging private investment to flow into that sub-market.
- *A capital gains tax partial exemption on the sale of rental dwellings* – would tend to deliver most benefit to investors providing lower rent stock, encouraging private investment to flow into that sub-market.
- *A shared equity model* – proposed by Caplin and Joye, would enable institutional investors to buy an equity share in a mixed-value pool of dwellings spread widely across the states and territories. In this model, the private equity investors receive their return in the form of a share in the growing capital value of the dwellings.

Each of these approaches has both advantages and disadvantages in the current economic and policy context in Australia, as the following table summarises.

Overview of Models

| Advantages | Disadvantages |
|--|---|
| <i>Consortium bond model</i> | |
| <ul style="list-style-type: none"> ▪ Cost effective (efficient) ▪ Effective partnership between Commonwealth & States ▪ Total subsidy capped for the Commonwealth ▪ Closely targeted to need ▪ High leverage of private investment ▪ Generates a large volume of private investment ▪ Draws on existing financial instruments (bonds) ▪ Helps maintain a deep market for government bonds in Australia ▪ Provides strong incentives for states to manage the expanded public stock efficiently ▪ Simple and straightforward financing procedure with minimal transaction costs | <ul style="list-style-type: none"> ▪ Concentrates financial and operational risk on States ▪ Relies on public borrowing in a neo-liberal climate of public debt reduction ▪ Requires new management systems to be put in place in SHAs to manage risks |
| <i>Macquarie Bank retail investors model</i> | |
| <ul style="list-style-type: none"> ▪ Could aggregate large volume of small savings ▪ Could provide a growing stream of finance for well-organised and professionally run community housing organisations (CHOs) ▪ Provides equity-like investment opportunities akin to commercial property trusts in the residential sector (diversification benefits to investors) | <ul style="list-style-type: none"> ▪ Numbers don't stack up: requires substantial subsidies to work, hence very costly for government – i.e. limited leverage of government funds ▪ Current shortage of suitable CHOs ▪ Not targeted at households below \$30,000 income |
| <i>Macquarie Bank alternative model (taxation exemptions)</i> | |
| <ul style="list-style-type: none"> ▪ Trades on existing 'cottage industry' nature of the rental sector ▪ Could be facilitated by states granting targeted land tax and stamp duty concessions to investor-landlords ▪ Provides a long-term basis for secure leases (security of tenure) and cost savings on maintenance, etc. ▪ Could encourage downward 'filtering' of higher rent stock to affordable segment | <ul style="list-style-type: none"> ▪ Difficulty in quarantining tax benefits to affordable stock – large 'deadweight cost' ▪ 'Distorts' market outcomes and reduces efficiency ▪ Possibility of fraud via benefits claimed on stock not rented at affordable rents ▪ High surveillance costs to ensure compliance with rules ▪ Current shortage of suitable CHOs ▪ Politically infeasible, contradicting existing fiscal philosophy of government central agencies winding back special tax concessions |

| Advantages | Disadvantages |
|--|---|
| <i>Woods Tax Credit model</i> | |
| <ul style="list-style-type: none"> ▪ Trades on existing 'cottage industry' nature of the rental sector ▪ Total tax subsidy can be capped (as in the U.S.) ▪ Could be facilitated by states granting targeted land tax and stamp duty concessions to investor-landlords ▪ Provides a long-term basis for secure leases (security of tenure) and cost savings on maintenance, etc. ▪ Could encourage downward 'filtering' of higher rent stock to affordable segment | <ul style="list-style-type: none"> ▪ Difficulty in quarantining tax benefits to affordable stock ▪ 'Distorts' market outcomes, reduces efficiency ▪ Possibility for fraud via benefits claimed on stock not rented at affordable rents ▪ High surveillance costs to ensure compliance with rules ▪ Politically infeasible, contradicting existing fiscal philosophy of govt. central agencies winding back special tax concessions |
| <i>Shared equity model</i> | |
| <ul style="list-style-type: none"> ▪ Does not require government subsidy ▪ Allows households to diversify their savings, potentially leading to greater lifetime wealth accumulation ▪ Reduces initial barriers to accessing home ownership ▪ Reduces housing stress, especially in early years of purchase ▪ Potential to develop a large secondary market in 'bundled' equities ▪ Attractive to households in the broad middle of the income hierarchy (fourth to sixth income deciles) and higher ▪ Delivers greater security of tenure than private renting | <ul style="list-style-type: none"> ▪ Stimulates housing demand without necessarily stimulating supply, thus reinforcing rising housing prices ▪ Model has not emerged 'naturally' through market forces anywhere in world ▪ Unclear what government facilitation would be necessary to overcome market barriers ▪ Of limited, if any, relevance to households in bottom three income quintiles ▪ Model driven by realising future capital gains, but institutional investors are yield-driven ▪ No track record, so high risk premium initially demanded by investors ▪ Model may only suit dwellings and areas promising high capital gains ▪ Home-owner may be left with little or no equity ▪ Likelihood of conflicts between home-owner and financier 'partner' – over maintenance, renovation, etc. How are conflicts to be resolved? ▪ Banks unlikely to invest, constrained by capital adequacy requirements |

Lessons for Australia from the UK Experience

The first and most obvious point to make in answer to this question is that the UK Government has, and has had for many decades, a much more substantial housing role and funding commitment to social and affordable housing than the federal, state and territory governments combined. The scope and scale of housing policy is greater in the UK and entails a commitment to relatively generous levels of housing benefit for tenants; a high level of social housing grant (to local authorities and housing associations); a robust regulatory framework and an effective central

government guarantee to private lenders to housing associations; and an aggressively interventionist land use planning system that mandates private developer contributions to affordable housing outcomes. That said, and as argued in this report, the level of the future government funding commitment to housing in the UK is problematic. In both countries the challenge of ensuring sufficient public funding for major policy areas like housing is intensifying.

Hence, the first lesson is that the more a government invests, the greater the social and economic returns – provided that transparency, accountability and adequate risk management arrangements are in place.

If Australia is to follow the UK in leveraging private investment at a reasonable cost then substantial institution (and trust) building will be required. Private investors will need to be confident that the risks are transparent and manageable in order to price their involvement at a level that does not require politically impractical levels of subsidy or guarantees.

What is apparent from the relatively successful British experience is that *both* demand side *and* supply side subsidies are required at substantial and sustained levels to attract large, sustained inflows of private finance to the sector. In Australia's federal system of split responsibilities this places a high premium on close cooperation between the three levels of government. It is unlikely that a successful affordable housing policy can be conceived and implemented at any one level in Australia. As the UK experience amply demonstrates, a major advance on the large scale involvement of private finance will entail clever and committed institutional design. For Australia important questions remain. If a significantly larger role is to be taken by the non-profit community housing sector:

- would the regulatory framework follow the arms length UK model of a statutory regulator, *and*
- if so, would this regulator be located at the federal or state level, *or*
- would the state housing authorities perform the intermediary function, borrowing and on-leasing to the community sector?

The second lesson is a negative one – it is very difficult to establish a private *equity* market for rental housing, especially at the affordable end. Only in the United States has this market developed to any extent and, even there, it is relatively marginal. Suggestions for overcoming the barriers have been made, including the creation of tax exempt residential letting schemes (TERLS), together with the introduction of strong codes of practice setting minimum standards for the management and maintenance of privately rented dwellings and TERLS. Politically, this approach would be very difficult to introduce in Australia, where the trend has been the other way – viz. winding back special taxation arrangements. The other basic problems with attracting private equity investment into this sector are:

- the basic contradiction between affordability and making a profit; equity investors normally bear the residual risk in return for the chance of appropriating unconstrained returns
- it costs too much; the required subsidies from government will be higher than those necessary to attract debt finance

If the full equity approach is too difficult to traverse, then Australia might learn from the British experiments in different types of shared equity arrangements to improve access to owner occupation. The challenge in both countries here is to establish simple and transparent arrangements that will encourage private investors or non-profit housing providers to take up their equity shares and to build longer-term equity arrangements. We have argued (in chapter 5 and at length in the appendix in relation to the Caplin and Joye model) that capital markets left to themselves are unlikely to move in this direction – this is especially the case at the current time given the general nervousness in both countries about the stage of the property cycle. Small scale and piece meal schemes are also unlikely to make a significant impact. To be sustainable and (in particular) to establish a viable secondary market for any private equity component a sufficient volume of transactions is required. In the UK the main shared ownership scheme relies on the housing associations to hold equity, underpinned by that sector’s grant and loan system. Others require up-front government subsidy. To work in Australia shared equity schemes would need to wait until there was a viable community housing sector. Alternatively, each State and Territory could establish a special-purpose vehicle to play the equity partner role. The key question then would be – how are these agencies to be funded and held accountable. If government wished to remain more at arms length and stimulate the growth of a genuine private shared equity market, it would have to deal with the current barriers identified with respect to the Caplin and Joye model and similar approaches. It is also worth repeating that the effective subsidy costs to government in attracting private equity will always be greater than relying on private debt, because of the existing equity premium in capital markets. The final hint, in this instance, from the British experience is that purchasers demand the opportunity to ‘staircase’ – i.e. the option of increasing their ownership share over time to 100%.

A third lesson for Australia might come from considering the debate and tentative developments in the UK around the re-introduction of the role of employers in housing provision. This currently focuses mainly on certain public sector employees in high value regions like London, although the basic approach is nationwide – and depends significantly on ownership of land and on the use of the land use planning to determine the value of that land. Direct intervention in housing provision, by avoiding excessive deadweight costs, may be a more flexible, better targeted and less costly way for governments in both countries to deal with their ‘key worker’ problem in rapidly growing regional economies. Since all three levels of government in Australia are large employers, this again suggests the need to coordinate and share such a role, which would entail an explicit recognition that the housing role of government extends well beyond supporting the private market and supplementing at the edges.

A fourth lesson centres on the highly interventionist nature of the planning system in Britain. Land use planning has a number of not always consistent objectives, of which housing design and location are only two. Given the high environmental, social and economic costs (externalities) associated with unplanned urban development, it is inevitable that planning authorities will sometimes act in ways that constrain the supply of housing in relation to growing demand, with associated higher costs of land. Property markets, like other markets, fail in many situations, on both efficiency and equity grounds. If housing prices are not to be driven beyond affordable levels in situations of constrained supply, the planning system can be used to facilitate (require) affordable outcomes, both in terms of land provision and cross subsidy from market housing. If Australian state governments

move in this direction (as the N.S.W. government has tentatively demonstrated) they will have to find effective ways of amending or replacing existing legislative planning instruments and dealing with political opposition from 'the development lobby'. A single state government moving in isolation to limit new urban development in this way would also have to face the issue of inter-state competition for investment and the potential economic and political costs entailed. One way to limit this 'bidding down' phenomenon familiar to the Australian Federation would be for the Commonwealth to broker a national approach to 'harmonise' the resulting planning changes across the States and Territories, as has occurred in other policy arenas like those addressed by the Coalition of Australian Governments.

A fifth lesson stems from the growing British focus on the *macroeconomic significance* of housing markets and policy – both in terms of the market's effect on interest rates and macro volatility and an increasing concern about competitiveness. Elements of this issue have been brought home to Australian federal policy makers during the recent housing boom. The Reserve Bank of Australia has been carefully tracking the links between interest rate movements, housing investment, consumer debt and aggregate consumption demand in the economy. The current 'debt overhang' places 'speed limits' on the broad economy that may, in turn, feed back into housing investment and construction rates, with further consequences for housing affordability. In the current era of globalisation housing assumes a more central economic role than in the past and renders more complex the RBA's role of simultaneously achieving full employment, low inflation and external balance. Australian housing and economic policy makers can therefore learn from the extensive British research and policy developments in this field.

Finally, perhaps the most important lesson to be gleaned from the British experience is that housing is and will always be a central concern of good government, especially with increasing disparities in incomes and housing costs. As a corollary, it is clear that the development of appropriate institutional forms takes time. The current UK arrangements have emerged over a 30 year period. Long term policy development and implementation requires long term bipartisan political commitment, based on workable alliances between the key government, private sector and professional organizations. In relation to the private financing of affordable housing, potential private investors, especially the key institutions like the banks, need to be consulted and comfortable with the emerging policy regime, especially where changes are being mooted. Political risk must be minimised in order to get private investors of all types – financial institutions, institutional equity and individual equity - to the table and to keep them there at a low cost to government.

1 INTRODUCTION

The issue of ensuring an adequate stock and allocation of affordable housing is becoming a major housing policy concern in Australia. The increasing interest in this area stems from a growing realization that, in an era of limited public expenditure and intensifying housing stress in parts of the Australian housing system, there is a policy imperative to attract more private investment into the affordable end of the market as effectively as possible. Despite a concerted attempt to develop ways in which government funds might be used to leverage institutional funds into investment in affordable housing, recent proposals have concentrated on the means of expanding private finance into owner-occupation rather than into the rented sector. Recent policies have focused on providing deposit assistance for first home buyers and rent policy solutions have looked at generating part equity solutions where risks and financing can be shared by institutions and individuals.

Over the last fifteen years, it is probable that there has been less than \$1 billion of leveraged private investment in Australia producing no more than 1,000 affordable rental housing units, though no firm data exist here. The two main policies – the Social Housing Subsidy Scheme and the Building Better Cities Program, introduced by the Hawke-Keating governments – were relatively short lived experiments and were not evaluated. During the 1990s there has been a real decline in public funding for, and the beginnings of a decline in the stock of, social rental dwellings in Australia.

In the UK the problem starts from a very different position – one in which at its height, the public sector provided and directly financed almost one third of all dwellings and around 50% of all new output. The objective there since the 1970s has been to reduce the extent of public sector commitment, to realise the built up equity in the existing social sector stock, to transfer much of the responsibility for affordable housing provision to the private non profit sector and to introduce both private funding and private incentives and constraints into the operation of the independent non profit social (housing association) sector. It has also been to provide a range of incentives to enable lower income households to access owner-occupation and to free up the private rented sector so that there is some incentive to increase private finance overall.

Over the last fifteen years, some 34 billion pounds of private investment has been leveraged into the social housing sector, around 7 billion pounds over the past two years. This has been used both to expand provision in the housing association (HA) sector and to transfer a growing proportion of the local authority sector stock to associations. As a result, the housing association sector has increased from 2.7% of the stock in 1988 to 6.6% in 2001, while the local authority sector has declined from 24% to 14% over the same period. Overall, however, the numbers of dwellings owned by social landlords has declined by more than 1.3 million since 1988, the date when private financing was introduced.

Affordability has been maintained by the transfer of over 2 million units from the public sector to the owner-occupied sector often with the help of large discounts funded from existing equity. This has involved large scale private finance and the transfer of risk and responsibility to private owners. Problems of affordability are now seen as particularly concentrated among those on lower incomes who are neither able to access social housing nor to obtain owner-occupied housing – in other words, as in Australia, on those dependent on the private rented sector.

Thus, the debates in the two countries, while starting from different institutional frameworks and different political ideologies, are now concentrating on much the same areas of concern – how to ensure adequate housing for all while achieving the most possible from the private sector and reducing public commitments as far as possible; and, how to address the issues of access to that housing for those on low incomes unable in either the short term or at any time in their lives to pay for it for themselves. The mechanisms by which affordability can be achieved differ between the two countries because of their different institutional and ideological positions but in both countries the task of developing more sophisticated approaches to private finance is seen to be an important element in the answer.

The aim of this project, is to summarise and compare the debates, research findings and policy developments directed towards attracting private investment into affordable housing provision in Australia and the United Kingdom; and to present this material in an accessible and policy-useful manner to AHURI stakeholders at this critical time in Australian housing policy. Earlier Australian reviews of British developments are either partial, outdated or both. This study will provide an up-to-date, systematic comparative critical review of trends, developments, options and constraints, with particular emphasis on the implications recent changes in Britain have for future Australian policy directions.

As a systematic approach to the topic, this review will further develop the conceptual frameworks and typologies required to identify the key drivers that affect investment flows into the affordable housing sector, in order to provide Australian housing policy makers with a clear, focused and current picture of the most recent developments and prospects.

The **specific research questions** (RQs) to be addressed are:

1. What is meant by “affordable housing” in Australian and British policy debates and developments? How has this changed in recent times? What impacts on policy are these changes having?
2. What is the scope, volume and impact of private investment in affordable housing in Britain, focused on the past 5 years?
3. What were the barriers to private investment encountered and how were they overcome in the British case?
4. In particular:
 - (a) what institutional reforms and capacity building were required in order to ensure greater private investor involvement? And what barriers/constraints still remain?
 - (b) what public policy levers were necessary/successful in stimulating appropriate investment and supply responses?
5. What are the realistic future options and likely developments in private financing in Britain, in the light of the forecast need?
6. What are the main similarities and differences in the conditions and opportunities for private funding in Australia, compared to Britain? To what extent (in what ways) do British approaches fit the Australian investment and policy climates?

7. What, in particular, determines the successful implementation of stock transfers between the local council and housing association sectors? What factors block or reduce the likelihood of such transfers? What implications for Australia, if any, do the British experiences have?

This review will include all forms of private finance, including both institutional and individual investment and will cover private finance for:

- a) New housing investment
- b) Housing and related urban regeneration – including stock transfers
- c) Low income household home ownership, including shared equity, guarantees/mortgage indemnity and mortgage payment insurance
- d) Private finance and land provision through the planning system

A Note on Method

This project undertakes a selective review of:

- a) relevant existing studies focusing on the role, presence and impacts of private investment in affordable housing provision in the two countries.
- b) relevant policy documents and government statements.

This review attempts to identify, on the basis of the researchers' knowledge and experience in the area, the key information, debates, issues, drivers and likely developments influencing the financing of affordable housing in the United Kingdom and Australia. Each of the four researchers has been centrally engaged in policy-relevant research in this area and draws on this experience in accessing and commenting on the secondary material. The critical focus for the study is the role – current and potential – of private finance in expanding the provision of affordable housing.

The report focuses heavily on developments in the UK, because it is there that:

1. a buoyant and seemingly successful private financing market has emerged
2. significant policy reforms have and are currently underway in that country, particularly as they impinge on the role of private finance.
3. Australian policy makers and researchers are likely to be less familiar with British than domestic developments

Nevertheless, recent Australian studies and material are also presented and assessed, both in the text (mainly in chapter 5) and in an extensive critical appendix.

This is not an exhaustive or systematic review of the field but one which seeks to identify key drivers and barriers to the introduction of private finance into the provision of affordable housing, drawing on the experience to date of the UK and the understandings brought to the task by the researchers. The review is critical in the sense that the researchers attempt to assess the significance and impact of the developments discussed, rather than simply summarise them. Based on this review, the researchers have drawn a number of key conclusions and implications for Australia; these are presented in the final chapter.

The reports, previous research and other material discussed meet the following criteria to:

- clearly relate to or cast light on the factors influencing how affordable housing is financed in either country *or* provide background data on industry, market or policy conditions
- address issues relevant to one or more of the research questions posed by this project
- relate, wherever possible, to current or prospective developments and concerns
- have (in the judgment of the researchers) clear relevance to important questions of policy and challenges to policy makers
- are (again, in the considered view of the researchers) based on sound methodological premises

Initially, it was intended that the researchers would undertake a limited number of formal interviews, particularly in the UK, to supplement the secondary data and the researchers' extensive direct experience. However, it was decided during the conduct of the project that formal interviewing of key actors would add little to the outcomes sought with respect to the research questions posed, since major British government reviews on private finance, home ownership and housing supply were undertaken over the same period. These reviews are commented on extensively in the report. Informal discussions were held with people involved in relevant policy developments in the UK (by Peter Williams) but only in order to clarify the historical context and sequence of the growth of private finance in the UK housing system. The analysis presented in this report, based on the material reviewed, depends on the personal knowledge and engagement of the four researchers in housing policy development in both countries over the past 20 years.

This report has been written through a process of successive iterations. All four researchers have contributed to this process, one that is complex and not always free from problems. However, it has meant that each researcher has been obliged to be very clear about what she or he is arguing and to be prepared to revise or extend – and on occasion, compromise – to produce the final product. It has meant that each member of the research team has been a constructive critic of the others. The end product is very much a collective achievement.

Report Structure

Chapter 2 addresses research question 1 and discusses the ways in which the concept of affordable housing has evolved in both Australia and the United Kingdom. The significance of housing cost, income, household structure, tenure and location are highlighted and the main affordability outcomes sketched in for both countries.

Chapter 3 takes up research questions 2 and 7, dealing with the flows of private investment into British affordable housing and the particular role of stock transfers of public housing from local government to the housing association sector.

Chapter 4 looks at the barriers constraining the flow of private finance into affordable housing in the United Kingdom (research question 3) and the policies and institutional changes that have helped, at least partially, to overcome these constraints (research question 4).

This chapter then looks to the future and discusses what the constraints, options and likely developments are for the continued growth of private investment in affordable housing in the United Kingdom (research question 5).

Chapter 5 outlines the debates over attracting private investment into affordable housing in Australia, summarising the main approaches current in policy debate in this country and draws a number of comparisons and lessons for Australia (research question 6).

Chapter 6 presents the conclusions of the report with respect to the seven research questions posed.

2 WHAT IS AFFORDABLE HOUSING?

This section of the report discusses various approaches to defining and measuring housing affordability outcomes, firstly from the perspective of recent developments in Australia and then from the British viewpoint. As stated in the preceding chapter, in this report 'affordable housing' refers to new and existing dwellings consumed by low-to-moderate income households across all the main housing tenure categories, without suffering housing stress. The definition of and benchmarks relating to housing stress vary across policy environments. Where housing markets operating under current conditions display declining affordability outcomes (i.e. fail to meet some agreed affordability benchmark), some form of government subsidy or other intervention may be warranted.

This chapter provides a comparative overview of affordable housing issues, conditions and outcomes in Australia and the United Kingdom, as a context for the more detailed analysis of the role of private investment in affordable housing provision in both countries that forms the focus for the remainder of this report.

2.1 The Australian Perspective on Affordable Housing

2.1.1. Defining Affordability

The debate in Australia over 'affordable housing' was strongly boosted in the early 1990s by the first publications of the Commonwealth Government's *National Housing Strategy* (NHS).

The term 'affordable' housing conveys the notion of reasonable housing costs in relation to income: that is, housing costs that leave households with sufficient income to meet other basic needs such as food, clothing, transport, medical care and education (NHS, 1991, p. ix).

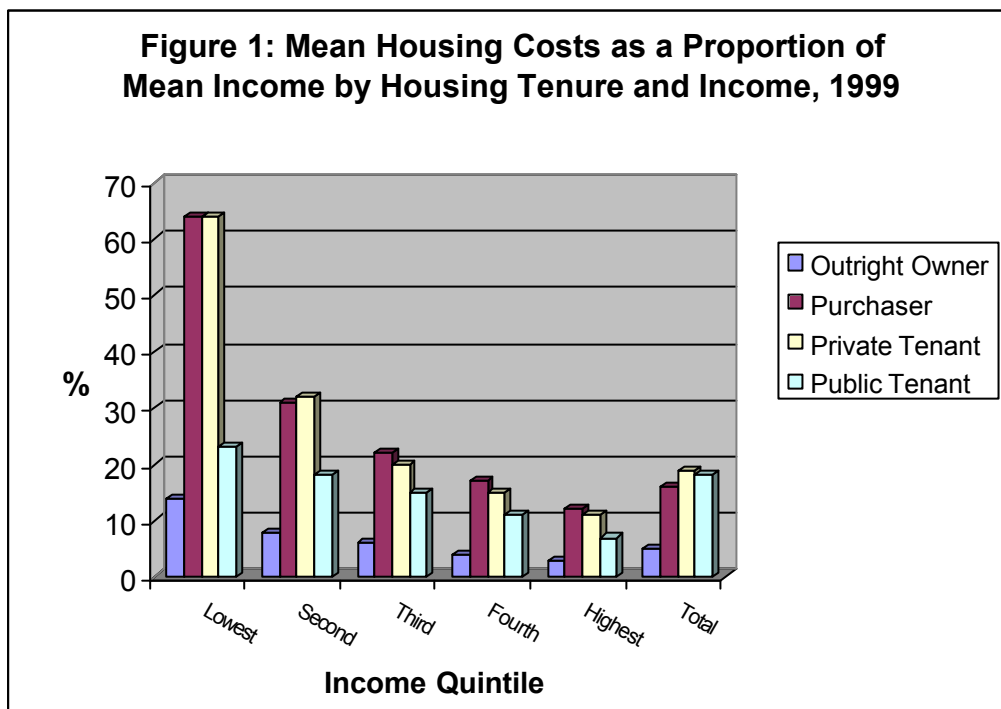
The NHS approach drew for its inspiration on the outcomes of the national poverty inquiry carried out by Ronald Henderson in the mid-1970s (Commission of Inquiry into Poverty, 1975.). The Henderson Inquiry clearly established the link between poverty and housing costs in Australia, concluding that housing tenure, as well as income source and level, educational attainment and employment status, was a critical determinant of the incidence of poverty or extreme financial hardship across the population at large (Berry, 1977). As a high order need, housing exerted a prior call on a household's available income, constraining its capacity to meet other high order needs and lower order wants.

The longest tradition of defining affordable housing in Australia derives from public housing rent setting policies. In much of the post war period, public housing rents have been broadly set at 18 to 25 per cent of gross household income by most State Housing Authorities, with the percentage varying by household type and across states and territories. The original Commonwealth State Housing Agreement (CSHA) in 1945 required state housing authorities to charge economic rents based on full cost. Rental rebates were introduced by the authorities to keep rent levels to a specified proportion of household income – in Victoria's case, for example, this was set at 20 per cent (Eather, 1988, p. 82). Affordability was also supported through Commonwealth low interest, long term loans for public dwelling construction, the major form of capital provision through the CSHA until loans were replaced by Commonwealth grants in the late 1980s.

2.1.2. Measuring Affordability in Australia

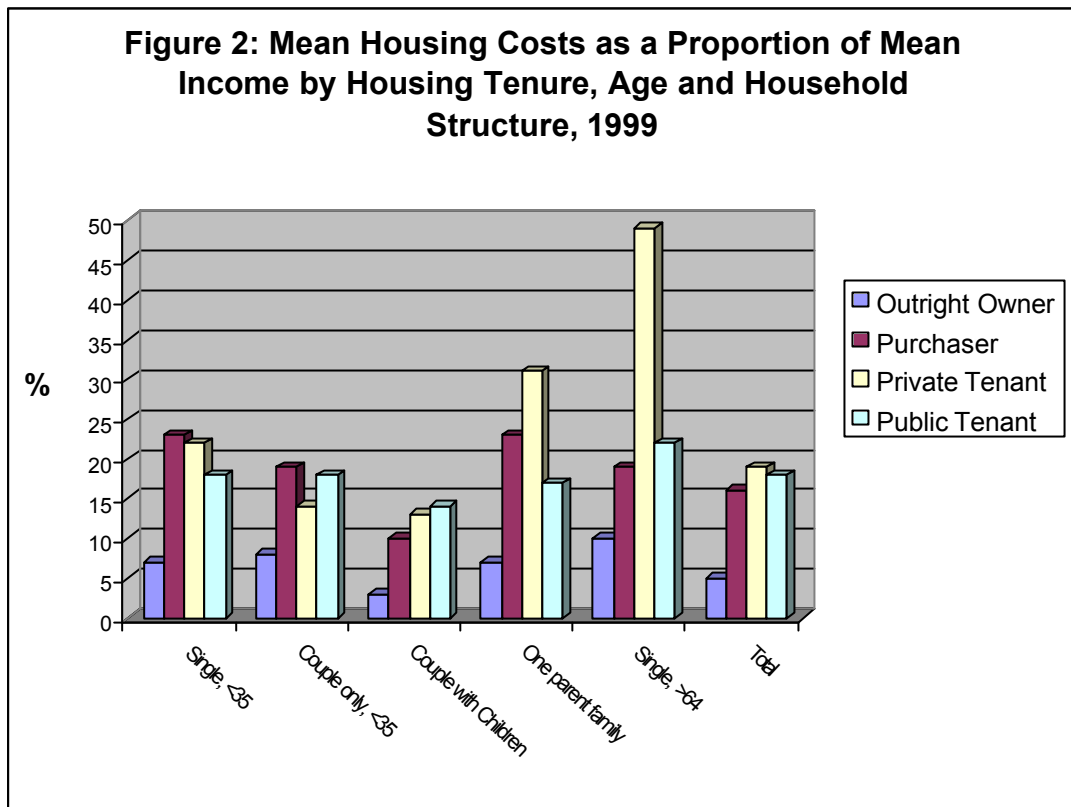
The NHS reviewed a number of income-related approaches to measuring and benchmarking affordability outcomes (see NHS, 1991, appendix A and the discussion in Milligan, 2003). Drawing on unpublished data from the Australian Bureau of Statistics (ABS), this study demonstrated the large variations in the ratio of average housing costs to income across different income groups, household structures, locations, housing tenures and age groups. Figures 1 and 2 update the picture sketched by the NHS at the end of the 1980s, using more recent ABS data.

Figure 1: Mean Housing Costs as a Proportion of Mean Income by Housing Tenure and Income, 1999



Source: Australian Bureau of Statistics, *Australian Housing Survey, 1999*, Table 13 (cat. no. 4182.0).

Figure 2: Mean Housing Costs as a Proportion of Mean Income by Housing Tenure, Age and Household Structure, 1999



Source: Australian Bureau of Statistics, *Australian Housing Survey*, 1999, Table 14 (cat. no. 4182.0).

A number of key points can be drawn from the figures above.

- 1) Outright owners pay, on average, a very small proportion of their incomes in housing costs. Purchasers and tenants, on the other hand, pay, on average, almost a fifth of their incomes on mortgage and rent costs. The relatively low rents paid by public tenants are more or less offset by their very low incomes, by comparison to purchasers and private tenants.
- 2) However, the picture changes when we look across the income range. Both purchasers and private tenants in the bottom income quintile pay, on average, in excess of 60 per cent of income in housing costs, while public tenants pay around a fifth and outright owners about a tenth of their incomes for housing. The differences are also pronounced in the second income quintile, with purchasers and private tenants paying in excess of 30 per cent of their incomes in housing costs.
- 3) With respect to age and household structure, single parent families and single aged people renting in the private market pay relatively high proportions of their incomes in housing costs. Young singles and single parent families purchasing also pay, on average, in excess of a fifth of their incomes on housing.

Berry and Hall (2001) adopted the NHS housing stress approach in a study carried out for the Affordable Housing National Research Consortium. They argued that, using this measure, private tenants in Australia were experiencing the highest level of housing stress among all tenure groups. More specifically:

- By 1996, around a quarter of a million low-income rental households in the capital cities paid more than 30 per cent of their household incomes for housing, a clear sign of intense 'housing stress'
- Between 1986 and 1996, the proportion of low-income private tenants living in housing stress in the capital cities rose from less than two-thirds to almost three-quarters; the figure for Sydney was 80 per cent. Developments since 1996 are certain to have been adverse, given the pronounced housing boom, especially in the largest cities. Indeed, by mid-2000, according to Berry and Hall, low-income households could not afford to rent or buy the standard, average price three-bedroom house in virtually any area of Sydney or Melbourne.
- Many lower income households pay more than 30% of income in meeting their housing costs. Recent work by Yates and Reynolds (2003), for example, show that in Sydney in 2001, 83% of the 20,000 sole parents with incomes less than \$600 per week pay more than 35 per cent of their gross household income in meeting their housing costs in the private rental sector. The equivalent figure for the 34,000 single person households is 72%.

The debate over definitions of housing affordability and the choice of benchmarks has sharpened in recent years, due in part to the slow-down in public housing stock additions, the residualisation or 'welfarisation' of the public housing sector and the decline in the stock of low-rent dwellings in the private sector (on the latter, see Yates and Wulff, 2000; Yates, Wulff and Reynolds, 2004). There appears to be a growing number of households who are ineligible for public housing but unable to access and maintain housing in the private sector at affordable cost. The debate over affordable housing – with respect to both home ownership and renting – has increasingly turned on how to better meet the needs of this disparate group, concentrated in the lowest third to the fifth income deciles (inclusively).

Despite some considerable refinement in the ways in which affordability might be measured, affordability indicators have not been employed as formal performance indicators for housing assistance measures outside of the public sector.

As indicated above, rent setting policies in the public sector have ensured that households pay no more than a fixed percent of gross household income in meeting their housing costs.

Rent assistance for households in private rental, however, operates more as a form of income support. It varies according to household structure. It varies with rent paid only in low rent environments. In high rent locations it alleviates pressures but it does not guarantee affordable outcomes.¹

Direct home ownership assistance, in the form of an up-front grant for first home buyers, currently is targeted neither to income nor to housing costs. It is geared towards increasing access to home-ownership more generally. Indirect housing assistance in the form of tax measures is perversely targeted with greatest assistance going to households least in need of it (Yates, 2003).

¹ The affordability outcomes in Figure 2 reflect housing cost ratios after rent assistance is taken into account. They treat rent assistance as an income supplement.

2.2 The British Perspective on Affordability

2.2.1. Defining Affordability

The rhetoric of UK housing policy was best defined in the government's statement in their white paper, *Fair Deal for Housing* in 1971 (Department of Environment, 1971) that policy should aim to achieve 'a decent home for every family at a price within their means'. This has been modified a number of times, for instance, in the Housing Policy Review (Department of Environment, 1977) and in the latest Green Paper, *Quality and Choice: a Decent Home for All* (DETR 2000). The details of how this policy has developed can be found in Whitehead (1998).

This general approach, together with a system of 'as of right' benefits for all tenants has meant that the government has never seen the need to adopt detailed affordability criteria in relation to housing provision and policy. Rather, mechanisms have been put in place both to provide affordable homes through supply subsidies and through housing benefit to low-income tenants. Affordability is therefore defined indirectly through conditions relating to the different subsidy mechanisms and problems are concentrated among those who are either ineligible for benefits or who do not claim these benefits. The latest version (DETR, 2000, p. 70) stated:

"Policies for affordable housing must cater for a range of needs:

- for people whose incomes are well below the levels required for sustainable homeownership and who are likely to need to rent their homes on a long term basis;
- for people who aspire to home ownership but can only afford properties in lower price ranges; and
- for people with special needs who may require both subsidised accommodation and appropriate support in order to live in it successfully."

The two main identified mechanisms for delivering affordable housing are concentrated on new output:

- the provision of Social Housing Grant to support the development by housing associations/registered social landlords of housing for letting at sub-market rents or for sale on shared or low-cost ownership schemes; and
- the use by planning authorities of powers to require an element of affordable housing to be provided under the section 106 arrangements specified in Planning Policy Guidance (PPG)3 and DETR Circular 6/98.

Thus, even now, when the term affordable housing is central to the debate, the definition is in terms of subsidy and mechanisms rather than anything to do with the relationship between price/rent and income per se. Indeed, the government has consistently refused to provide any formal definition of affordable housing – most notably in the new version of PPG3 which is currently out for consultation. The aversion to a definition flows partly from a recognition that affordability is hard to define and second that any definition becomes a benchmark which governments are

held to and can be criticised for failing to meet (thus why do it).² Instead, in order to require affordable housing through the planning system local planning authorities must identify local housing needs and implement policies which address the needs that have been identified. The local plan is then subject to an Inspector's report and can be challenged in Court.

In the last few years the term affordable housing has taken on a broader definition to include the need for assistance to lower income employed households. This element, called the intermediate market, includes those who have resources just above the incomes necessary for income support/housing benefit and not in enough need to obtain traditional social rented housing. Terms like 'the working poor' and 'key sector workers' are sometimes used in this context in Australia; the terms 'key sector worker' and 'low income employed' are current in British debates.

The Greater London Authority (2000) in their report, *Housing for a World City*, identified the need for intermediate market housing – and estimated that need at around 15% of their overall estimate of affordable housing – the rest to come from traditional social rented housing. This approach is now being carried forward through the 'London Plan' which calls for 50% of all new output to be affordable (GLA, 2003).

Over the last few years, in the context of increasing problems of access to both the social rented sector and the owner-occupied sector in pressured areas in the South, a large number of studies on the need for the full range of affordable housing have been carried out (see e.g. Monk and Whitehead, 2000; GLA, 2001; Llewellyn Davies 2003). Equally, there have been many initiatives to develop shared ownership, shared equity, starter homes and key worker housing, both by government and by regional and local planning authorities (Housing Corporation, 2003; Monk and Whitehead (2000a; Monk et al, 2002; Holmans, Scanlon and Whitehead, 2002).

Thus, the term affordable housing has become the preferred term for the provision of new housing that meets the needs of both traditional social tenants and those who need help to achieve their aspirations of home ownership. The current result is a wide range of rather specific schemes which attract government subsidy as well as site-by-site negotiated provision, usually but by no means always involving housing associations and usually but again by no means always involving Social Housing Grant (Crook et al., 2001; Crook et al, 2002; Crook and Whitehead, 2002). In addition, traditional social housing without direct government subsidy for development as well as a range of low cost home ownership projects and a small amount of cost renting are provided. In some parts of the country this would include housing sold at market prices but aimed at the lower end of the market. In pressured areas, affordability usually requires cross subsidy from the rest of the development and/or from social landlords as well as government grant.

This definition of affordable housing – including all government subsidised housing but also housing obtaining cross subsidy from others at the instigation of government policy – is the one that underpins this report. It implies a broader coverage than would result from a focus on social housing as currently understood in Australia.

² These rationales undoubtedly provide an insight into the similar failure to include affordability explicitly as a policy objective in Australia despite regular calls for this (for example as initiated by the NHS and followed up regularly in annual budget submissions by the Australian Council of Social Service).

2.2.2. Affordability in the UK Rented Sector

Affordable housing in the UK was traditionally provided by local authorities at rents set to cover the historic costs of the stock owned by the relevant local authority with additional subsidy from its own rate fund (a local tax). From the 1970s housing associations became important providers based on a capital subsidy system which ensured that rents could be held at 'fair rent' levels. Thus, affordability was defined in relation to the existence of subsidy, ownership and tenure rather than in terms of outturn rents.

The position changed in 1972 when a national rent rebate and housing allowance system was introduced. This separated the question of the dwelling rent from that for the tenant. There have been many changes in eligibility and in structure – but the principles of what is now called housing benefit have been fairly consistent. Basically, affordability is ensured for those eligible for assistance – in that those whose incomes are exactly equal to the mean tested allowance for their household structure pay no rent. Thereafter every £1 of additional income involves a 65p increase in rent.

In 1974, low income private tenants became eligible for housing allowances based on similar principles. The system was not changed as rent controls on new lettings were relaxed in the 1980s. As a result a complex regulatory framework was built up, first to ensure comparability in rents between housing benefit tenancies and market tenancies and to restrict under-occupancy and then to limit assistance to a maximum of the median rent for the relevant local area. (An analysis of the development from needs to affordability can be found in Whitehead, 1991 and Hancock, 1993).

The rules under which social sector rents are set have changed a number of times over the last thirty years. In particular, local authorities are no longer permitted to make local contributions and since the mid 1970s rent increases have been deemed by central government with subsidy available only to cover any residual deficit between deemed rents and costs. Since 1988 housing associations have been permitted to set their own rents in order to cover costs as long as these rents remain below market levels. The principles under which the Housing Corporation (the government agency and regulator) was required to work defined social housing as the provision of housing below market rents rather than the provision of housing with an element of supply subsidy. On the other hand, Social Housing Grant was to be allocated on the basis of regional needs through a competitive bidding system between associations which takes some account of the rents set. In all rented tenures housing benefit remains available to ensure individual rents are affordable.

In 2002, the government introduced a rent restructuring system which aims, over a ten year period, to bring consistency between rents within the social rented sector by requiring rents to be based 80% on local incomes and 20% on the capital value of the individual property up to market levels (DETR, 2000). Thus the link between rents and costs is broken, although the principles of residual funding will remain in place in the context of local authority housing. In the private rented sector a new approach to housing benefit which provides assistance based on area rents rather than individual property rents is currently being piloted in a number of different types of housing market.

2.2.3. Affordability in the UK Owner-Occupied Sector

Home ownership affordability has traditionally been defined by the rules of access to mortgage finance. Before deregulation of the private finance market that was determined by both a savings record (not least, for a deposit) and repayment/income and value/income ratios. Thereafter it has become easier; a savings track record is no longer required; there are multiple sources of finance (rather than a reliance on building societies) and there is now a full range of mortgage products allowing both borrowers and lenders to select a more tailored product suitable for individual circumstances.

Affordability in the owner-occupied market has been increased mainly as a result of interest rates (albeit there has been significant house price inflation). In part this was what allowed the government incrementally to withdraw mortgage interest tax relief over the 1990s. This cutback was also echoed in the social security system. The state covers mortgage payments for owner-occupier households who become unemployed, sick or have otherwise lost their income (e.g. by marital breakdown) The rules have been tightened over the years, both in terms of eligibility and the amount of repayment covered. In particular, there is no assistance for the first 9 months. This period is meant to be covered by Mortgage Payment Protection Insurance, provided by the private sector. The government has been encouraging this since the early 1990s and about one half of all new mortgages now have income loss related insurance.

In terms of affordability in the owner-occupied sector (as opposed to access) the government has been particularly concerned with the growth in mortgage arrears and possessions associated with economic recession in the early 1990s. Those problems have been alleviated by increased employment levels and particularly by lower interest rates. Even though house prices have been rising rapidly, average affordability has improved over the past decade as a result of lower inflation and interest payments. On the other hand, large numbers of households have large long-term commitments that will reduce only very slowly in the current low-inflation economy.

The government has supported a number of low cost home ownership options, both helping social tenants to transfer into owner-occupation and to assist such tenants and other new entrants to buy new or existing housing on the market. Such schemes are in principle limited to those who are unable to gain access to owner-occupation without additional assistance. Most of these schemes are available only to particular categories of household – e.g. social tenants or specified key workers rather than being directly allocated in relation to affordability criteria. The current areas of concern are in the context of access to home ownership for lower income households in pressure areas, particularly among key workers whose incomes have been rising more slowly than average while house prices have been increasing far more rapidly than incomes overall.

A full list of schemes can be found in the recent Low Cost Home Ownership Task Force report (Housing Corporation, 2003). All these schemes involve 'private finance' in that most purchasers regardless of the route of entry require a mortgage and this is provided by the mortgage market. Lenders have not found this type of lending to be problematic. Indeed, in general, the apparent exposure to risk is rather lower than for first time purchasers. Even so, there is some evidence of higher levels of arrears and possessions – and therefore of affordability problems (Bramley et al, 2002).

2.2.4. Measuring Affordability in the UK

Housing affordability can be measured in a number of ways, utilising a number of benchmarks. In order to give an overall picture of the British situation here, we focus, where possible, on the relationship of housing costs (rents or mortgage repayment) to average incomes (either individual earnings or disposable household incomes).

In many ways the most important question with respect to affordability to bear in mind how tenure structure, and therefore the location of affordability problems, has changed. In 1981 in England and Wales, 42% of households were potentially eligible for housing benefit. By 2001, however, 70% were in the owner-occupied sector (over 9% ex local authority) and therefore ineligible; only 20% were in the social sector receiving rent subsidies and 10% plus in the private rented sector. Those potentially eligible for assistance, other than from social security, had thus fallen by more than 10 percentage points over the twenty year period.

Over the twenty-year period, rents in England as a proportion of average male earnings have risen considerably (Table 1) although they still remain low by international standards. The ratio is highest in the private rental sector.

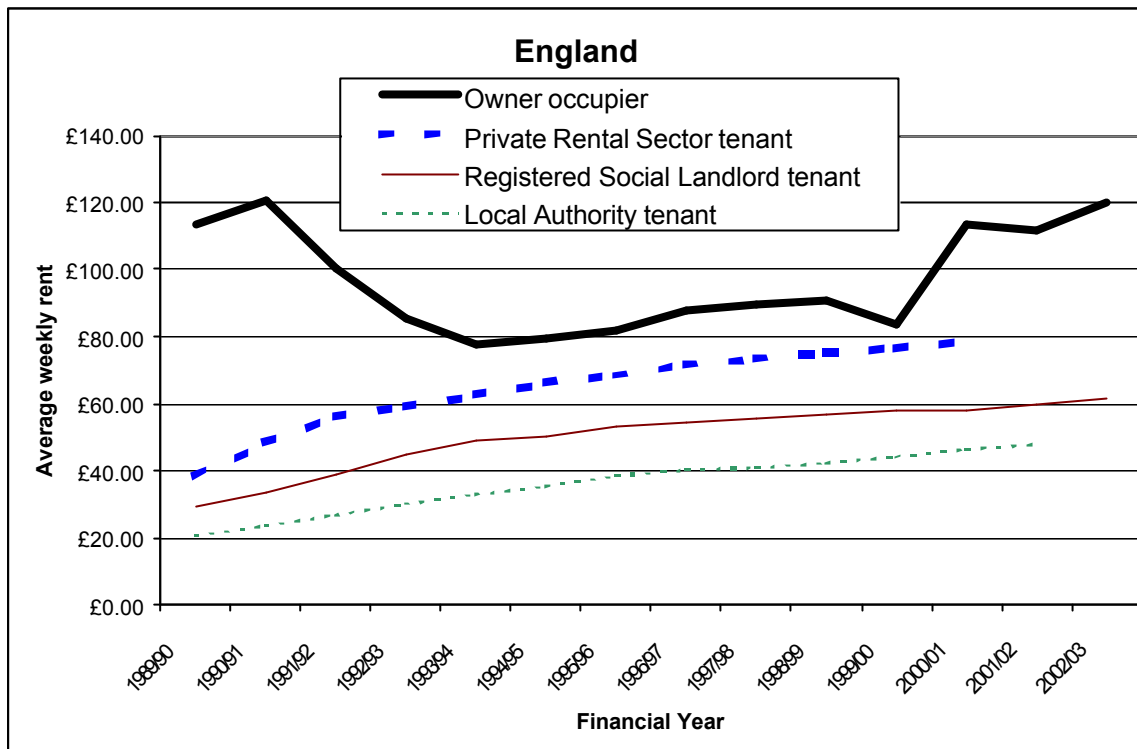
Evidence for England on trends over the 1990s (see Figure 3) suggest that social sector rents have risen less fast than those in the private rented sector and that social sector rents remain well below market levels, even in areas of relatively low demand. This may reflect both the generally higher incomes of households renting privately and possible constraints on market supply. However, this outcome is also likely to be driven by the significant subsidy flows to social housing.

Table 1: Rents as a Proportion of Average Male Earnings in England

| | 1981 | 1991 | 2001 |
|--|------|------|-------------|
| Local Authority Rents | 9.4 | 10.7 | 13.2 |
| HA Assured Rents | 11.5 | 13.3 | 15.3 |
| Private Rental Sector Rents (‘fair rents’ for housing benefit purposes) | 10.2 | 11.1 | 18.0 (1998) |
| Private Market Rents | | 21.3 | 22.0 (2000) |

Source: compilation by Alan Holmans (unpublished)

Figure 3: Average Weekly Outgoings among lower income households (social sector rents, private rented sector gross rents where housing benefit paid and outgoings on lower quartile house prices).



Source: Dataspring

Table 2 shows the ratios of net rent and mortgage payments to household income at the end of the 1990s. Across income groups it is clear that, in the social sector, housing benefit works to maintain low proportions of income spent on housing even among those on the lowest incomes. Where it works much less effectively is in the furnished private rented sector. Equally, those on a mortgage and with very low incomes face significant affordability problems.

Table 2: Ratio of Mean Net Rent or Mortgage Payments to Mean Disposable Income of Household Head and Partner: 1999/00 England (percent)

| Income (£ per week) | Rented from Council | Rented from RSL | Rented Privately | Owner-occupiers with mortgage |
|--------------------------|---------------------|-----------------|------------------|-------------------------------|
| Under £100, Under £5,200 | 10 | 16 | 64 | 36 |
| £100-£199 | 11 | 13 | 31 | 36 |
| £5200-£10,399 | | | | |
| £200-£299 | 12 | 14 | 29 | 21 |
| £10,400-£15,599 | | | | |
| £300-£399 | 12 | 16 | 26 | 18 |
| £15,600-£20,799 | | | | |
| £400 and over | 7 | 13 | 21 | 15 |
| £20,800 and over | | | | |
| All Incomes (%) | 11 | 14 | 26 | 15 |

Source: *Housing Statistics 2001*, Tables 7.13 and 7.14. Original source is the Family Resources Survey

One indirect indicator of housing affordability trends is the changing extent to which households in the different tenures are dependent on housing subsidies.

The number of housing benefit claimants has varied with the size and structure of the rented sector, the economic cycle and eligibility criteria. Payments were at their height in the early 1990s but remain high into the twenty first century – with nearly 4 million households in receipt of assistance (Table 3).

Table 3: Housing Benefit Claimants, England, 1980/1 – 2000/1

| Numbers of Claimants(000s) | | | |
|-----------------------------------|--------|--------|--------|
| | 1980/1 | 1990/1 | 2000/1 |
| Rent Rebates (council housing) | 1330 | 2944 | 2230 |
| Rent Allowances (private housing) | 240 | 1044 | 1718 |

Source: Housing and Construction Statistics

The majority of households receiving assistance will also be in receipt of income support.

Around 750,000 private tenants were in receipt of housing benefit in 2001 as compared to 1995 when numbers reached their maximum at 1.16million. The proportion of social tenants in receipt of housing benefit continues to be over 66%, while in the private rented sector the proportion has declined from nearly 50% to around 30% of all private tenants.

In the owner-occupied sector, although house prices have risen rapidly over the last decade, user costs of owner-occupation have fallen for much of the decade as a result of declining interest rates. The major indications of lack of affordability relate to mortgage arrears and possessions. They show the numbers of both arrears and possessions rising from very low levels (e.g. around one quarter of one percent in arrears) in 1980 to a maximum in terms of possessions in 1991 of 0.77% in 1991 and 2% in 6-12 months and 1.5% in over-12 months arrears in 1992. These figures were associated with high unemployment, a sluggish housing market and the emergence of negative equity. In 2003 those figures were down to 0.02% possessions and 0.25% for 6-12 months and 0.11% for over-12 months arrears (Council of Mortgage Lenders, 2004, Table 27).

The numbers of mortgage claimants for income support has been heavily affected by changes in eligibility. These numbers similarly reflect the economic cycle, rising from just over 300,000 in 1990 to 555,000 in 1993 and falling again to 233,000 in 2003 (Wilcox, 2003).

In terms of access, mortgage costs to income ratios for first time buyers were around 17% in the early 1980s, rising to over 25% in 1990 and falling back to 12% in 2003. These variations reflect, on the one hand, the fall in interest rates and, on the other, the impact of rising house prices. Price to income ratios for first time buyers were running at around 2.25 in 1980; 2.86 in 1990; 2.49 in 1995 and 2.92 in 2003. These figures obviously do not take account of those people excluded from entering owner-occupation by problems of affordability. Average house prices to earnings ratios give some better indication. These were less than 3.5 times in 1996 and have now risen to 5.64 times in 2003 (Wilcox, 2003).

Obviously these figures hide variations around the average – and in particular reflect only those actually able to obtain access to owner-occupation. More detailed evidence on affordability relating local earnings and sometimes the incomes of those

in low wage public sector employment to lower quartile house prices shows ratios up to 8 times income in parts of London and that in some 40 authorities even two earner households in the public sector would not be able to buy (Wilcox, 2003).

Summary

In the UK, affordability is not formally defined in either the rented or the owner-occupied sectors. Evidence of problems suggest that many are cyclical – relating particularly to unemployment and to difficulties in selling housing in a declining market rather than to underlying affordability in terms of rents/user costs to income. Other problems relate to access, notably to owner-occupation among lower paid households. Average rental affordability has declined over the last decade but housing continues to take relatively low proportions of income in the vast majority of the sector. Data relating to the private rented sector are not adequate to pick up the variation around averages and therefore to identify pockets of problems – notably in high rent areas. In the owner-occupied sector measures suggest that user costs are only now reaching levels reached in the late 1980s in money terms but that there are problems of affordability among low income mortgagors and for those trying to access owner-occupation in housing pressure areas.

2.3 How Affordability Can Be Achieved

In both Australia and the UK, the fundamentals that determine affordability are incomes, the cost of the housing resource being acquired, and who pays these costs. Because housing is an asset, the assessment is complicated by the need to fund the asset, and the capacity this gives to modify the timing of payments and to increase the range of those who potentially can be required to pay. Further, particularly because housing often takes a large proportion of household income, variations in incomes and costs can generate risks for households and funders alike. These affect both cost and choices made. Finally, affordability is determined by the quantity of housing that people choose and what society regards as acceptable housing conditions. Policy instruments can modify affordability by addressing each of the relevant elements – (i) the resource costs themselves, (ii) households' capacity to pay, (iii) who pays the costs, (iv) who funds the housing, (v) how risks can be managed, and (vi) what are acceptable housing standards:

(i) Reducing resource costs:

Resource costs associated with housing include the costs of production, management and maintenance of housing and the supply of land. The most important concern here is the extent of constraint on land supply, but this also includes infrastructure – which often means that increases in demand lead to rising house prices rather than increases in the output required. Equally, it means that there are rarely benefits to consumers from improving efficiency of production. Finally, because adjustment is often so slow, while housing markets may be in short term equilibrium, these costs are far above the longer term costs of provision. These problems are common across the two countries, at least in pressure areas. In the UK the current emphasis is on (a) developing off-site construction, (b) improving regulatory frameworks, and (c) addressing issues of land supply (see, for example, the interim and final reports of the Barker Review (Barker, 2003, 2004).

(ii) Improving capacity to pay

Capacity to pay for housing is strongly related to income distribution – especially given difficulties in adjusting supply and the extent to which standards are set above those that households on lower incomes can afford to purchase or rent. The general

tax system is the most obvious means of improving distribution – but in both countries, post-tax income distribution is worsening as a result both of the nature of economic development and government policy. Housing specific subsidies can be cost-effective in overall terms but generate tensions in terms of departmental government budgets. The UK's experience also suggests that demand subsidies work best on the government's terms when they are supplemented by rent regulation and administrative allocation – as this increases effective targeting. Overall, Australia clearly has the better baseline position – in terms of a more even income distribution – at least by income group if not by locality. The UK, on the other hand, has a sophisticated rental housing based demand subsidy framework which is broadly consistent with affordability objectives as set out above in section 2.2.

(iii) Subsidise those most in need

Traditionally, in the UK, housing costs have been made more affordable by government supply side subsidies which reduce rents for those in receipt of social housing. Current subsidies have been supplemented by cross subsidy between the existing stock and new building. This has proved possible in part because of general unexpected inflation which has increased the value of the existing stock and meant that current rents, even when held below market levels have more than covered the historic costs of provision and maintenance. A rather different reason is that the value of the stock has increased more rapidly than general inflation – in part because of supply constraints. Rent pooling has been one approach to enabling current housing investment to be funded by other tenants. Refinancing housing – e.g. by introducing private finance – has been an effective mechanism for realizing past increases in value and allowing costs to be borne by current and future tenants. Equally, refinancing has allowed government to recoup past expenditure – implicitly turning a past subsidy into a loan. Apart from improvement subsidies, assistance to homeownership has tended to come through tax benefits rather than direct subsidy – again involving government in paying some of the costs of provision and maintenance. Currently there is a growing emphasis on subsidies to low cost home ownership. More generally, owner-occupiers can vary payments over time and between generations by using debt financing and refinancing mechanisms.

A rather different source of funding is that arising from the economic rent generated by house building in a constrained environment where increases in demand increase housing and land values. This provides a further source of potential funding – from landowners rather than tenants/occupiers or government itself.

(iv) Ensure appropriate financing choice

An individual household can fund housing through:

- their own equity;
- others' equity (traditionally in the context of private renting, although it can also form an element in a shared equity form of home ownership);
- private debt finance (which enables payments to be restructured over time);
or
- government funding.

In the past, the UK government has tended to provide the funding for social housing, while private finance, sometimes with the help of government subsidy, has funded both owner-occupation and private renting. While governments can clearly

fund more cheaply than the private sector, their spending priorities together with macro-economic objectives and constraints have placed a premium on transferring funding to the private sector. Using private funding can, in principle, allow all investment with positive value at market interest rates to be undertaken – although of course what will be positively valued will depend on the factors listed above, especially the level and certainty of relevant government subsidies. The case for private finance is also based on the introduction of market pressures towards increased efficiency in allocating funds and producing adequate housing; i.e. private investors will tend to minimise operating costs in order to maximise the net present value of their investments. There is thus a potential trade-off between the cost of finance and the cost of production, management and maintenance.

(v) Reduce costs associated with risk of default or arrears

Insurance can be self-provided (especially by those on high incomes and owning a range of assets); market provided; or through a government safety net. Markets have tended to be poorly developed, in part because government has addressed the problems directly; in part because the risks are political and in part because of more general market failures. Restructuring payments and financing also inherently modifies who takes risks and generates the need to develop new insurance markets or alternative safety nets.

(vi) Regulate to ensure housing quality and reduce profiteering.

Standards set by government can be close to that which would anyway be achieved by the market, can reflect standards achieved by higher income households, or can include elements – e.g. environmental requirements – which individuals are generally not prepared to choose for themselves. The greater the difference between accepted standards and individual preparedness to pay, the greater the problems of achieving both the standards and affordability. Of particular importance in this context is the extent to which acceptable standards rise with average incomes and housing consumption – ensuring continuing problems of affordability at the lower end of the housing system. At the present time owner-occupation appears to be becoming an accepted standard for all those in work – raising important issues of affordability at the point of access.

2.3.1. Potential for Private Finance to improve affordability

In the UK, resource costs have been rising fairly continually over the decades – and the construction industry suffers from low productivity, an inability to adjust supply in relation to variations in demand and structural incapacities to innovate (Barker, 2003, 2004). However, land costs and availability remain the most important factors associated with higher house prices and declining capacity to adjust to demand.

In terms of capacity to pay, growth in employment is relatively concentrated in service industries, the public sector and part-time employment. At the same time higher incomes are only serving to inflate house prices. Further, two or more income households have relative bargaining power in the housing market making the problems of the single lower income household particularly difficult. The housing benefit system in the UK in part substitutes for a more generous social security system – particularly because of the very large regional and local differences in house prices and rents.

In both countries, government subsidies for social housing have been declining in financial terms and are becoming more concentrated on providing additional social housing in regeneration areas, new housing in growth areas and intermediate market

housing across areas of housing pressure. The introduction of private finance and changing property rights – e.g. in the context of the Right to Buy - has enabled considerable restructuring with respect to who pays and when – as well as in terms of the extent of investment undertaken. In addition, the introduction of affordable housing requirements when land is supplied through the planning system has enabled transfers from land-owners to tenants and first time buyers.

The area where the greatest innovations have taken place in the UK is in the context of the introduction of private finance into social housing as well as in enabling the 'Right to Buy' – i.e. by facilitating the subsidised purchase of local authority housing by sitting tenants (see chapter 3). The capacity to introduce such finance has been enhanced by the scale of the unencumbered stock of assets; this has supported payment restructuring, especially over time, as well as increased investment in both the new and existing stock.

Insurance markets have been developed and improved with respect to both mortgagees and mortgagors. However, coverage is by no means complete – raising issues about the sustainability of the growth in owner-occupation given the volatility of housing prices (and incomes).

Finally, agreed housing standards – in terms both of who must be housed and in what conditions – have been significantly modified over the years. Some aspects – e.g. density standards for new dwellings – have clearly declined. Other standards, notably basic facilities and, less obviously, crowding have, equally, clearly increased – impacting negatively on housing affordability.

This report focuses on private finance to facilitate affordable housing outcomes – i.e. by concentrating on policy approaches (ii) to (v), above. Chapter 3 and 4 consider, in more detail, the role of private finance in the provision of affordable housing in the UK and the current and likely future barriers to its growth. Chapter 5 discusses the role of private finance in Australia and contrasts this with developments described in the UK.

3 PRIVATE INVESTMENT IN AFFORDABLE HOUSING IN THE UNITED KINGDOM

3.1 Introduction – the UK approach

The three fundamental opportunities for government, investors and housing providers that have helped to frame policy towards affordable housing in the UK are:

- (i) the existence of a very large local authority housing sector (at its maximum, in the late 1970s, accounting for almost one third of the total stock) the value of which had been consistently increased by general inflation and relative house price rises – enabling the separation of financial subsidy from economic subsidy (in other words economic subsidies could in many cases be funded from existing assets rather than from public expenditure);
- (ii) the liberalization of the housing finance market and indeed the more general global finance market from the 1970s onwards. This enabled both the restructuring of social housing assets and the reduction in new supply subsidies without very large scale increases in direct costs and assisted the growth of home ownership. In the social sector this occurred first in relation to new affordable housing provision and then through the transfer of ownership of the existing stock to housing associations. In the owner-occupied sector this enabled the funding of the Right to Buy, the development of a range of low cost home-ownership initiatives, and the introduction, in some contexts, of private insurance rather than public subsidy;
- (iii) the rapid growth in land prices arising in part from the effects of land use planning constraints, and the land use planning system itself, which have the potential to provide both land and subsidy to assist the provision of affordable housing.

All of these opportunities were underpinned by the generous demand side subsidies that continue to be available to all low income tenants - reducing the risks to landlords and finance institutions alike.

In this context, the most important changes over the last decade have been concentrated on reducing public sector involvement, introducing private finance and cross subsidy and thus restructuring payments between groups and over time while maintaining affordability. It is on these issues that we concentrate. First, the development of a private finance market for social housing is described in section 3.2. Second, section 3.3 examines how private finance has facilitated the growth in social rented housing through the housing association sector, including via the mechanism of large scale stock transfers from the local authority sector to the associations. Third, section 3.4 provides an overview of attempts to boost low income home ownership. Fourth, section 3.5 briefly outlines other approaches to encouraging the provision of affordable housing.

3.2 The Institutional Context of Private Sector Involvement

The big changes that have taken place in terms of tenure and ownership over the last three decades have been:

- (i) greater targeting in the social housing sector together with the restructuring of that sector to introduce independent social landlords and private finance

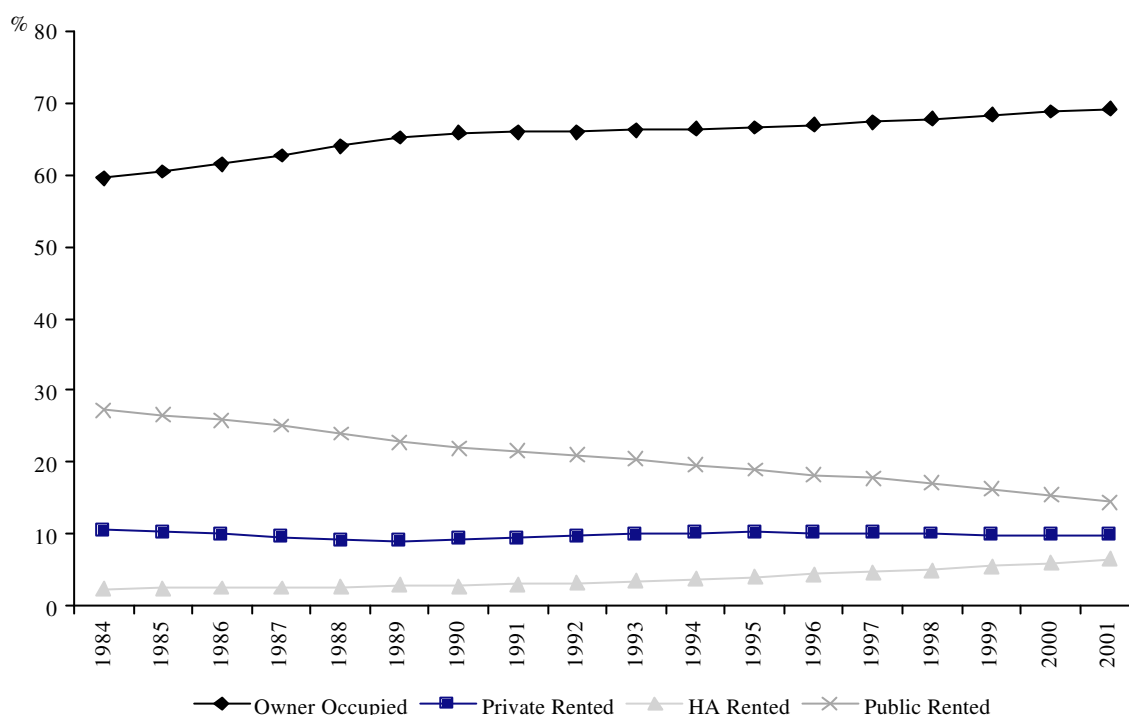
- (ii) the growth in owner-occupation from around 57% in the late 1970s to nearly 70% at the turn of the century. This process has brought many households who require affordable housing into that sector
- (iii) the restructuring of the private rented sector to make a far higher proportion of that stock accessible on the market – and to increase the total size of the private rental sector by about one third from 1988 to 2001. Again, this sector includes significant proportions of households in need of affordable housing

The pattern of change is shown in Figure 4.

In the UK, social housing (that is low income non profit housing subsidised by government) is provided by both local authorities (municipalities) and housing associations (HAs, also referred to as registered social landlords - RSLs). At its peak in the late 1970s, around 33% of all homes were provided by local authorities and housing associations. At present, the proportion is around 20%, with housing associations expanding while local authority ('council') provision has declined (see Figure 4). There were approximately 5.3 million units of social housing in the UK in 2001 (21% of the total stock and falling). Almost a third of that stock was located in the housing association sector (see Table 4, below).

This reshaping of the social housing sector in the UK is a product of a number of policies. In 1980 the then Conservative Government introduced the Right to Buy policy which allowed existing local authority or 'council' tenants to buy their homes. Nearly 2 million homes have been bought under the Right to Buy. The same government also resolved to stop local authorities building homes and shifted resources to housing associations. In the mid 1990s some local authorities moved to shift their housing stock from direct ownership to locally controlled housing associations as a way of reducing the impact of the Right to Buy. This had the potential benefits of enabling existing asset values to pay for future investment and reduced the power of local authorities. The government thus embraced such transfers and made them part of a formalised government programme titled *large scale voluntary stock transfer* (LSVT), where the whole or part of an authority's stock was sold either to an existing housing association or to a newly created one (see Cowan and Marsh, 2001 for a useful discussions of the origins of stock transfer).

Figure 4: Stock of dwellings by tenure, Great Britain



Source: Office of the Deputy Prime Minister, Housing and Construction Statistics

Table 4: Social Housing Stock, by Country, 2001

| | England | | Northern Ireland | | Scotland | | Wales | | UK | |
|-----------------------------|---------|-----|------------------|-----|----------|-----|-------|-----|-------|-----|
| | 000s | % | 000s | % | 000s | % | 000s | % | 000s | % |
| Local authorities | 2,812 | 66 | 126 | 87 | 558 | 79 | 188 | 77 | 3,684 | 69 |
| Housing associations | 1,424 | 34 | 19 | 13 | 145 | 21 | 55 | 23 | 1,643 | 31 |
| Total | 4,236 | 100 | 145 | 100 | 703 | 100 | 243 | 100 | 5,327 | 100 |

Source: as for Table 3.

Although some housing associations have been in existence for many years, the development of new housing stock only became 100% government grant fundable in the 1970s. This led to a rapid expansion of this sector under the supervision of a government quango, the Housing Corporation (HC). The HC oversaw an annual approved development programme (ADP) through which individual associations were allocated grant (and public sector loans) to develop new homes and acquire and refurbish existing stock. In the late 1980s, and reflecting the continuing desire to see housing associations take over from local authorities as the main providers of new social housing while at the same time recognising the pressures this put upon the budget, the government introduced a mixed funding regime. Under this regime, public loan finance was replaced by private finance and the housing association grant was to be progressively reduced and replaced by additional borrowing directly from the finance market to fund the development programme. Although it was recognised that rents would have to rise to reflect these increased costs and to build the reserves

necessary for supporting private finance, the government agreed that housing benefit, the means tested rental assistance payment made to all eligible social housing tenants, would be increased to 'take the strain'. Around 70% of social housing tenants received housing benefit in full or part. Thus government moved from a regime dominated by capital grants to one increasingly dependent upon revenue contributions by housing benefit (see Whitehead, 1999 for a useful summary).

Housing associations are non profit making bodies controlled by boards (typically unpaid) and operated by paid staff. There are around 3,000 housing associations in the UK but only around 250 actively develop housing. With the growth and expansion of the sector via funded development and stock transfer from local authorities it was probably inevitable that the sector would become less homogenous. Associations now vary in size from national organisations with forty thousand plus homes to small very local associations with less than 100 homes and there has been significant active merger activity as well as the creation of group structures where several associations combine to secure economies of scale in terms of funding and other costs.

3.3 Private Financing for Social Rented Housing

3.3.1. The development of the private finance market for social housing

Origins of private financing in social housing

Since 1987/88, there has been an active and growing private finance market for housing associations in the UK. The market came into being as a consequence of the private initiative of the National Housing Federation (NHF), a small number of Housing Associations (HAs) and some financial experts. Some larger housing associations were frustrated by the shortage of government development grants and recognised that with the assets they had built up they could raise finance from the debt and bond markets. This they set about doing.

The UK government recognised the potential merits of the approach and provided capital funding in the mid-1980s, even though the initiatives went against the general principles of public expenditure which counted all funding, whether private or public, against that expenditure. The housing sector was successful in obtaining agreement that the private element of mixed funding would not be counted as public expenditure, as long as associated risks were transferred to the private sector. This provided the potential for stretching public finances and bringing in stronger private sector market discipline

Government Support for private finance market

Apart from providing challenge funding, the UK Government assisted in the introduction of private finance into social housing by providing implicit 'guarantees' and comfort to lenders. This includes:

- *providing security of revenue streams* through the availability of housing benefit for all low-income tenants in the rented sector
- *giving housing associations the right to raise rents* up to a maximum of the market rent in order to cover costs
- *giving private financiers first call on the assets* in the event of bankruptcy by treating the Social Housing Grant (SHG) for mixed funded associations as a subordinated loan

- *ensuring oversight of housing associations through a regulatory body, the Housing Corporation, to address emerging issues of governance and finance (Pryke and Whitehead, 1993; Whitehead, 1999)*

The position is rather different for Large Scale Voluntary Transfers (LSVTs) in that the comfort of SHG is not available for existing property. However, the transfer price includes the costs of bringing the dwellings up to Decent Homes Standards. Even so, LSVTs are more open to location and dwelling type specific risks and to potential lack of demand, particularly because of the concentrated *and* homogeneous nature of their housing stock.

It was believed that private lenders would fund stock transfers because:

- private finance was secured against a first charge on the property (and often with a 'back up' all monies charge) and the public funds second charge. In other words, if the HA defaults, then the lender receives the proceeds of the dwelling sale before any of the grant is recouped by the government.
- the housing association sector was government regulated
- debt was repaid from rents which were effectively guaranteed by a government assistance payment, housing benefit.

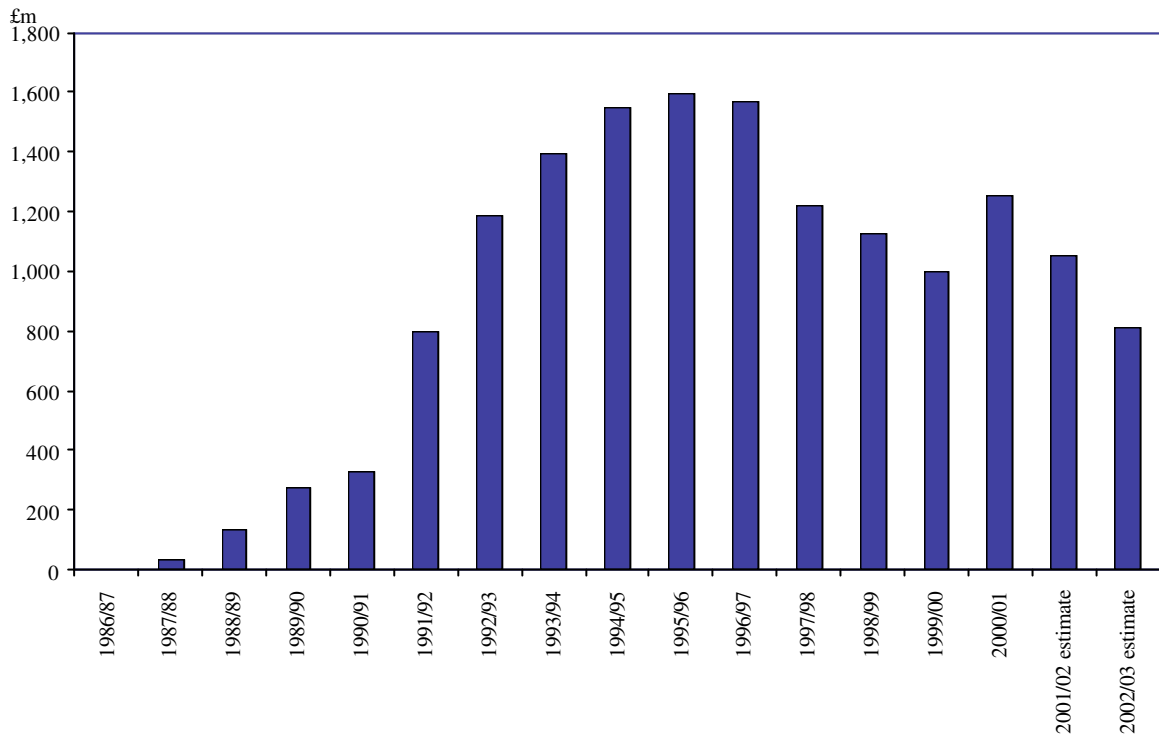
Market depth

Agreement among key players to the principle of private finance and building the practice were two different things. There was inevitably uncertainty and resistance, not least because obtaining private finance would entail significant reductions in capital subsidy from Government. HAs recognised that this could become the mechanism through which governments could erode their support of social housing.

There were a limited number of players and the Housing Corporation had to take on a promotional role to get more lenders into the market. The HC first appointed a private finance adviser in 1987. Along with the central government, the HC set up the Housing Finance Corporation, which accessed the wholesale finance market mainly for smaller associations.

The market began slowly but has now built up to over £34 billion of lending with no losses to date (see Figure 5; note this is for Great Britain rather than the UK). It surpasses to date the total of private finance raised for all other private finance initiatives in the UK.

Figure 5: Housing associations' annual private finance raised, Great Britain



Source: UK Housing Review 2002/2003, table 57

Lending in the early years was understandably cautious, reflecting a new market and limited competition (Pryke and Whitehead, 1993 and 1995; Saw and Whitehead, 1996). Margins were therefore higher and loan terms more demanding (e.g. asset cover and income cover ratios were close to 150% but both have fallen to around 100% to 120%). Some early loans were structured rather like residential mortgages and it took some time for the market to evolve the loan documentation now common. Unfamiliarity and uncertainty meant that not only were rates of interest high initially but loan terms were conservative (as noted above) even though they were dealing with stock otherwise unencumbered by debt. Over time there has been a move towards fixed rate borrowing and more recently some modest use of derivatives though (as noted above) this is controlled. As associations have become more experienced they have often re-financed loans and sought to achieve a balanced borrowing portfolio mixing fixed and variable rate loans and short and long term debt. The housing associations have a primary task which is providing good quality homes and the management of finance tends to be a secondary issue. The lenders recognise that they must build close relationships with associations who in many cases are seeking simplicity and certainty.

Thus, a system of relatively careful lenders and conservative borrowers is in place. Debt and bond finance is now widely available.

The market sources funds from financial organisations including UK and foreign banks, building societies and some specialist loan vehicles, while the borrowers include most registered housing associations in the UK (some are too small and/or too inactive to borrow). There are well over 150 lenders in the market across the UK although it is dominated by a small number of very large lenders. The majority of lenders are UK based. The number of foreign banks participating in the market has

fluctuated over time and has been in decline in recent years. In the 1990s the HC had a specific remit to widen the market and encouraged a number of such banks to enter what in reality is a specialist market. However, over time many have departed reflecting the continuing need for specialist knowledge and the intensity of competition from other lenders.

Because some of the bigger lenders operate with a minimum loan size this has left space in the market for smaller lenders. Some borrowers form 'clubs' to allow aggregated lending for which there is more competition and lower margins. Potential borrowers may make direct approaches to lenders (who may or may not run the association's banking facilities) or go via financial advisers. The lending decision is based upon an assessment of the specific borrowing proposition and the overall strength of the association and particularly its management and its financial position - balance sheet, reserves etc. Over time lending deals have become reasonably standardised, albeit there are always differences to be accounted for and of course there is continuing innovation in terms of the structuring of loans.

3.3.2. Market information and signals

Since the 1990s it has become an increasingly developed market, with a well-understood and documented process (the National Housing Federation for instance produce a regularly updated Private Finance Manual). A specialist journal, *Social Housing; the journal of new initiatives in housing finance*, has emerged; annual surveys of private finance (in England by the HC and NHF), Wales (Welsh Federation of Housing Associations, WFHA) and Scotland (Communities Scotland), rating agency activity (notably Standard and Poors) and conferences serve to disseminate information. The sector has slowly built up its private finance skills although the majority of finance directors see private finance as a means to an end and tend to operate quite conservatively. They are encouraged in that conservatism both by their boards and the HC. The HC for example does not allow HAs to enter into swaps and hedging arrangements without its prior permission.

Government has to be careful in this new environment about the signals it sends to the market. There have been a number of government interventions which have threatened to deter private investment in the market and the political risk of this continues. For example:

- The Housing Act 1996 had insolvency provisions in a draft, which would have prevented lenders accessing their security. Once this was understood, the bond market value of HA deals re-priced to reflect this. The Government backed down after strenuous lobbying.
- More recently and again around insolvency (the Enterprise Act) lenders have had to remind government of their position. As detailed below, the Government has also completely changed the rent regime in England through which debt is repaid. Government now 'sets' the rents and this has caused considerable concern to lenders. The upshot is the government recognises that in exceptional circumstances associations must be able to operate out of the agreed rental envelope.
- Currently there is an active debate on the reform of housing benefit (HB), the state welfare assistance to those who cannot afford to pay their rent. To date the presence of private finance has constrained government in what it can do to HB. Lenders are understandably following the reform proposals closely.

3.3.3. Variations across countries in the UK

Although there is a UK lending market, in reality there are variations across the four countries, reflecting national housing structures, different regulatory and policy regimes and the headquartering of financial institutions. Such variations might also arise in Australia if such a market emerged. Lenders have been able to cope with the generally modest variations in policy and law that exist without this being reflected in willingness to lend or price.

England

England dominates the UK private finance market. The joint HC and National Housing Federation (NHF; the trade body for housing associations) Private Finance Survey (HC/NHF, 2004) showed that as at 31 March 2003 total finance raised was £30.6 billion of which £22.2 billion had been drawn. 44% of the total funding raised was for stock transfer associations although this market declined in the year reflecting a change of government policy. In the year 2002/03 around £6 billion was advanced, with £2.4 billion for stock transfer and the rest for new development and re-financing of existing housing association debt. Banks had around 60% of the total market with building societies 24% and institutional finance through the Stock Market 13%. However, building societies were more strongly represented at both ends of the spectrum of lending, to stock transfer associations and associations under 1,000 units. As of 31 March 2003 16 lenders provided 81% of funding and 4 just over 50% (7 lenders have committed over £1 billion). The lending league was headed by the Nationwide Building Society with over £5 billion of funds committed. Royal Bank of Canada Capital Markets has been the lead arranger for £1.5 billion of bond issues, about 38% of the issue value to date.

Unhedged variable rate lending continues to dominate the market (47% of funds) and as a generality the terms under which funding was raised hardened in the year. New variable rate borrowing had an average margin over LIBOR (the interbank rate) of 39 basis points (i.e. 0.39%), down from 50 basis points the previous year. HA debt funding benefits from a 50% capital weighting under the Basel Accord and this gives lenders capital relief on what are relatively large loans.

Scotland, Northern Ireland and Wales

The housing association sector in Scotland is small relative to England (80 associations compared to 2,300) and many are tenant based and very localised. As in England HAs are funded and regulated by a specialist body, Communities Scotland (CS) though this is now a government agency rather than a quango. The CS Loan Portfolio Bulletin (Communities Scotland, 2003) indicates that as of 30 September 2002 total loan approvals stood at £2.22 billion up from £1.22 billion a year earlier. Most loans are for new schemes and debt re-financing was a small part of the market. The Royal Bank of Scotland, with over £557 million of loans, dominates lending in Scotland. There are eight lenders with total loans in excess of £100 million and who have over 75% of the market. Fixed rate lending has been declining and variable rate loans dominate as in England. Interest rates and fees remain low and the Bulletin comments on the 'very competitive nature of the market'.

The Northern Ireland market has been slow to develop, not least because of the much higher grant rate in the province and the surpluses generated by housing associations. In 2002/03 a further £30 million of private finance was put in place with Northern Ireland banks and notably First Trust Bank dominating the market. The total market in the province now exceeds £230 million. In Wales, private finance facilities totalled £836 million as at end of March 2003, up from £751 million the year before.

Banks hold 54% of this funding albeit that Nationwide Building Society remains the market leader.

3.3.4. Stock Transfer: from Local Government to the Housing Associations

Origins of Transfer

As already noted, in addition to social housing development funded by a mixture of grant and private sector borrowing (now roughly 50/50), there has been a substantial programme of stock transfer with well over 150 local authorities switching all or part of their housing stock from direct council ownership to housing associations. Since 1988 nearly one million homes have been transferred. By contrast, some two million homes have been sold under the Right to Buy.

For the most part, transfers result in local authorities getting a capital receipt from the sale of their homes. Normally, the receiving housing association has to raise the funds from the finance market to purchase the homes (at the net present value of the 30 year rental income stream minus the cost of repairs) and typically this is 100% debt funded. However, in a minority of cases, the value of the housing stock to be transferred is so low (because of disrepair and local market conditions) and the requirement to upgrade to a decent standard so costly that a government subsidy has been needed. In essence, there are now two private funding markets: the mixed funded market for mainstream housing associations and the stock transfer market, with the latter dominated by a small number of large lenders (reflecting in part the scale of the transactions which are typically over £50 million). Hence, the growth of private investment in social housing in the UK was driven by housing associations seeking to finance expansion of their stock through *both* development of new housing *and* the acquisition of existing local authority dwellings.

Under the Conservatives, stock transfer was seen as a useful way of realising existing assets and limiting local authority involvement. It was also seen by some councils as a way of securing a continued social housing stock. However, many Labour controlled local authorities continued to resist pressure to transfer. With the arrival of the Labour government in 1997, they began to lobby for clear alternatives to stock transfer and 'slow death' under the Right to Buy. On the other hand the Labour government reiterated the benefits of separating strategic and management roles as well as the potential for funding investment in the existing stock from increased asset values.

Initially there was considerable resistance to any new models (indeed in the devolved governments of Wales and Scotland it became and still is the primary approach). However over time there has been a gradual weakening, partly because once in power the government realised how substantial the backlog of poor housing in the local authority sector was.

3.3.5. Government process for transfer

Today in England there are three options³ available to local authorities:

- retaining their stock; or
- selling their stock through large scale voluntary stock transfer (LSVT); or
- managing their stock through arms length management only organisations (ALMOs);

³ There is continuing pressure for a fourth option.

The government amended the local authority finance regime to include more substantial management and maintenance allowances under a new resource accounting regime. This meant some authorities could both retain their stock and upgrade it.

Second, after much pressure the government announced a new regime of arms length management only organisations (ALMOs) in England. These ALMOs were a half way house between stock retention and disposal via stock transfer. The local authority retained ownership of its stock but passed the management of it to a new arms length body with its own board/staff (in practice staff moved across from the LA). Although ALMOs cannot raise funds privately the government created an ALMO programme so that those LAs given permission to set up ALMOs (they had to meet housing service performance standards) were then given an increased capital allocation to undertake all the upgrading work.

The government has found a considerable demand for ALMOs and although there is a quality threshold there are many authorities seeking to set them up. This has had the effect of diminishing the demand for LSVT and thus for private finance. Moreover, there is now more emphasis on partial stock transfer, i.e. single/multiple estates rather than whole stocks. This has had the effect of diminishing the size of the loans required.

Recently the National Audit Office conducted a review of LSVT, looking at value for money questions (National Audit Office, 2003). This report concluded that although stock transfer was notionally more expensive than retention it did produce a worthwhile outcome (one of its more contentious conclusions was that transfer and renovation costs were £1,300 a home higher than the equivalent renovation under local authority ownership though this calculation was hugely dependent upon the discount calculation used). However, it gives some underpinning to the decline in the government's enthusiasm for LSVT and provided further support for the shift in policy towards a more varied agenda.

Concerns

The government's management of stock transfer can certainly be questioned and there are issues about the way such transfers are evaluated and set up and about the roles played by both the Office of the Deputy Prime Minister (ODPM) and the HC. The recent consultation paper on improving the stock transfer process makes it clear that both the ODPM and the HC need to be much clearer in what they do and to be more fully engaged. One big unanswered question is whether there should be any attempt to claw back surpluses generated by a stock transfer HA once it has delivered its initial plan. This would be contentious for lenders because these HAs are 100% debt financed at the outset and it is the surplus at the end that repays the outstanding debt. However, we know from the longer established stock transfer HAs that they have typically outperformed their business plans and have begun to generate considerable cash surpluses. This can encourage a range of responses and the question for government is how instrumental does it wish to be in this process. Having funded the original assets on which these surpluses are arising, it is understandable why there is this interest.

Outcomes

Notwithstanding these unresolved issues, stock transfer is generally considered to have been a success. Tenants and staff have achieved better conditions and although there are continuing questions about the accountability of such HAs, the overall verdict is positive. It is important to stress this is not a universal view.

Transfer remains a hotly contested issue. 'Defend Council Housing', an anti transfer pressure group with links to fringe socialist parties, has been actively opposing stock transfer and ALMO proposals across the UK. Recently it was involved with the defeat of a proposed ALMO in the London Borough of Camden and a stock transfer in Wrexham, Wales. To date, where such defeats have taken place the government has not backed down and provided the equivalent funding for the local authority. This was certainly the case in Birmingham where splits in the council led to a negative vote. Subsequently, as elsewhere, the local authority has therefore had to bring new proposals to the table to secure funding but this is obviously difficult given inflamed local politics. The received wisdom now is that a single transfer of a very large housing stock is difficult to achieve; it worked in Glasgow, not least because of the huge additional subsidies put in by the Scottish government. This opens up complex issues about consultation and balloting (and in the case of Glasgow how any subsequent ballots take place around the planned break up of the initial single landlord into a series of more localised landlords).

3.3.6. Key Problems in Introducing Private Finance into Social Housing

So to summarise, the key problems encountered in introducing private finance to date have been -

- Unfamiliarity and conservatism; this was a new market and both lenders and HAs approached it cautiously
- Regulation; HAs were (and are) regulated under statute. Thus they did not have complete freedom of action. This has been a factor for lenders even though they benefit from the protection this offers and stress the value of these benefits
- Government policy; social housing is a sensitive issue and one where there are party political views. Policy is thus subject to regular change and there is significant political risk for lenders
- Competition and price /margin squeeze; as more lenders entered the market and as existing players increased their appetite for funding HAs there was a downward pressure on margins. This made HA lending more difficult to sell to internal lender credit committees and some lenders withdrew from the market. Continuing mergers and acquisitions have also reduced the numbers of lenders in the field. On the other hand, there is no evidence of problems in finding appropriate lenders
- Limited stock of financial advisers; given the specialist nature of the market there have been a limited number of advisers. The significance of this has been compounded by the price sensitivity of their HA customers. There has been a reluctance to fund the advice needed. The products used have tended to become standardised – this has provided cost reductions but limited potential for innovations.

Notwithstanding these difficulties, the development has clearly been successful, albeit that it remains based on the availability of explicit and implicit subsidy on both the demand and the supply side. Margins have been eroded but this has tended to result in a shift to fees. That in turn has given a mild incentive to re-financing; borrowers with existing debt can re-finance at a lower rate and lenders have extracted their fees and are more relaxed about a shorter-term outcome.

3.3.7. Making New Social Rented Housing Affordable

Traditionally, additional social housing has been funded by site specific government subsidy (currently SHG) set at a level which relates to costs and ensures affordable rents. Over the last few years there has also been a growing element of self-funding by housing associations, using existing surpluses on the assumption that rents will rise over time to offset the need for cross-subsidy. Thus, rent pooling as a means of supporting new permission has started to re-emerge.

A second important policy aimed at land allocation and to a lesser extent, funding, has been the use of planning agreements. Securing affordable housing through the planning system has been included in all Planning Policy Guidance on housing (PPG3) issued since 1981. Provided local planning authorities have policies in their statutory development plans that assess the need for affordable housing in their districts they may require private developers to contribute to meeting this need. When developers agree to make contributions, they are made legally binding contracts under Section 106 of the 1990 Town & Country Planning Act as part of the process of gaining planning permission. Over 90% of all districts now have such arrangements in place. These allow them to negotiate a proportion of units on larger sites as long as the viability of the development is not undermined. The policy of achieving mixed communities means that the vast majority of what is negotiated is built on-site, either with the involvement of housing associations who will then own and manage the housing provided or, more rarely, by providing low cost home-ownership directly to the market. On occasion commuted payments are allowed which can be used to support new affordable housing elsewhere.

At the present time perhaps 12,000 units per annum are being provided under 106 agreements, mainly in London and the other Southern English regions. This represents about 8% of total current output. The vast majority of these units are traditional social rented housing although the emphasis is now moving towards achieving at least some shared ownership and other low cost home-ownership units. In the Midlands and the North the majority of what is provided is low-cost home-ownership, sometimes without either formal 106 agreements or cross-subsidy from the rest of the site (Crook et al, 2001, 2002).

The policy has been generally successful in providing land for affordable housing. It is also seen as effectively addressing the mixed communities' agenda. It has been less successful in increasing overall provision of affordable housing in that the majority of units provided also involve SHG and the cross subsidy from land values has been necessary to bring costs within accepted limits for grant provision.

The policy is quite well embedded into the general planning and development process, even though negotiations are time consuming and adversarial. London has developed the policy most effectively and has included an overall 50% affordable housing requirement within the London Plan (GLA, 2003). Some of these units will continue to be provided in 100% affordable housing sites but the majority will be mixed developments under section 106 of the *Housing Act 1996*.

The government has now put out to consultation a suggestion for a 'voluntary' payment at a rate set by the local authority which the developer might choose instead of paying planning gain (across all types of gain i.e. including infrastructure, education etc). This is in response to concerns about the transaction costs of negotiation and the problems associated with the outcome of these negotiations. This is seen by many as undermining the potential for ensuring affordable housing as

compared to other priorities for planning gain, particularly if land does not have to be made directly available (ODPM. forthcoming, a).

The fundamental principle involved in this policy is that planning permission provides large scale increases in land values, especially in areas of housing pressure. Negotiating planning gain for affordable housing is a partial substitute for a development land tax with the added benefit of hypothecation and land provision (Barker, 2004).

3.4 Financing Affordable Home-ownership

There has been a growing emphasis on providing low cost home-ownership in order both to reduce the amount of public subsidy required to create affordable housing and to meet the increasing aspirations of more stable family households (see Bramley et al., 2002 for a useful review).

The government has supported low cost home-ownership in four main ways:

- large scale capital subsidies with respect to the Right to Buy
- SHG for shared ownership which has the attribute that the total stock of housing is increased
- the use of s106 to provide land and subsidy to new provision; and
- loans to support the purchase of lower cost homes particularly in pressured areas.

The use of SHG and s106 is no different in principle from its use to provide social rented housing. All of the UK's low cost home-ownership programmes lever in private finance in one way or another. There are two aspects to this: first where a new home is developed by a housing association it is part funded by grant and part (or sometimes 100%) by private finance in the normal way (i.e. as per social rented housing). Second, the purchaser of the new or existing home then raises a mortgage to fund their share of any purchase. Some lenders refuse to have the double exposure this might imply, i.e. funding the development and then the mortgage but this is by no means universal.

Provision of affordable low cost home-ownership through the planning system also presents no particular problems for private finance. Purchasers obtain mortgages on the usual criteria. Purchasers of all types of low cost home-ownership tend to be slightly older than the average borrower and will borrow rather less than average in proportion to income.

Purchasers with a discount, a cash grant, part purchase or an equity loan are viewed with favour by lenders because of the additional security this implies. Typically borrowers have access to most if not all of the products offered by a lender. Lenders have experienced some difficulty with the traditional shared ownership model because of the complex three way partnership between themselves, the consumer who is both tenant and owner and the housing association who is landlord in receipt of that rent.

The friction is most obvious when the consumer gets into difficulties with either rent or mortgage payments or both. The complex administration this implies has meant some lenders have refused to operate in this market and have focussed their attention on Homebuy or other more simple schemes (described below).

As this suggests, simplicity and clarity is a key to successful private finance. The more elaborate the structure the narrower the market in terms of both providers and borrowers. Moreover lenders like subsidy up front rather than a drip feed through the life of a scheme – such arrangements are too vulnerable to change.

3.4.1. Buying the home you rent

Established in 1980, the Right to Buy (RTB) through which existing local authority housing tenants can buy their homes at a discount has been a huge 'success'. Over 2 million tenants (1.6 million in England) have bought their homes and it has made a significant contribution to the growth of home-ownership in the UK. An equivalent Right to Acquire (RTA) and Voluntary Purchase grant (VPG) (established 1996) operates in the housing association sector – the former for housing associations selling the home if it was built with public subsidy after 1997 and the latter being for a voluntary scheme for homes built before 1997. So far RTA has generated some 171 sales and VPG 872 sales in England. There was also a Rent to Mortgage scheme (it converted the rent into a mortgage) established in 1993 but it has so far produced only 373 sales in England.

3.4.2. Buying a new or existing home in the market

There are a number of schemes designed to help tenants and others buy homes in the market place. Some simply assist purchase of existing homes, others provide new homes to buy.

Cash incentive schemes are designed to get tenants to buy in the open market with a cash subsidy (typically around 10,000 pounds). Since being established in 1989 it has helped some 30,000 tenants.

There are then three 'shared ownership' schemes. Traditional shared ownership is delivered through a 'building homes for sale programme' operated by housing associations. The homes are built with a mixture of grant and private finance. The homes are then sold to applicants who may be existing tenants or simply first-time buyers priced out of the mainstream market. The purchaser buys between 25% and 75% of the equity with a mortgage and pays rent on the rest. They can then 'staircase' up to 100% ownership. Established in the 1980s some 45,000 homes have been provided.

A variant on this is Do It Yourself Shared Ownership (DIYSO) where the approved applicant buys an existing home (with strict value limits and other conditions). Established in 1991 some 25,000 homes have been bought this way.

The third scheme, HomeBuy, is rather different. This is an equity based mortgage scheme – by which repayments relate to the increased value of the property over the period that the owner-occupier remains in the property. It has limited parallels with the Caplin/Joye model discussed in the Australian Prime Minister's Taskforce on First Homeownership (see chapter 5). Introduced in 1999 in England, the approved applicant buys a home in the market with a private mortgage (75%) and an interest free equity loan from the housing association (25%). Again they can staircase to 100%. Some 5,000 sales have been funded.

The latest policy is the Starter Home Initiative which began in 2001. This is directed specifically at certain categories of key workers and at particular pressure areas in the South of England. Initially, the scheme provided a lump sum payment to assist in the down payment on a dwelling found in the market. The government provided £250 million and around 9,000 key workers were helped to buy their homes. The most recent version, 'the Key Workers Living programme', offers four products

including an equity loan similar to that involved in the Home-buy scheme. Some £690 million of funding has been provided.

Much of the funding is now being concentrated into challenge funding in regeneration areas and into intermediate market initiatives concentrated on public sector key workers. As such the funding is aiming to achieve objectives in addition to affordability, particularly related to effective redevelopment of difficult areas and to broader employment policies. In the first context, there are considerable benefits associated with risk sharing in low demand areas. In the second, providing housing assistance can be a low cost way of ensuring adequate labour supply (paralleling the use of housing benefit to reduce the costs of social security).

As can be seen from this short description, the schemes vary widely in their content and impact. RTB sales are in excess of 2 million, all other schemes have produced around 106,000 sales. Some of the latest schemes have been so hedged around by conditions that allocations have not been taken up even though there are enormous affordability problems in the relevant areas. Not surprisingly, the recent Low Cost Home-ownership Task Force has argued for simplification and rationalisation (LCHOTF, 2003).

Of all the schemes other than the RTB perhaps the most popular with purchasers and lenders has been Homebuy. However, this has been seen as expensive in public expenditure terms, albeit that the public sector equity share is returned with house price inflation, in part because of administrative failures in recycling the returned funds.

To the extent that a major problem is the lack of overall provision of housing, shared ownership and s106 based schemes which add to the total stock have the most obvious long term benefits. The recognition of the need to achieve such increases is currently leading to a number of initiatives to generate shared equity arrangements, - where institutions hold a share of equity rather than a mortgage – perhaps in perpetuity. So far these schemes are mainly small demonstration projects.

3.5 Other Approaches to Increasing Affordability

3.5.1. Fiscal Measures

The UK government undertook a comparative review of the use of fiscal instruments that might be used to assist in both the provision of affordable housing and in making existing housing more affordable (Holmans, Scanlon and Whitehead, 2002).

Six possible approaches were identified and assessed as follows:

(i) Tax relief for construction

The majority of experience on tax relief for construction of affordable housing relates to tax credits in the United States. These provide a stream of tax relief to developers and other actors to build affordable housing (defined by income group) for a set period of time. This relief can then be sold to institutional investors on capitalising the benefits.

The evidence suggested that they have been effective in providing housing but inefficient in terms of transactions and other costs. It was argued that the introduction of the subsidy in England could be equity based, covering rental property or cover the equity proportion of shared equity. It could also be redesigned to cover loans. Taken together with measures to expand land supply (policy 5, below) and probably including employers as relevant partners, this could generate significant additional

affordable housing – though at a cost in terms of crowding out and the transaction costs involved. The UK's Business Expansion Scheme (BES) and assured tenancy accelerated depreciation schemes introduced for short periods in the 1980s provide some evidence on how they might work (Crook et al, 1991; Holmans et al, 2002).

(ii) Government assistance to purchase in high cost areas

This is a significant aspect of current government policy (ODPM, 2003) but is basically an extension of existing policies including the current Homebuy and the Starter Home Initiative. It directly addresses the problems which arise because house prices vary more than incomes across the country and is a cheaper way of addressing this than varying public sector salaries.

The case for providing a more coherent set of policies is strong (as set out in the Low Cost Home-ownership Task Force report – Housing Corporation, 2003). However, targeting is important – the less well it is targeted the greater the deadweight loss. Moreover, any such scheme is likely to remain cash limited. It has the benefit of being able to be concentrated on particular groups and areas and to be varied in relation to economic conditions. But the more effective the programme is the greater the inflationary impact on prices, unless supply side questions can also be adequately addressed.

(iii) Savings schemes for first time buyers

This type of scheme has been reintroduced in a number of countries in response to access problems. They have become tax inefficient in the UK because the 'subsidy' is regarded as taxable income. There is some evidence that a range of employers would wish to reintroduce these schemes were they to be made more tax efficient, especially if it were agreed that pension style relief would be available or the early years of a pension could be used for house purchase. In 2004 and in the very special circumstances of a self invested pension fund the UK government agreed that the owner of the pension could borrow up to 50% of the value of the fund to buy a property which in turn would be placed in the fund. It will be interesting to see if this principle is taken further.

(iv) Employers' involvement in supply

On the supply side employers would normally be expected to work in partnership with housing associations and developers and to purchase nomination rights either for rented property or shared equity and other means of maintaining the property as affordable into the longer term. Many, particularly public sector, employers may have the capacity to offer land rather than direct payments and could be important players in implementing policy 1, above. In the private sector, however, the evidence is that employers have little interest in directly assisting supply – they would rather help a small number of employees – or simply pay higher wages (Monk and Whitehead, 2000; Monk et al, 2002).

Important practical issues identified in the UK context relate to ensuring transparency with respect to the principles of best consideration (which must be achieved by public agencies) and helping to develop workable larger scale shared equity instruments.

(v) Providing affordable housing on non-residential land

This is fundamentally a legal planning issue. The most obvious way forward would be through an extension of the rural exceptions policy to urban areas and of s106 for affordable housing to non residential land. This would be highly unpopular unless there were additional fiscal incentives in the form (for instance) of tax credits.

There would be potential benefits to large scale urban redevelopment schemes, in achieving mixed development objectives and perhaps making it easier to raise institutional funding.

(vi) VAT relief

At the present time new building is zero-rated as is social sector improvement that increases the number of units. All other renovation and repair costs are normally subject to VAT. VAT relief on major renovations perhaps restricted to RSLs would make social housing grant go further. Extending it to the private sector to cover properties that are leased by the social sector on longer leases (e.g. five years) would help to bring property back into use.

The government's actual approaches since this 2002 report was published have been very different. First, the government is now consulting on the creation of Property Investment Funds (PIFs) , a UK equivalent of the US Real Estate Investment Trust (REITS) and the Australian listed property trusts (LPTs). This tax transparent PIF is intended to attract long term private and corporate investment into real estate including both commercial and residential real estate and could be used to assist urban redevelopment and to help institutional landlords enter the private sector. It is not clear at this stage whether it will result in a major expansion of long term private rented housing – or even whether it would add to total stock. Unlike the earlier BES schemes where there were generous tax reliefs the PIFS are designed simply to remove double taxation, i.e. of the company itself and the investor with only the latter being taxed on the income from the PIF.

Any government subsidy approach linked to providing incentives for private funding to support regeneration is likely to build on the Community Investment Tax Credit which has been introduced in a very limited fashion using special vehicles in certain redevelopment areas.

Second, the Housing Bill now in Parliament provides for making SHG available directly to private developers and landlords, without requiring social landlord involvement. This would mirror the Gro-grant approach used in Scotland where subsidies were made available to developers to build affordable homes in high cost areas. Third, the new consultation on s106 does not include contributions from non residential land for the provision of affordable housing – although the proposal is still under discussion. Equally, the idea of an optional charge may reduce the capacity to obtain the land necessary to provide mixed communities and affordable housing in pressure areas. If the Barker Review's ideas are taken forward, s106 would be used only for affordable housing but there would be national and regional development gains levies in part to cover infrastructure development. Fourth, there is a possibility of making VAT more tenure neutral – but by introducing VAT on new building rather than by reducing taxation on investment in existing units.

Overall, these initiatives respond to particular pressures rather than develop a coherent response/stance to affordable housing. In particular, they appear inadequate as a means of providing the incentives identified as necessary to ensure the development of large scale projects which can make it worthwhile for institutional

investors (Crook and Kemp, 1999). However, they do reflect the importance that government currently places on addressing the need for greater flexibility both in the finance market and the subsidy system to get more affordable housing.

3.5.2. Insurance/risk sharing

An alternative approach to improve affordability would be to use guarantees or insurance to reduce costs by sharing risks. As a general rule the UK government is opposed to providing any form of guarantee because of the liabilities taken on. By removing/reducing risk the cost of funds can fall and affordability can be increased. Such guarantees can be structured in a variety of ways. However, it is unlikely that the UK government would proceed down this path. Having removed one interest rate 'guarantee' in the shape of mortgage interest tax relief there is little appetite to introduce another.

Private insurance guarantees can be used to increase access and affordability as has been evident in Australia with all loans above 80% LTV requiring insurance. In the UK such guarantees were required to cover large loans but this was very much to protect the lender rather than to extend affordability. In recent years they have become less common reflecting both competition and media/consumer pressure.

Local authorities are also able to offer loan guarantees but these are uncommon. There has been some pressure to make them more widespread but the procedures are cumbersome and lenders view them as unreliable. Shared equity with a public sector stake up front would be deemed much preferable. Lenders are always concerned about making loans backed by promises of action if problems arise. If this then proves difficult to enforce the lender's exposure is already in place via the loan.

A more radical departure involving insurance is the Dutch Guarantee Fund through which private sector lending to housing associations is underwritten by a central guarantee fund behind which stands the government.

3.6 Concluding Remarks

Improving affordability involves a number of different approaches towards reducing the costs of housing relative to household incomes - by demand side subsidies; subsidies to suppliers to reduce rents and prices; increasing the supply of market housing to the point where rents and prices are reduced; increasing the supply of housing available at sub-market rents and prices - so increasing the numbers of households assisted; or increasing the efficiency of production so that costs themselves are reduced. ***In the UK the introduction of private finance - directly through funding Housing Association provision and indirectly through contributions from developers and land owners to new affordable housing provision - has been concentrated specifically on the last two mechanisms.***

The objectives of introducing private finance into social housing in the United Kingdom were threefold: (i) to stretch the public subsidy over a larger number of units so that more people could obtain housing within their means. It was accepted that private finance would be more expensive than public, implying higher rents. However housing benefit provided a safety net for those with the lowest incomes who could not afford these rents. Thus rents increased (especially because RSLs had to build reserves to meet funding ratio requirements) but more people were helped into affordable housing; (ii) through LSVTs to realise asset values built over the years either to reduce public spending elsewhere or to increase the capacity to expand the output of affordable housing; (iii) to introduce private pressures towards efficiency and so reduce the costs of management and maintenance and increase utilisation of

assets; in some contexts this increase in productive efficiency - i.e. lower costs per unit - can more than offset the increased costs of finance arising from the use of private finance. At a more macro and political level private funding is a way of moving assets off budget and so helps to manage macro economic and European Union monetary requirements.

There have been a number of evaluations relating to the introduction of private loan finance into the provision of social housing and of the contributions to provision from landowners and developers through s. 106 agreements. These evaluations are reviewed in the forthcoming report – *Evaluation of English Housing Policy Since 1975* – to be published by the Office of the Deputy Prime Minister in late 2004. Other evaluations include assessments of:

- the impact on rents and the operation of registered social landlords (Chaplin, et. al , 1995)
- the restructuring and efficiency of housing associations (Pryke and Whitehead, 1993)
- the development of the market in private finance (Saw and Whitehead, 1997; Whitehead, 1999)
- the financial viability of different types of housing associations (Saw, Royce, Pryke and Whitehead, 1996)
- the relationship between housing associations and the finance institutions (Pryke and Whitehead, 1994)

Similarly, there have been evaluations of the large scale voluntary transfer program (Gibb and MacLennan, 2002; National Audit Office, 2002). Finally, the use of section 106 agreements has also been closely examined, both as to process and outcomes (Crook et. al, 2002; Crook et. al, forthcoming; Monk et. al, forthcoming 1 and 2).

In total, these evaluations suggest that, although overall costs to government have been higher than for conventional public funding, outputs have increased – i.e. the number of households assisted is greater than would have been the case under a fully public funded regime – and the markets for private finance have become more efficient over time, reducing the extent of the cost differential.

The UK has, as demonstrated in this chapter, successfully built up both programmes and substantial expertise around private finance for extending the scope and scale of affordable housing. However, such has been the overall shortfall in supply, house prices have continued to rise sharply and affordability to worsen in many areas (Barker, 2003, 2004). What is also clear is that new supply of affordable social housing depends on the continued availability of government subsidy and cannot simply be achieved through cross subsidy from landowners (Monk et al, forthcoming). In that respect the failure to balance one with the other has negated some of the overall benefits to be derived from the programmes. For Australia there are certainly some lessons to be learned from the UK's private finance related initiatives. In Chapter 4 we develop this analysis further and consider some of the tensions as this market has developed over the past decade and in the light of the current and future policy agenda.

4 PRIVATE INVESTMENT IN AFFORDABLE HOUSING IN THE UNITED KINGDOM: CHALLENGES AND OPPORTUNITIES

4.1 Introduction

It is clear from chapter 3 that the UK has used a wide range of policies to restructure social housing and to limit the government's financial involvement while aiming to maintain affordability and to increase choice. Much of its success has depended on the introduction of private finance into social housing provision and on the development of partnership and risk sharing approaches between government and other actors in the field. Where there has been less development is in changing the range of ownership in affordable housing – almost all initiatives have been in the context of debt rather than equity finance.

British experience over the past two decades in this policy field suggests that for a regime of private investment in affordable housing to be sustainable, investors must be confident that funding levels, incentives and monitoring procedures are adequate to the task of ensuring efficient operation of affordable housing providers. This is critical in the case of the housing association sector where poorly performing HAs at risk of financial failure must be identified, tracked and, where necessary, restructured.

The chapter begins by considering how the policy environment has changed over the past few years and then moves on to examining the current and emerging threats to the regime which has seen private finance levered into assisting the provision of affordable rental and owned housing. It finally examines how the market might be developed in the future.

Like the previous chapter, most of this chapter is devoted to private finance for social housing but it also considers the ways in which private finance can contribute to lowering the cost of home-ownership and particularly access to that sector.

Section 4.2 raises a number of important *challenges* to British housing policy as it has developed over the previous 20 years. The future environment may not be as benign with respect to attracting private investment into affordable housing provision, as was the past. This section looks at the situation with respect to social renting. Section 4.3 addresses the renewed interest in facilitating low income home ownership and stresses the somewhat ambiguous stance of government in this context. Section 4.4 points to a series of possible changes in British housing policy in the emerging environment, both with respect to social housing and low income home ownership. The question of the move beyond private debt to equity finance is raised, along with the possibility of the growth of the secondary mortgage market.

4.2 Social Housing: From a Favourable to a Less Favourable Public Policy Environment

4.2.1. Pressures on Housing Association financial viability

The private finance regime for social housing in the UK developed in what can be seen to be, in hindsight, a fairly favourable environment. During much of the 1990s land, construction and labour costs were falling and rents rising making associations financially sound and well able to service debt payments. It is only in the following decade that costs have begun to rise sharply while rents have been put under government control. These factors along with very evidently increased competition

from other providers, notably the private rented sector, increased customer expectations and the emergence of areas of over-supply of social housing means that a squeeze has begun which may well intensify. Not all associations have recognised the changed environment and even where they have, not all have been able to fully adjust to it.

Of fundamental importance in determining future viability of the private financing model is the nature of the revenue stream available to housing associations. Government policies already introduced both limit their capacity to adjust rents and increase potential uncertainties with respect to housing benefit income.

Constraints on rent adjustment

Housing associations are beginning to adapt to the constraints and incentives implicit in the government's new rent restructuring regime introduced in England in 2001/02 (see Wilcox and Williams, 2001 for details). Basically, housing association rents have been linked to local property values in order to bring a closer market logic to the sector. Previously rents were based around scheme costs, albeit that with pooling arrangements there was some averaging out. In some areas rents must rise and in others they must fall. Although this policy is to be implemented over ten years and there are 'waivers' for associations who cannot immediately begin the process, this new regime will ultimately limit what associations can do. The government agrees that, in the event of an association defaulting on its loans and a lender taking possession of its property security, the lender has the right to increase rents, sell property or take any other actions it decides to recover its loan. However, it must be recognised that this would immediately impact upon that association's local competitiveness (and the public image of the lender!).

Housing Benefit uncertainties

Having introduced what some would see as 'rent control' and a major change in the rules of the 'game' the government has now announced that it is to introduce pilot reforms for the provision of HB to tenants, initially in what is a fully deregulated private rented sector (Department of Work and Pensions, 2002). In the pilot areas claimants will get a flat rate allowance based on average rents for properties of the size they require. The thinking is that tenants are now paying rents that are more closely related to the value of their homes. However, the intention is to go further with this market logic and 'incentivise' tenants to 'shop' around and to look for the homes that they want and wish to 'pay' for. Following the pilots the government intends to refine this policy and roll it out across the private rented sector as a whole. In the longer run the stated policy intention is to extend this approach to the social rented sector once rent restructuring has been substantively implemented. This would be a UK wide reform. While it is far too early to assess the potential impact of such a reform, inevitably these long-term proposals add an element of uncertainty and increased risk regarding social sector landlords' future rental incomes. The combination of increased risk and falling returns to HAs and to lenders could have considerable implications for future private investment flows, in terms of both the volume of future funding and its cost.

4.2.2. The changing policy environment

There have been four important developments in the last 24 months in relation to the social housing sector in England, all concerning the role of the HC and, through it, housing associations.

Inspection requirements

Government assesses what housing organisations actually achieve on the ground in terms of their housing services to tenants through inspections. In 2002 the government decided to transfer the HC's housing association inspection function to the Housing Inspectorate within the Audit Commission. The Audit Commission is the government's 'watchdog' on the performance of local authorities. The HC introduced an inspection regime in 2001 as a parallel to the Housing Inspectorate established by the government with respect to local authority housing. In 2002 the government announced that it wished to see a single housing inspectorate established (this was a consequence of a bargain struck by the ODPM with HM Treasury in return for an increased grant allocation for the HC). The location of the single inspectorate was to be decided through a bidding competition between the Audit Commission and the HC as to where to locate it (in reality there were questions as to how far this was a real competition). Bringing housing association and local authority housing inspection together was more than simply an administrative nicety. It also provided a means of getting a clearer sense of the relative performance of the two types of organisation (potentially with that knowledge informing decisions as to future resource allocation). It also had the effect of removing one element of the HC's role, albeit only a recently created one. It has become clear that taking the inspection function is not the limit of the Audit Commission's ambitions. It is believed to also want to take over the HC's regulation function. Lenders remain concerned as to how this will work out in practice. The uncertainty engendered may reduce the flow of private lending to the HAs or increase its price, at least until a new system of inspections has been demonstrated to work effectively.

Devolution

A key aspect of government policy has been devolution, first to the constituent countries of the UK, namely, Northern Ireland, Scotland and Wales and second within England to the new regional assemblies as a first stage of creating elected regional government. As part of this process and as a way of developing stronger regional housing strategies, the regional assemblies are to take on a role with respect to the HC's allocation of grant funding to housing associations. At this stage the process will be consultative with the assemblies influencing the allocation. However, government has set out its intention to transfer the funding allocation to the assembly once it has become an elected body. The process of regional devolution will be slow so there is no likelihood of an immediate change. However a principle has been established.

Changes to Grant allocation procedure

Linked to this the HC has now announced a new system of grant allocation which will have the effect of limiting the flow of funds to some housing associations. Understandably, the government has been keen to see best use made of grant finance. The pressure has grown to concentrate finance into associations who are 'good' at development. In order not to exclude the others completely they will be required to partner with a 'developing' association. This will limit the growth of some associations and thus their borrowing potential. We return to this point later.

Uncertainties associated with changes to the administrative structure of the Housing Corporation

The fourth element of change has been the clear signal from the Deputy Prime Minister and Secretary of State with responsibility for housing, planning and local government that he would ideally like to merge the HC and English Partnerships

(EP), the England regeneration and housing development agency. The two organisations have overlapping responsibilities and the government has increased that by giving EP a housing gap funding role, i.e. setting up a scheme to bridge the gap between the costs of developing a scheme and the income it might produce via rents/sales if it is to be kept at affordable levels. The two organisations are now being required to work closely together (historically they have not) and the chief executives have been appointed to each other's board.

In addition, in terms of ensuring the provision of additional affordable housing, uncertainties have been increased both by the government's policy changes with respect to the operation of s106 agreements, together with the significant changes in fiscal policy suggested by the Barker report (2004). These are likely to reduce output levels and increase the difficulties of levering in significant private cross subsidy.

It is also clear that, within the government, questions are being asked about housing associations and value for money. There are a number of aspects to this:

- First, the government has recognised the weaknesses of a strategy that favours one single type of supplier, the housing associations sector, for affordable rental and low cost home-ownership. When government seeks an increase in the supply of affordable rental and low cost home-ownership housing it has to do so on the terms of that sector
- Second, the government has become increasingly aware of the assets and reserves that have been built up by housing associations on the back of government grant and revenue subsidy and its limited capacity to influence the use of those assets and reserves
- Receipts from the disposal of those assets are also not under the control of the government
- Although the housing association sector has always been compliant in seeking to accommodate government priorities, the increasing diversity of the sector and the range of initiatives the government is seeking support for are such that it is increasingly difficult for any association to be fully responsive.

Taken together, there are a lot of threats to the established role of the HC and through the HC to housing associations. There is a prospect of a more demanding regime and one in which there will be a clear choice agenda as to where to deploy resources and under what terms. There is thus a prospect of a radical restructuring of the policy drivers.

More positively, both the HC and housing associations have been very reliable vehicles for the delivery of policy and a range of new initiatives. These include the recent Starter Home initiative designed to help create more affordable homes for key workers (discussed in the previous chapter). The government faces a real dilemma that in undermining either regulator or associations it may lose a key delivery vehicle.

Crucially, there are implications here for the private finance market. From the creation of the private finance regime in 1988, the HC has been the key regulatory and investment body and central to lender activity in the sector. It is estimated that the regulatory functions it fulfils and the confidence it thus gives lenders has resulted in lending at interest rates 1% lower than would otherwise be the case (the 50% capital risk weighting referred to earlier also assists). Associations are registered with the HC and are regulated by it. They operate under regulations set down by the HC, they provide regular quarterly data and reports to it and are subject to periodic

visits. In the event of an association breaching HC guidelines and requirements (including a variety of financial ratios) the HC can initiate supervision action, freezing grant and imposing statutory appointees on its board. The recent attempts (welcomed by lenders) by the HC to strengthen its intervention powers via the Housing Bill 2003 have failed. It was realised that should this right have been legislated for it might trigger a redefinition of HAs from the private to the public sector. This would have resulted in any private finance they raised being counted as public expenditure and thus falling within government expenditure limits. If this was the case it would nullify much of the advantage of using HAs over local authorities.

For lenders, the current uncertainties around the HC pose a number of questions. First, the HC is known and understood. It is familiar and lenders are comfortable with it. There are regular meetings between the HC and individual lenders and with the lender trade body, the Council of Mortgage Lenders. Second, if the HC were to cease to exist lenders would want the functions it currently undertakes to continue, especially regulation but also investment. This last point requires explanation. The benefit of the current co-location of the investment and regulation functions in the HC is that it puts a real onus on the HC to get its investment decisions right in order to minimise the regulatory work load. Separate them out and there is a risk that this powerful link is broken and lenders might be exposed to poorer investment decisions (and thus expose their own lending).

This is a difficult area. There is a view in government that the HC stands in the way of full risk transfer to lenders – that the lender can avoid some due diligence and rely on the HC to protect them from borrower risk. Clearly the HC does stand between the lender and the risk of default. Under the Housing Act 1996 a statutory insolvency regime was established. Under this regime lenders agree to allow the HC a period of time to ‘manage out’ a housing association insolvency, once default has been declared. The lender retains the right to ultimate foreclosure but recognises that from both a borrower and lender perspective the best disposal of an insolvent association is probably to another association. Few banks would prefer to take on the direct management of an insolvent association and the bad press and publicity it would generate if they began to push up rents/dispose of homes as they must to restore it to solvency. Equally, no lender can agree to an outcome where they do not recover most, if not all of the debt outstanding.

To date, no lender has had to take possession of an insolvent housing association. It has been argued that it would be helpful to the market if an association defaulted because it would bring more realistic pricing back to the market. To return to the earlier point about risk transfer, given that the HC (and the relevant bodies in the other UK countries) has always stood between the lender and losses and secured a transfer of engagements to another association, it has been suggested the market has become rather complacent. Driven by competition to lend, the price of loans has fallen across the market largely regardless of the quality of the credits concerned. It is felt that pricing is now partially unrealistic and does not reflect a proper view of risk, or at least one without the long stop of the HC. The government has a rather ambiguous view of this. Partly it objects to what it sees is an inadequate risk transfer. At the same time it benefits from the low prices charged. The point lenders make is that they are realistically pricing the market given the existence of the regulator. If it did not exist then the price of loans would rise, threatening affordability.

In reality, given the benign conditions which have existed, lender risk has been low but not non-existent. Ultimately if a HA fails and no transfer is secured to another HA the lender faces the prospect of losses. Looking forward there is ample evidence to suggest those risks are increasing. This reflects the possible impacts of the new Basel 2 Accord (the new bank regulatory structure being developed by the Basel Committee within the Bank of International Settlements for introduction in 2007) and the tighter regime within which housing associations are now operating (rent control, rising costs, less certain demand). It is likely that a new era of risk based pricing will be introduced with falling financing costs for the very best associations and rising costs for weaker associations.

4.2.3. Further pressures on the Housing Association sector

Changes in government policy are perhaps the greatest threat to the private finance market but there are others. They include the question of market demand, the scale and performance of associations, alternative lending opportunities and financial market consolidation. We consider these in turn.

(i) Market Demand

Lending to social housing (or indeed to developing low cost home-ownership) is predicated on there being long term demand for that product. Recent government research in the UK has pointed to areas with falling demand for both social housing and private housing (due to loss of economic activity and over-supply of homes, notably of social housing). This new phenomenon of low demand is being taken very seriously by the government which has now committed itself to long term market renewal in such areas (typically in the Midlands and North of England). It is funding 9 market renewal areas and has committed to spend over £500 million in the next 3 years (while recognising it will have to spend much more, perhaps over 20 years). The programme will be taken forward through a combination of clearance, renewal and new building plus a range of other social and economic measures. Some of the housing associations with stock concentrated in these areas are rather exposed, along with their lenders. Some have diversified out of these areas. With both falling demand and falling values this is a matter of real concern.

More generally, there is also the question of the long-term demand for the large social housing sector in the UK. With rising affluence and expectations can the UK sustain a sector of over 5 million homes? There is no clear answer to this. Private finance has only been committed to part of this sector but it may limit how far it can go. With government seemingly keen to continue to push home-ownership levels upwards (in Europe the UK is at the EU average of around 70% but a number of countries have home-ownership levels of 80% or upwards) and with stable economies and low interest rates further growth might be possible.

(ii) The scale and performance of associations

There are a large number of small housing associations in the UK. With the current market's low margins, lenders ideally require larger loans to make significant profits. This can be achieved by aggregating small association borrowings through syndicates and borrowing clubs. These have been successfully established and at the moment no association has difficulty accessing the debt finance market. That is not true for the bond/investment market. Investors are typically looking for bond issues of around £100 million or more. Again, it is possible to aggregate association borrowings into a consolidated issue and this has been done but only really for relatively large associations.

However, there are two issues to consider. First, there is the question of performance (ODPM, forthcoming). Housing associations in the UK have operated under a fairly benign performance assessment regime. As long as an association has maintained high standards of management and financial probity it has normally been able to access the grant and to remain in business. The government is, however, wanting more and we can expect to see a more strongly directed regime in the future with 'performing' associations being rewarded with more opportunities than those who do not. This growing segmentation will then begin to impact upon and shape the finance market.

Second, there is the question of what capacity housing associations have for continued growth (and borrowing). The National Housing Federation recently undertook a preliminary study of future borrowing capacity (NHF, 2003). The study concluded that there was very variable capacity across the sector and much would turn on the evolution of the new rent regime and the age of their stock. This cautionary message that growth capacity might be limited has triggered a renewed debate as to whether the government should now be considering writing off its grant funding to housing associations (which, because it is repayable on disposal of property is treated as a loan for balance sheet purposes). The government will have to weigh up the arguments for this and whether such a concession might be used to further other objectives regarding efficiency.

(iii) Alternative lending opportunities

Third, and linked to the first challenge to HAs, is Basel 2. Mention has already been made of this but when introduced in 2007 it will usher in a new risk sensitivity in lending and make for a more differentiated lending market. With lenders operating in a housing association market subject to universal standards of regulation and investment the UK market has been somewhat undifferentiated but this will change in the future. It will create new barriers and opportunities.

(iv) Consolidation in the finance market

Finally, we cannot ignore what is happening in the financial services sector. Mergers and take overs are commonplace and will continue. As the number of lenders reduces so associations will have fewer lenders to choose from. Moreover, each lender will more quickly meet its 'exposure limits', i.e. the proportion of the total loan book that can be advanced to any single client. The departure from the market of some of the early entrants, notably German and Japanese banks, brought in by the HC departed, reflects both the growing intensity of the competition and the complexity of the market. As departures have continued, the market has consolidated around a relatively small number of key players who have developed core staffing and skills to deal with it. This has generated growing concern that the market has developed into a cartel and/or is vulnerable to the future departure of a key player.

This does not mean there will come a point where associations have no access to the market. Those limits will be adjusted upwards over time but, more importantly, bigger associations will have increasing access to the bond/investment market.

Mergers and take overs are a consequence of market competition. Shareholders are understandably in low inflation environments demanding a high return on capital. This is driving lenders to look ever more closely at the return on capital deployed, balanced off as always with the risk related to that return. Housing associations are a high volume but low margin/low risk business. Lenders will want to have some of this market but the question is how much and whether over time a view will be taken that

the return is too low given the risk involved. Thus, we cannot ignore the question of alternative investment opportunities. This is also a market and it will change over time.

(v) Growing scrutiny of the stock transfer programme

In 2001 the British government commissioned a study of the sources of finance for stock transfer, a specific part of the market but one where both the sums involved were large (to that point £9.5 billion had been raised to fund the transfer of 593,000 homes from local authorities to housing associations) and the borrowers were potentially less experienced than established housing associations. The aims of the study were to review the market, consider value for money issues, barriers and the potential for the market to expand to cope with a bigger stock transfer programme. Briefly, the key conclusions of the report (ODPM, 2002) were: loan facilities were competitively priced, the returns to lenders were low and thus the market was vulnerable; value-for-money (VFM) was being achieved; some housing association boards and staff had insufficient skills to act as 'well informed and experienced clients'; the deals had become commoditised, i.e. highly standardised and perhaps lacked full tailoring and optimisation in respect of the specific credits being considered; there was no aggregation of deals and there were a number of detailed deficiencies which required further attention.

It was clear that, although the ODPM was 'satisfied' with the outcome, HM Treasury (HMT) was not. Partly this reflected HMT's inherent suspicions of the private market in general and a view that the ODPM was more concerned with maintaining its programme of transfers rather than the broader issue of value for money (an understandable tension given the roles of the different departments). HMT pressed the ODPM to do more. In the ODPM review of the Decent Homes target (a target to ensure all social housing met defined standards by 2010) under its public service agreement (PSA) Plus review (a baseline review of housing expenditure and programmes set up following the Government's 2002 Spending Review) further consideration was given to the funding models in place to support stock transfer (and by implication to secure the decent homes target of improving all social housing to a specified standard by 2010). In particular, although noting the conclusions of the 2001 study, it was felt that the funding market had not been dynamic enough and had failed to evolve new ways of financing stock transfer.

This new study titled *Additional Finance Models for Housing Transfer* has now concluded that although there are a number of alternative ways of financing stock transfer these have been available for some time and there has simply been no demand to take them forward. These include capital market aggregation, the use of structured finance and the creation of joint venture models (see ODPM, 2003a). Instead, the report has concluded that there are a range of reforms which can be made to the stock transfer process (and the ways finance is raised) that in turn can impact upon what models are used. These will include removing the requirement to fully fund a transfer over 30 years, funding fees to be met by the HA rather than the transferring local authority and making the process more open to allow existing HAs to bid for the transferred housing stock. A consultation paper (ODPM, 2003b) setting out the various options was issued in October 2003 with the aim of introducing the changes no later than April 2004.

Whether this will result in either less government pressure regarding the private finance market and/or change in the market is unknown, only time will tell. The steady growth of bond market financing and the slow shift towards cash flow based lending and away from traditional secured lending means that the market is evolving anyway. We will return to this later.

The NHF's own scoping study of financing options (NHF, 2003), mentioned above, was a useful broadening of the agenda, away from stock transfer to housing association finance more generally. The results of this study have not been fully released publicly but it concluded that although there are only a small number of lenders there is no shortage of funds. However, with continuing sector growth and HA mergers it could soon be the case that individual associations will reach any lender's individual lending limit (as noted above). But set against this, the report suggests that at that stage such HAs can then issue their own bonds.

4.3 Access to home-ownership

As already noted (chapter 3), in the UK, as in Australia, there has been growing concern about declining access to home-ownership. The government backed home-ownership programmes have not only been small in scale (except the Right to Buy) but there has been a range of operational details. The Government's recent Home-ownership Task Force (LCHOTF, 2003) identified a number of issues including a lack of clarity as to the client focus of the programmes and poor administration by the housing associations through which the programmes are run.

Over the last few years, UK governments have reduced the level of state assistance to home-ownership. Reductions have included withdrawing mortgage interest tax relief for home-owners (this was worth at its peak £8 billion per annum), keeping annual increases in the thresholds for Stamp Duty and Inheritance Tax on owner-occupied property well below the rate of house price inflation and reducing both income support for mortgage interest for out of work home-buyers and the grant support for low income home-owners for undertaking home improvements. In addition, the government has reduced the scale of its various low cost home-ownership initiatives.

By contrast, government has introduced a working tax credit which gives assistance to lower income home-owners (though there are issues of low take up) and has begun to recognise the large numbers of poor home-owners (over half the defined poor in the UK). In addition, it has responded to the issue of failing housing markets..

The Task Force along with the recent Miles Review looking at the case for long term fixed-rate mortgages in the UK (see Miles, 2003) and the Barker (2004) Review examining the low level of housing supply reflect the current government's concern with housing issues in general and home-ownership in particular. The government (as noted in chapter 3) initiated a Starter Home Initiative designed to assist key public service workers into home-ownership. To date it has allocated £300 million to allow grants of up to £10,000 to assist purchasers. It is expected that this programme will be significantly expanded and developed. The weakness of this initiative is that it is demand driven rather than supply based. There are limits as to how far it can go without creating further pressure on house prices. Similar concerns have been raised in Australia in relation to the First Home Owners Grant (Berry and Dalton, 2004).

The Labour government's policy to mainstream home ownership since 1997 in reducing subsidy and encouraging private insurance in part reflected its view that the previous conservative government had developed a housing policy unduly dominated

by the promotion of this tenure. In a broad sense the government had passed some of the risks associated with home-ownership back to the home-owner. On the other hand its commitment to the intermediate market for home ownership in the pressure areas of London and the South East reflects the political difficulties they face because of the increasing difficulties faced by key workers in meeting their home ownership aspirations.

The ambiguous stance of both government and many housing associations and the HC to running low cost home-ownership programmes has meant that the potential value of these shared ownership and shared equity schemes has not been fully realised and lenders have begun to stand back from them. Although the lender role is no more than providing development finance and mortgages for the purchasers of the homes built there have been a number of operational difficulties, including in relation to the treatment of rent and mortgage arrears and rights for possession and subsequent sale.

The government's increased interest in home-ownership for employed households facing affordability problems together with its recognition that risks in the sector could have implications for the economy suggests that the situation may change. However, the underlying stance is undoubtedly that home owners should bear their own risks and costs.

4.4 Possible Future Developments in the Private Finance Market

4.4.1. Introduction

We have sketched out the policy tensions that currently exist. We now consider likely developments in the private finance market in relation to housing associations and the provision of affordable homes for rent and ownership in the UK.

4.4.2. Future private funding for social housing

There remain clear attractions to funding housing associations. The sector is highly regulated, the debt is secured and there have been no significant losses to date. Typical transactions are reasonably straight-forward and well understood. Although the market has grown it is very dependent upon cycles of government funding and these tend to rise and then fall over time. Currently the trend is upward. All of this provides a counterbalance to the evidence of increasing risk related to income and viability. In this section we consider some of the issues that are now emerging as this market matures and, in particular, the phenomenon of increasing differentiation between associations and indeed, between lenders. There is also the question of whether we might see a move in private finance towards equity investment rather than debt.

Differentiation and change

One view is that reflecting the general outlook the funding market will begin to differentiate more clearly in terms of credit quality. At present the variation in pricing of loans to HAs is quite narrow. However, with increasing evidence of the differential financial position and performance of housing associations and a more demanding external environment in terms of greater regional and local variation in the demand for social housing (Murie, 2002) pricing may begin to widen as a reflection of this greater differentiation. That will add to the pressure on the weaker associations and this in turn may impact upon the rate of change and consolidation in the sector.

Certainly there will be a growing premium on information about the performance of the sector. This will be a challenge for both lenders and regulators. Equally, as policy generated pressures increase, we need to recognise that associations will be in very different circumstances in terms of their capacity to respond and cope with change. With core income constrained we can expect to see both increased diversification (probably with increased risk in some cases) and a renewed focus on efficiency and effectiveness as a way of driving down costs. As a generality there has been little evidence of this to date despite better use of technology, the creation of group structures formed on the basis of scale economies and better management. Moreover, as the recent report of finance for stock transfer suggests there is a strong case for existing housing associations being able to bid for stock being transferred. The opening up of a competitive 'disposal' process might be difficult to handle politically but there is no doubt it has its attractions. If this did arise then we might see further integration between the already overlapping LSVT and traditional housing association lending markets.

The scale and importance of the private finance market is such that governments across the UK must remain sensitive to the factors that might damage it. The ODPM report on sources of finance for housing stock transfers confirmed that the current funding arrangements provided value for money but noted that the market was vulnerable to the departure of a major lender (ODPM, 2002). One obvious conclusion to this is that the market reacts most negatively to surprises and to decisions taken without prior discussion even though they impact upon private finance. This should not be confused with a reluctance to change. Government, lenders and associations have much to gain from sharing views as to how the market might develop and indeed how, in an ideal world it should develop. There was some disappointment that the Government then set up, without due industry consultation, the working group on additional finance models for housing transfer discussed above. Rightly there is a continuing search within government for new ways forward but there is a danger that it diminishes the important contribution made by lenders.

Bringing private finance to housing association funding has resulted in greater commercial awareness in those bodies and has helped make social housing more business like. The challenge now is to continue to evolve this market. Moving forward there are major questions about the efficiency and effectiveness of the housing association sector and how under a grant funded regime (albeit only in part) the natural processes of rationalisation under market competition common to the private sector might come about. In essence there are probably too many developing associations to secure the most efficient use of resources. In England the HC is ceasing to distribute grant to all associations and will become far more selective. This may produce some sector rationalisation. However, unless an association is obviously failing or it opts to transfer or merge there are no other mechanisms in place that can require change in the structure of the sector.

Beyond debt?

Alongside the question of rationalisation comes the question of funding structures. As discussed earlier, the market is currently dominated by debt finance, albeit that capital market structures are gaining market share. Syndicates, joint ventures and funding clubs have all been mooted as ways forward for reducing costs, given that some exist already and there has been nothing to prevent them coming into being. More radically there is the question of equity investment and how one can move social businesses more fully into the private sector (not least as they become bigger and more financially secure). Equity investment would challenge the concept of non-

profit making and much else so this is not an easy area. However, private equity is a clear alternative or addition to grant and loan structures in the social housing sector.

The funding market and the housing association sector in the UK have made great progress over the last 15 years and there is every reason to assume this will also be true in the next fifteen. As this review has indicated, there are many issues to resolve, not least around the treatment of housing associations under the new capital adequacy regime being introduced via Basel 2, but there is no reason to believe that both social policy and commercial interests cannot continue to be met.

From a lender perspective what happens depends on other lending opportunities, relative rates of return and the rate of return being required by the organisation and its shareholders. The evidence suggests there are unlikely to be any new entrants to the market as it currently exists. The question is will there be more departures? If there were and/or if there was default, margins might rise and the higher returns would attract lenders back in. Bond market funders, and notably the Royal Bank of Canada, have been aggressively pushing the merits of this different funding stance (as well as offering retail debt). Bond finance is based around selling the borrowers' funding requirement to investors. These investors are looking simply at returns and want no relationship with borrowers (unlike the debt funders who work closely with the borrower). There is a trade off here. Bond finance can be more difficult to raise at any moment in time because it depends upon shifting investor appetite. Timing is crucial. Coming to the market at the moment there is appetite can mean the finance can be raised relatively cheaply. By contrast, coming to the market when there are few investors in play can mean the price has to be higher and possibly that the deal must be wrapped, i.e., it has to be credit enhanced by a monoline insurer to give it A-grade characteristics. Where this has happened the association has found that the wrap can then become a very inflexible instrument, effectively preventing re-financing without considerable breakage costs.

Bond finance, then, suffers a timing/demand weakness, i.e. the success of the issue is highly dependent upon the investors' 'appetite' at the time it is issued. Given external shocks and alternative opportunities there is something of a lottery in this process. Debt finance does not suffer the same problems. However, bond finance does tend to have a less demanding schedule of covenants and to be more open to enhanced borrowing power. The bond market argues that it can be more innovative and will help associations make better use of their assets. Moreover, by offering retail debt (either in syndicate with a debt funder or through use of own funds) with a bond option it is possible to overcome the timing problem. It is competition between bond and debt that will drive the market forward over the next five years.

However, there are other potential developments in this sector. First, there are now a number of associations that are very large in terms of their balance sheet capital value and with respect to their ambition to grow and diversify. There have been discussions and exploration around the questions of acquiring publicly listed company (plc) status and taking in equity investment. This points up the growing diversity of the housing association industry and how far it has come from being a 'movement'. It is unclear how an association could become a plc and retain some of the characteristics of its current non-profit status. It would presumably mean repaying all government grant currently locked up in its stock. It would also raise the question of how it would be regulated (although the 1996 Act anticipated the arrival of private housing companies providing social housing). Depending upon the outcome of this it could impact upon the pricing of funds raised.

Second, the government clearly wants more from housing associations and from its expenditure on social housing. This suggests there may be a willingness to explore new options, particularly if this results in more output for limited expenditure. The gap funding via EP for housebuilders discussed earlier is a step in the direction of opening up new providers and markets. Another route might be to encourage the securitisation of existing housing association funding. The government sold the HC's (and other countries) 'loan' books in 1997 raising around £1 billion. However, a much bigger amount of grant remains locked up in associations. As already noted, the return on this grant arises when property is sold and a receipt is generated. To make this attractive to investors this grant funding would have to be sold at considerable discount. Another route is to maximise the use of the assets held by associations by increasing the gearing. This might be seen to be a risky option (not least given the results of the debt capacity study) but it could be contemplated, perhaps with the use of a government guarantee. In essence, we are probably at the stage where some radical re-thinking is required. Assets have been built up and for existing associations and notably stock transfer associations change might be contemplated.

It is possible that current boundaries might be broken. This might encompass changing the institutional arrangements as well as the funding structures and the organisational form of some housing associations. There would be considerable resistance from a variety of quarters. Even if this does not happen it is quite clear, as noted above, that associations are moving into a tougher more competitive regime. This is going to force ever greater diversity in the sector and it will add to the tensions around funding structures and arrangements.

4.4.3. A Possible future direction for home ownership programmes

There is some prospect that we might begin to see lender equity investment in the current shared equity low cost home-ownership schemes (described in section 3.4.2). At present the equity stake is held by the housing association and this is redeemed with house price inflation, on the sale of the home (when the shared owner either 'staircases' to 100% ownership or sells up and moves). Lenders have begun to consider whether they might hold the equity share instead. With a mature shared equity market there would be a steady flow of sales and thus a return to the investment made by the lender. Equally, it might be possible to securitise the equity stakes. Much turns on the scale of the shared equity market and its maturity. To develop this market government needs to expand the current programme.

Whatever the weaknesses of the Caplan and Joye model (discussed in detail in the next chapter), it does open up the issue of risk sharing between home-owners, government and investors. It can be argued that if governments wish to expand home-ownership beyond what might be deemed its 'natural market limits' over the economic cycle then government will have to share that risk. Typically governments do find equity investment more difficult than assistance with debt servicing. The UK model of an equity loan has many attractions – there is a return to government and if the return is required earlier it might be possible to securitise the government's equity loans. More creative thinking is required around this, not least in terms of who might buy such loans and how liquid that market might become.

4.4.4. The broader financial environment

This opens up wider questions of financial engineering, securitisation and secondary markets not least just with respect to home-ownership programmes but also with regard to affordable rental housing. In the UK there is a growing debate about long term finance whether for ownership or rental. Such loans have limited appeal to debt

financiers over the long term and increase the attractions of securitisation (assuming there is an investor class who will buy in such funding). The UK government has begun to explore these issues with its Miles Review and this has already been taken forward by the launch of EMFA, a non governmental secondary mortgage market for Europe, paralleling Fannie Mae and Freddie Mac in the USA (EMFA, 2003).

Ultimately, big questions have to be asked about the balance of tenures in the UK (and Australia) and the appropriate role of government. In the UK the government has begun to champion a bigger private rented sector while at the same time suggesting both home-ownership and social housing provision can be expanded. Given current shortages and desired growth, this is all possible numerically but it is unclear how it can be reconciled in relative terms.

Setting this aside, the government appears to want housing associations to get involved in intermediate renting in the same way they are involved in intermediate owning (shared ownership). Associations have begun to respond to this by creating homes to rent or buy for key workers but ultimately there will be questions as to capacity and priorities. There are unanswered questions about how government might facilitate this move, given at the same time it might want to reduce its housing involvement overall.

The next chapter focuses on the very different pattern of development of private funding for affordable housing in Australia, before considering, on the basis of the analysis presented in chapters 3 and 4, any lessons the British experience may hold for Australia, in this context.

5 PRIVATE INVESTMENT IN AFFORDABLE HOUSING IN AUSTRALIA

This chapter outlines key issues and recent approaches put forward to stimulate private investment in affordable housing in Australia. After a brief historical overview to locate current policies in a broader context in section 5.1 and in light of the structure followed in previous sections for the UK, section 5.2 first looks at policy developments and proposals aimed at both large institutional investors and small investors in the rental sector. It then outlines recent attempts to boost low cost home ownership. Section 5.3 summarises these by indicating how many of the current proposals can be seen as forming part of an integrated whole. Section 5.4 summarises Australian proposals that have focussed on what might be called cost based rather than financing solutions and section 5.5 provides a brief overview of current initiatives, indicating the current state of play in Australia.

On the basis of this critical account of current debates in Australia, and the earlier analysis of the British situation in chapters 3 and 4, we then draw a number of important implications or 'lessons' for Australia.

5.1 Background

Australia has always had what by international standards is a large, diverse and dynamic private rental housing sector. Although this sector shrank from more than a half of the stock just after World War II, as the home ownership rate grew, to around a fifth by the early 1960s, this tenure share has been maintained over the past 40 years.

This vibrant rental sector has always been driven by small investors, single and couples investors owning one or two rental dwellings (Yates, 1996; Beer, 1999; Berry, 2000). This pattern of investment has been encouraged by the favourable taxation treatment of rental investment (i.e. 'negative gearing', depreciation and building allowances), the relative absence of other investment opportunities for small investors and the perceived attraction of a bundle of non-economic benefits of landlordship.⁴

Prominent by their absence have been professional and institutional investors. These investors have not taken up equity positions in the rental housing sector in Australia, though they are significant investors in commercial property. Until relatively recently they were also largely absent from the debt market for rental housing; small landlords, like owner occupiers, borrowed from primary lenders, the banks and building societies. However, in this latter context, the institutions, especially the growing superannuation fund sector, have (since the mid-1990s) moved strongly into the new secondary mortgage market. In the main, this has favoured funds for owner-occupied housing. The absence of the institutions from the rental sector has been caused by a number of economic and institutional factors which cause expected returns on equity to fall well below that required to compensate for a range of risks, including vacancies, tenant behaviour, illiquidity, poor market information and weak property management (Berry, 2002).

These barriers to investment apply particularly at the lower cost end of the rental market. Taxation effects, scope and management costs also tend to bias small investors away from the low cost submarkets (Wood, 2000). The consequence has

⁴ Larger scale investment by individual landlords has been discouraged by State land tax policies.

been a continuing sharp decline in the numbers of low rent dwellings in Australia – Yates and Wulff (2000) argue that between 1986 and 1996, the number of very low cost rental dwellings fell by a significant amount throughout Australia, creating a chronic national shortage of 150,000 low rent dwellings by 1996.⁵ Their follow up work shows that declines in the low rental stock and, indeed, low to moderate rental stock, have continued through to 2001 (Yates, Wulff and Reynolds, 2004).

Government policies aimed directly at the private rental sector have not been strongly in evidence in Australia. Apart from landlord-tenancy legislation imposed by the state governments, rental markets have been largely left alone. Legislation protecting security of tenure and a range of housing-related rights, such as occurs through much of Western Europe, has not been prominent here. The only exception has been short periods of general rent control imposed during wartime, but quickly wound back in the post-war period.

The major effects of government policy on rental investment are, as implied above, indirect, particularly those emanating from the federal tax system. Negative gearing currently delivers more than \$3 billion subsidy annually to investors (Colebatch, 2003). In the mid-1980s the then Hawke Labor government removed these benefits, substituting in its place a building allowance of 4 per cent on new rental construction. The aim was to stimulate the new construction of rental housing and reduce the deadweight costs of the existing arrangements. However, within two years the policy was reversed as a result of persistent lobbying by the industry sector, negative gearing reintroduced and the building allowance cut back to 2.5 per cent.

The relative disinterest shown by Australian governments, at all levels, in the rental housing sector can be contrasted to the active support provided for owner occupation. Total tax benefits flowing to the home owning majority exceed \$20 billion annually, mainly in the form of exemption from capital gains tax on sale and from not taxing imputed rental income during possession (Yates, 2002). Government support for this tenure, however, extends far back in Australian history. The state government owned savings banks were large suppliers of mortgage finance from the 1920s on. The prime vehicle for funding social housing (the Commonwealth State Housing Agreement) diverted a significant share of its funds to subsidised home ownership for sitting public tenants between 1956 and the early 1970s (Berry, 1988). In the 1960s the federal government introduced mortgage insurance through its Housing Loans and Insurance Corporation (privatised in the late 1990s). A number of state governments also had their own schemes to boost low income home ownership, through low-start mortgage arrangements, though they began phasing them out in the late 1980s (Dalton, 1999). South Australia is the main exception, where Homestart is still an active provider of mortgage finance to low income and other households who would find it difficult to access conventional lending sources. Finally, the federal government has, from time to time, provided one-off cash grants to first home buyers, the last such scheme introduced in 2000, ostensibly to offset the impact of the new general goods and services tax.

In the late 1980s the Australian Government instituted a Housing Policy Review, followed by a far-ranging study, the National Housing Strategy, that canvassed a number of key issues and policies aimed at increasing the efficiency and equity of housing provision in Australia (for a summary of the various papers forming the latter

⁵ This estimate takes into account both an inadequate stock of low rent housing for the number of low income households and the fact that not all of the low rent stock that exists is available for low income households because it is occupied by higher income households.

study, see NHS, 1992). The final report of the National Housing Strategy presented a comprehensive agenda for action. This agenda was based on a number of strategic objectives, the first of which was to "expand the range and supply of secure, affordable and appropriate housing choices accessible to all Australians, particularly to those on lower incomes" (NHS, 1992b, p28). This was to be achieved by improving access to home ownership, by expanding the quality, choice and supply of social housing and by making private rented accommodation more affordable, appropriate and secure. Access to home ownership was to be increased by allowing access to superannuation contributions, reducing transaction costs and increasing the variety of shared home ownership schemes. The increased supply of social housing was to be achieved in a number of ways including, inter alia, improving access to private sector finance for social housing underpinned by recurrent funding to maintain the viability of innovative financing schemes (p32). Private rental housing was to be made more affordable by introducing a rent assistance scheme reformed along affordability principles. Whilst there has been relatively limited success in respect to implementing policies to achieve these objectives, a number of the principles on which they were based recur in current proposals discussed below.

More recently, governments have been exercised by the effects of the long housing boom in parts of Australia, particularly the capital cities. Average housing prices and (to a lesser extent) rents have risen sharply over the past five years or so, placing Australia alongside Britain at the top of the house price inflation table for the developed economies (Berry and Dalton, 2004). In 2002 the Australian Government established a Prime Minister's Taskforce on home ownership to explore a number of policy proposals designed to improve ownership options for lower income households (these proposals are discussed further below). In 2003, following this enquiry and the increasing concerns, expressed widely in the media, as to the declining housing affordability picture in Australia, the federal government instructed its agency the Productivity Commission to carry out an inquiry focused on first home ownership. The inquiry addresses a number of questions concerned with measuring housing affordability, discerning the recent affordability trends in Australia and assessing the various factors held to be driving declining affordability outcomes – including the impacts of tax arrangements, infrastructure and land costs, planning regimes, macroeconomic factors, the availability of finance and the 'operation of the total housing market' (Productivity Commission (2003). A draft report was released in December 2003. The final report was released in mid-2004.

One of the persistent recommendations of the policy reviews and inquiries that have taken place over the last decade or so has been the need to encourage increased private investment into affordable housing at the lower end of the rental and owner-occupied markets. The following section provides an overview of current proposed solutions to achieving this goal.

5.2 Current Policy Proposals

Given that the greatest affordability pressures are concentrated in the private rental sector, it is not surprising that attention has focused on stimulating the bottom end of that market. There are several approaches or models designed to attract private investment that figure in the current Australian policy debates. All of these require some form of subsidy. A detailed analysis of a large range of delivery mechanisms carried out for the Affordable Housing National Research Consortium concluded that

the preferred model was one that provided a direct government subsidy for private (debt) investment in affordable housing (Hall, Berry and Carter, 2001)⁶.

One of the key differences in the policies that have been proposed is whether they attempt to attract funds from new institutional investors into this market or whether they target the small scale landlords who currently dominate the private rental market. The Consortium approach, which focuses on bringing institutional finance into the provision of affordable private rental housing through a public private partnership arrangement, is described below. Section 5.2 concludes with a brief overview of two alternative approaches that focus on retail investment. The first of the approaches outlined in section 5.2 relies on a direct government subsidy; the second two rely on Commonwealth taxation benefits.

A politically attractive alternative to developing approaches to increase the supply of affordable rental housing is to encourage affordable home ownership. In section 5.3 an unsubsidised shared equity arrangement ('the Caplin-Joye model') aimed at boosting home ownership for low and moderate income households is described. The Caplin-Joye model was placed on the agenda of an affordable housing taskforce established by the Prime Minister in September 2002, which reported in June 2003 (Joye et al, 2003). The advantages and disadvantages of each model are compared in relation to their respective capacities to deliver a large increase in the supply of affordable housing targeted to need. A more detailed, critical analysis of the approaches presented to the Prime Minister's Taskforce, including the Caplin-Joye model, is presented in the appendix to this report.

Whereas much of the Australian debate has focused on ways of boosting the private rental sector or, more recently, on stimulating first homeownership, policy development in the UK has targeted major reforms in the private funding of and planning support for social housing provision. This focus was stressed in earlier chapters. However, whilst the UK policy focus on social rather than private rental housing is in direct contrast with that in Australia, there is some similarity between the two countries in a common concern to increase opportunities for home ownership for households on low to moderate incomes.

5.2.1. Affordable Rental housing; An Overview of Approaches

(i) The Consortium model

The Affordable Housing National Research Consortium provides the most comprehensive recent assessment of the ways in which government assistance might be used to leverage institutional funds into investment in affordable housing. The approaches identified were distilled into four broadly feasible options. The Consortium classifies these four options into three supply side solutions that provide capital for investment through different channels and one demand side solution aimed at encouraging institutional funding of assisted home loans. Each of these was assessed against a range of criteria covering efficiency, equity, risk, effectiveness, budgetary impact and political feasibility. The Consortium's preferred solution is the first of the supply side options, based on a Commonwealth subsidy designed to ensure a guaranteed minimum return to debt investors. This option requires state and territory governments to each sell long-term bonds at market prices to private investors. Given the current low level of government borrowing in the Australian capital market, institutional investors like superannuation funds appear to be very keen to purchase such instruments.

⁶ This study is summarised in AHNRC (2001; www.cosortium.asn.au) and Berry (2002).

Capital raised in this way would be used by each state housing authority (SHA) to acquire new or existing dwellings, to be let at affordable rents to eligible tenants. However, since investors are receiving commercial interest returns on their loans, affordable rents would fall short of operating costs and interest payments to bond holders. This gap is therefore met by a cash (outlay) subsidy paid by the Commonwealth Government to each state and territory to help service its debt for the term of the transaction (20 years). The transaction is cost neutral to the states as long as the estimated subsidy covers the actual gap between rental yield and SHA costs each year.

The model requires SHAs to progressively sell off the dwellings (after a minimum period) when they fall vacant and to use the proceeds to retire (pay back) debt. At the end of the period (20 years) any remaining dwellings in the transaction are sold and the remaining debt retired; sitting tenants are relocated. This keeps the total required Commonwealth subsidy to a manageable level. This model generates a high degree of leverage of private loan funds; for every dollar of subsidy, four or five dollars of private investment is secured (under the base case assumptions).

Further discussion of this preferred Consortium approach is provided in the Appendix to this report. Further details about the feasible but less preferred Consortium options can be found in the Stage 2 and Stage 3 Consortium reports⁷.

(ii) The Macquarie Bank retail investors model

Alternative solutions to the targeting of institutional investors inherent in the Consortium approach have relied on targeting retail or individual investors. Several of those proposed are considered here.

5.2.2. Pooled funds

McNelis et al. (2002) provided Macquarie Bank (MB) with a brief to develop an investment vehicle that would mobilise the savings of professional retail investors for investment in affordable housing. MB proposed a 'pooled fund' – a vehicle, managed by a funds manager, that would aggregate or pool the savings of individual investors seeking a commercial return from residential property. The funds would be used to acquire housing for rental, managed by a community housing organisation (CHO), which provides property and tenancy management services for a fee chargeable to the pooled fund. The fund operates akin to a property trust in the commercial property sector; hence, the investment is of an equity-like nature. The CHO selects moderate-income tenants in receipt of Centrelink payments (annual income in the \$30,000 to \$40,000 range) and charges rent at a level required to generate a rental yield of 6 to 6.5 per cent. Investors receive an overall return based on both the rental yield and capital gain, the latter assumed to be between 0.5 and 1.5 per cent real.

The financial appraisal of this model is pessimistic. Macquarie Bank suggests that, given the risks and property market inefficiencies, professional investors would require a return in excess of 10 per pre-tax from this investment. Base case modelling promises a pre-tax return in the vicinity of 3 per cent and an internal rate of return (reflecting capital growth) of 6 per cent, well short of the required level. To make it work, significant government subsidies would need to be packaged into the arrangement. (The required subsidy per assisted tenant would be well in excess of that needed to drive the Consortium model.) The subsidies could take one or more forms, including an equity gift or recurrent operating subsidies, paid to the CHO.

⁷ For a subsequent comparison of roughly comparable options, which reaches broadly similar conclusions, see Allen Consulting Group (2004).

Alternatively, particular tax concessions with respect to the rental income or capital gains components of the overall return could be directed to the participating investors. These subsidy streams would need to be very considerable if rents are to be lowered to house lower income people. As it is, some subsidy would be needed to affordably house households receiving annual incomes up to \$40,000.

Macquarie Bank concludes that, in the absence of high subsidy levels, this model would only be likely to attract the genuine 'ethical investor'; those investors willing to take lower than commercial rates of return in a good cause. This class of investor, they suggest, is numerically small in Australia. It could, of course, include the government, who could take equity in the fund at a less than commercial rate of return.

5.2.3. Taxation exemptions

Macquarie Bank also offered an alternative model, one that trades on the current nature of the private rental sector as a 'cottage industry' or attractor of 'mums and dads investors' concerned with 'bricks and mortar' security, rather than full commercial returns. This approach simply rests on government providing specific incentives to small investors to leave more of their savings in affordable rental housing. The lever proposed is to offer landlord-investors a tax exemption on part of their rental income when they lease their dwellings to CHOs for a minimum period. State government could also offer land tax and local rate exemptions. CHOs would be in a position to negotiate long-term leases and guarantee management, maintenance and so on, all serving to reduce the leasing cost. These savings and subsidies can then be passed on to the tenant as lower rents. One consequence could also be that low rent stock currently resided in by higher income tenants may filter through to the lower income clients of CHOs.

(iii) The low-income housing tax credits model

The economist Gavin Wood (2001) also proposed a way of delivering greater incentives for small landlord-investors to provide more low cost rental housing. He argues that this stock has been declining in Australia (as Yates and Wulff, 2000 and Yates, Wulff and Reynolds, 2003 and Yates, Wulff and Reynolds, 2004, demonstrate) because the after-tax returns of landlords of low-cost dwellings are lower than the returns accruing to the landlords of higher-value dwellings. There are three reasons for this divergence:

- *Federal income tax*: negative gearing delivers higher after-tax returns to high marginal tax rate investors than to lower income investors. Since high-income investors tend to be concentrated in the high value end of the rental market – and low-income investors at the low rent end (due to the differential prospects for capital gains and wealth constraints) – after-tax returns are lower and rental yields higher in the low rent segment.
- *Economies of scope*: the management and associated costs (land tax, real estate agents' fees) of holding one high value rental dwelling are less than the costs for two cheaper dwellings of equal total value.
- *Higher maintenance costs*: low rent stock tends to be older and in need of more maintenance than newer high value dwellings.

Lower after-tax net returns provide a financial incentive for landlord-investors to exit the low rent segment. Wood proposes two tax-related policies to offset or even reverse this disincentive to remain in the low cost rental business.

(a) Low-income housing tax credit

A US-style tax credit paid to investors of dwellings renting below a threshold level (assumed in Wood's base case to be \$100 per week in 1996 prices). The tax credit is delivered as a reduction in the investor's annual total tax liability. Wood (following the US example) calculates the annual credit at the rate of 4 per cent of the dwelling's building value. Wood's microsimulation analysis concludes that this would increase the annual after-tax return to low-income investors by almost 1 per cent of the total capital value of the dwelling. The gain, on average, to high income investors is only 0.1 per cent, suggesting that this measure would be effective in targeting the tax subsidy to the low rent segment of the market.

(b) Capital gains tax reform

An annual threshold on capital gains taxation (CGT); i.e. tax is not payable on the first, say, \$10,000 of capital gain. Wood's analysis shows that if the current British capital gains tax regime (which has a threshold) replaced the Australian regime, landlords of low rent dwellings would gain an average CGT reduction of 0.3 per cent of dwelling value each year. This compares to an increase in CGT liability of about 0.1 per cent of dwelling value for landlords in the high rent segment.

Wood's analysis suggests that, properly targeted, subsidies delivered through the income and capital gains tax systems could increase the financial incentive for existing and prospective private landlords to remain in and expand the low rent segment of the market.

However, this approach depends for its effectiveness on landlords who receive the tax benefit actually passing it on in lower rents *and* renting their dwellings to lower income tenants. The fact that the low-rent segment of the private rental market is *not* efficient reduces the likelihood that normal market forces will bring about the desired 'rational' response. In short, landlords may claim the tax benefit and yet rent to higher income people unless stringent and effective administrative checks are in place and efficiently imposed. In the United States, State and local government have developed such checks, at a further cost of program implementation. Similar arrangements would need to be introduced and funded in Australia, reducing the leverage effect. Wood, for example, suggests that the tax benefits could be targeted to investors who rent to CHOs. Such a solution could then be operated as a head leasing model. However, the subsidy cost per tenant assisted would be higher than under the consortium bond model (Allen Consulting group, 2004).

5.2.4. Affordable home ownership

The second group of current policy proposals that are intended to increase the affordability of housing focus on home ownership rather than rental housing. The most prominent of these is the shared equity or partnership model as developed by Caplin and Joye (2002) (see also Joye [2002] and Caplin et al. [2003]) and proposed by the Prime Minister's Home Ownership Taskforce. As with the first two solutions outlined above, this also relies on a partnership arrangement. In this case, however, the focus is on private partnerships. The role of the public sector, while present, is underplayed. The Home Ownership Taskforce also released a second report which raised some concerns with the Caplin and Joye solution and, which proposed, instead, a solution which focussed on the characteristics of lower income home buyers.

(i) The shared equity model

The model proposed by Caplin and Joye (2002) aims to reduce the costs of home ownership, especially in the early years of purchase when most households are heavily mortgaged. Instead of committing a large part of household income to servicing a large mortgage debt, a household could buy its house in partnership with another investor. Equity would be shared and the household would only have to contribute a deposit and borrow to finance its share. There are some limited parallels here with the Homebuy shared equity model currently operating in the UK (and with the recent launch there of a shared equity mortgage). The income saved from servicing a smaller debt could then be invested in a range of other assets (e.g. extra superannuation contributions), rather than locked into the house, a large illiquid and risky asset. Caplin and Joye argue that, in retirement, the household would have generated more overall wealth than if it had kept its entire savings eggs in one basket, the family home. By retirement, of course, the household would also have paid off the mortgage debt on whatever share it still retained.

Under this shared equity arrangement, the household is the managing partner and the investor the limited or sleeping partner. The former decides when to sell, to whom and for what price. The household also decides on how the property is maintained, renovated and used. The sleeping partner 'wakes up' only when the dwelling is sold in order to receive its agreed share of the sale proceeds. The household saves on housing costs each year because the sleeping partner foregoes any ongoing rental payment on its share in favour of receiving all its return at the end, when the house is sold. In effect, the investor is swapping rental income for a share of the realised capital value of the dwelling.

The equity instrument created for the partner investor can be securitised – that is, bundled up and bought and sold by investors, akin to housing debt (mortgage-backed securities) that is now traded in the rapidly growing secondary mortgage market. Caplin and Joye envisage the creation of special purpose vehicles termed 'partnership real estate funds'. This 'deepens' the market and makes it more attractive to long-term institutional investors. The 'paper' created can be traded and continuously valued in the secondary market. Investors are not locked into a partnership with an individual household for life. They can buy a tradable share in the future returns of many individual dwellings, spread across housing markets. This reduces the risks borne by the investor and therefore lowers the required return, leaving more of the value of the houses to each of the owner-occupiers.

Their proposed solution is grounded in modern finance theory which is based on the premise that diversification is the way to maximising investor wealth over time. As a textbook solution it has something to offer. However, as a textbook solution, it is also based on a highly restrictive set of assumptions. A more detailed discussion of this model, and an evaluation of it, is provided in the Appendix.

(ii) The Housing Lifeline solution

A second solution which emerged from the Prime Minister's Taskforce was one proposed by Gans and King (2003). Their approach was derived from a concern that market based solutions were likely to be irrelevant for households who did not have access to the market. Their solution explicitly relied on government funding or risk management for low income households who were exposed to high income risk associated with income volatility and who were unable to insure against these risks. Their "housing lifeline" solution is designed to provide a form of housing benefit that

covers either rent or mortgage costs when a household faces a short-term fall in income.

This solution is seen as addressing affordability problems for households who have temporarily low incomes. It has the potential to address general affordability problems for households with permanently low incomes only insofar as it reduces housing costs by making lending or renting to lower income households less risky. As such it embodies some of the characteristics of the solutions proposed in section 5.3.1 below and therefore will not be considered separately in Table 5 below. More information on this proposal and an evaluation of it is available in the Appendix.

Table 5 below summarises the main advantages and disadvantages of each of the models outlined above.

Table 5: Overview of Models

| Advantages | Disadvantages |
|--|---|
| Consortium bond model | |
| <ul style="list-style-type: none"> ▪ Cost effective (efficient) ▪ Effective partnership between Commonwealth & States ▪ Total subsidy capped for the Commonwealth ▪ Closely targeted to need ▪ High leverage of private investment ▪ Generates a large volume of private investment ▪ Draws on existing financial instruments (bonds) ▪ Helps maintain a deep market for government bonds in Australia ▪ Provides strong incentives for states to manage the expanded public stock efficiently ▪ Simple and straightforward financing procedure with minimal transaction costs | <ul style="list-style-type: none"> ▪ Concentrates financial and operational risk on States ▪ Relies on public borrowing in a neo-liberal climate of public debt reduction ▪ Requires new management systems to be put in place in SHAs to manage risks |

| | |
|---|---|
| Macquarie Bank retail investors model | |
| <ul style="list-style-type: none"> ▪ Could aggregate large volume of small savings ▪ Could provide a growing stream of finance for well-organised and professionally run community housing organisations (CHOs) ▪ Provides equity-like investment opportunities akin to commercial property trusts in the residential sector (diversification benefits to investors) | <ul style="list-style-type: none"> ▪ Numbers don't stack up: requires substantial subsidies to work, hence very costly for government – i.e. limited leverage of government funds ▪ Current shortage of suitable CHOs ▪ Not targeted at households below \$30,000 income |
| Macquarie Bank alternative model (taxation exemptions) | |
| <ul style="list-style-type: none"> ▪ Trades on existing 'cottage industry' nature of the rental sector ▪ Could be facilitated by states granting targeted land tax and stamp duty concessions to investor-landlords ▪ Provides a long-term basis for secure leases (security of tenure) and cost savings on maintenance, etc. ▪ Could encourage downward 'filtering' of higher rent stock to affordable segment | <ul style="list-style-type: none"> ▪ Difficulty in quarantining tax benefits to affordable stock – large 'deadweight cost' ▪ 'Distorts' market outcomes and reduces efficiency ▪ Possibility of fraud via benefits claimed on stock not rented at affordable rents ▪ High surveillance costs to ensure compliance with rules ▪ Current shortage of suitable CHOs ▪ Politically infeasible, contradicting existing fiscal philosophy of government central agencies winding back special tax concessions |
| Woods Tax Credit model | |
| <ul style="list-style-type: none"> ▪ Trades on existing 'cottage industry' nature of the rental sector ▪ Total tax subsidy can be capped (as in the U.S.) ▪ Could be facilitated by states granting targeted land tax and stamp duty concessions to investor-landlords ▪ Provides a long-term basis for secure leases (security of tenure) and cost savings on maintenance, etc. ▪ Could encourage downward 'filtering' of higher rent stock to affordable segment | <ul style="list-style-type: none"> ▪ Difficulty in quarantining tax benefits to affordable stock ▪ 'Distorts' market outcomes, reduces efficiency ▪ Possibility for fraud via benefits claimed on stock not rented at affordable rents ▪ High surveillance costs to ensure compliance with rules ▪ Politically infeasible, contradicting existing fiscal philosophy of govt. central agencies winding back special tax concessions |

| Shared equity model | |
|--|---|
| <ul style="list-style-type: none"> ▪ Does not require government subsidy ▪ Allows households to diversify their savings, potentially leading to greater lifetime wealth accumulation ▪ Reduces initial barriers to accessing home ownership ▪ Reduces housing stress, especially in early years of purchase ▪ Potential to develop a large secondary market in 'bundled' equities ▪ Attractive to households in the broad middle of the income hierarchy (fourth to sixth income deciles) and higher ▪ Delivers greater security of tenure than private renting | <ul style="list-style-type: none"> ▪ Stimulates housing demand without necessarily stimulating supply, thus reinforcing rising housing prices ▪ Model has not emerged 'naturally' through market forces anywhere in world ▪ Unclear what government facilitation would be necessary to overcome market barriers ▪ Of limited, if any, relevance to households in bottom three income quintiles ▪ Model driven by realising future capital gains, but institutional investors are yield-driven ▪ No track record, so high risk premium initially demanded by investors ▪ Model may only suit dwellings and areas promising high capital gains ▪ Home-owner may be left with little or no equity ▪ Likelihood of conflicts between home-owner and financier 'partner' – over maintenance, renovation, etc. How are conflicts to be resolved? ▪ Banks unlikely to invest, constrained by capital adequacy requirements |

5.3 Integrated Proposals

As far back as 1989, housing economist Judith Yates developed a proposal that effectively integrated the ideas embodied in the Affordable Housing National Research Consortium model, the Caplin and Joye shared equity proposal and the Gans and King Housing Lifeline proposal. This approach, a part of which underpinned the National Housing Strategy equity bond proposal (National Housing Strategy 1991), simultaneously provided a shared equity solution with an income support to cover declines in income that threatened the capacity of the household to meet rental payments. Whilst the National Housing Strategy proposal was aimed at generating finance for affordable (social) rental housing, the Yates proposal that preceded it was a more tenure neutral proposal.

5.3.1. Yates' housing policy reform proposal

Yates's (1989) proposal arose out of a concern about the growing inequities and inefficiencies of existing housing policies. Poorly targeted tax expenditures, which encouraged and supported owner-occupation, dominated direct and targeted support for low income renters.⁸ The concern was that this would contribute to an increasing

⁸ Yates' proposal relied on estimates of direct and indirect housing assistance available in Flood and Yates (1989) that highlighted the lack of tenure neutrality in this assistance and pointed to both inequitable and inefficient outcomes as a result of its structure. Yates (2003a; 2003b) provides more recent estimates of the value and distribution of tax concessions to owner-occupied housing. In 2001,

polarisation of incomes along tenure lines and to the residualisation of what was then a public housing system. It attempted to find a solution that balanced the politically rational desire to encourage owner-occupation with the economically rational desire to target subsidies to those most in need of them. It proposed a radical restructuring of assistance based on a form of support that enables the shelter and asset components of housing to be separated and assistance to be directed solely towards the former. This proposal consisted of several essential components: a compulsory housing cost insurance scheme, the provision of shared equity arrangements and the introduction of housing bonds to fund investment in affordable housing. The first of these provides income support for shelter; the second two facilitate the separation of consumption and investment components of housing and work towards ensuring that affordable housing is available for all.

The compulsory housing cost insurance scheme integrated a tax on housing and provision of a housing benefit scheme into a single package. The tax was set as a compulsory income tax levy, the value of which varied with the value of owner-occupied housing; the benefit could either be means tested or universal but was to be available to all households regardless of tenure. This serves several purposes. First, it provides a politically rational way of effectively introducing a tax on owner-occupied housing and to redress the current imbalance associated with the exemption of income from owner-occupied housing from the income and capital gains tax systems. The introduction of a housing benefit scheme would provide owners and purchasers with the same level of support as provided to renters when their economic circumstances changed. Second, it would operate as a mortgage assistance scheme for purchasers and so provide the type of life-line support proposed by Gans and King. Third, it would provide asset rich income poor older owners with some level of income support as embodied in the Caplin and Joye proposal.⁹

Packaged in this way, the introduction of what amounts to the taxation of owner-occupied housing can be seen to be a policy that supports rather than attacks the ideology of home ownership. Ideally this tax would be accepted as a means of redistributing housing costs over the life-cycle for owner-occupiers and as a means of introducing an insurance scheme for purchasers. In conjunction with the equity bond scheme, which is an integral part of this proposal and which will be outlined later in this section, it would also serve to pool the risks regarding capital gains on housing. The tax, which would be a hypothecated tax, would provide the revenue needed to fund the housing benefit scheme. It would mean that revenue received from higher income and higher net worth owner-occupier households is used to provide housing cost cover for lower income households, regardless of tenure.

The shared equity and housing bond component of this integrated proposal served to separate housing consumption from housing investment. Equity sharing is self-explanatory. In Yates' proposal equity sharing was a requirement for any household applying for housing benefit but consuming rental services in excess of those supported by the housing benefit or insurance scheme. Households would be expected to pay a net rental yield on the equity they give up (the housing benefit scheme would assist in meeting the cost of rental services). The housing bond

these were in the order of \$20 billion, with the largest dollar amounts (as much as \$12,000 per year) going to high income, outright owners.

⁹ There are constraints which limit the extent to which this support to purchasers and owners is available; in the main, assistance is likely to depend on acceptance of a shared equity arrangement not dissimilar to the Caplin-Joye proposal for older households. These constraints are outlined later in this section.

provided a financial instrument through which the equity shares in owner-occupied housing could be financed. The net rental yield, along with a return based on pooled capital gains from all participating dwellings, provides a return for holders of housing bonds. Yates proposed taxing the rental yield on these bonds but allowed capital gains to remain tax-free. This was intended to provide a financial instrument that had the same effective tax treatment accorded to owner-occupied housing (with the tax on net rental income for owner-occupied housing being equivalent to the compulsory levy).¹⁰ Yates argued in favour of state ownership of any assets that were equity shared as a means of avoiding potential conflicts between landlord and tenant but did not see this as essential. State involvement, however, was seen as essential to guarantee access to a shared equity scheme and to protect against exploitation of those entering such an arrangement. Shared equity in Yates' proposal was seen as a means of blurring the distinction between owner-occupied and social rental housing with security of tenure being guaranteed.

The combined effect of Yates' integrated scheme was to provide a "by right" affordable rental component of housing and a "by choice" investment component with subsidies for the former based on the argument that it is the secure shelter component of housing that is a merit good and is the proper basis for government assistance to housing. The housing bonds provide an opportunity for investors to spread the risk of investing in residential housing by providing opportunities for risk pooling through a broader geographic coverage than is possible with investment only in owner-occupied property.

5.3.2. National Housing Strategy equity bond proposal

The National Housing Strategy proposal (NHS, 1992), developed just a few years after Yates' housing policy reform proposal, recognised the potential capacity for raising funds for social rental housing that existed in the housing bond proposal and used this to develop an instrument, called an equity bond, that made effective use of tax incentives to encourage private sector participation in funding social rental housing.

The National Housing Strategy bond proposal, which was outlined in the *Financing Australian Housing Issues Paper* (NHS, 1991:64-68), addressed inefficiencies arising in the mechanisms put in place in NSW and concurrently in a number other states in the mid to late 1980s to raise equity finance from the private sector for rental housing. The key component of the proposal was the introduction of equity bonds that had the same risk and return characteristics as the complex public-private partnership arrangements then in place. At their most generous, these partnership arrangements provided a guaranteed tax-free real rate of return to the investor and a tax-free capital gain equal to the inflation rate over the investment period. With the exception of the guarantees involved, these returns are similar to those enjoyed by investors in owner-occupied housing. Equity bonds, so named because they provided equity finance with a return equivalent to that available to investors in owner-occupied housing and blurred the distinction between equity and debt finance, were seen as providing a more flexible instrument for fund raising than the ad hoc once-off mechanisms then in

¹⁰ The question of how to treat mortgage interest costs is one that could be further developed. There are a number of changes that could be made to ensure owners and investors were treated alike. All investors, for example (whether owner-occupiers or not) could be permitted to deduct mortgage interest on a once only basis on housing debt up to a fixed value. This would assist first home purchasers at the time they were most in need of this assistance. Yates (2003b) proposed introducing mortgage deductibility on a once off basis for first home buyers in return for taxation of capital gains when the dwelling was sold.

place. They removed barriers to entry imposed by scale requirements for one-off arrangements and, in the hands of a non-profit housing provider, they provided an efficient instrument through which tax benefits available to investors could be passed through to renters. The introduction of such bonds into the capital market, it was argued, would eliminate uncertainties currently associated with tax rulings on new investment initiatives and the ability to trade these bonds in a secondary market would provide the liquidity required by investors. The issuing of these bonds and any subsequent trading would be undertaken through a housing intermediary or special purpose vehicle. The funds raised would be used to provide affordable rental housing (possibly with the assistance of a housing benefit) and to fund the rental component of shared equity arrangements.

Equity bonds were seen as enhancing equity in the current provision of housing assistance because they enabled renters, and particularly those at the low to moderate end of the rental market, to access tax benefits equivalent to those enjoyed by owner-occupiers.¹¹ They were also seen as advantageous because they could provide a tax enhanced savings vehicle for households accumulating funds for a deposit, or for households either unwilling or unable to enter home ownership. Such households would be able to enjoy a return on their savings equal to that derived from the return on owner-occupied housing enjoyed by well-off outright owners. They would facilitate the operation of mixed tenure schemes both by enabling renter households to accumulate equity in their dwellings and by enabling owner occupiers to divest themselves of part of the equity they currently own.

The possibility that such market oriented structures may not result in housing that is affordable to all was addressed by the provision of a rental subsidy that met any gap between the cost of providing rental housing funded with equity bonds and the rent deemed to be affordable. The equity bond proposal, along with a proposal for a revised form of rent assistance to be extended to all low to moderate income households formed part of the National Housing Agenda articulated by the National Housing Strategy after a 2 year research and consultation process.

5.4 Supply Side Proposals

The proposals considered in section 5.2 addressed affordability problems by focussing primarily on the financing of housing - whether rental or owner-occupied.

An alternative approach is based on the view that it is the supply side of the housing market that has the primary influence on the cost and hence affordability of housing. Caplin, Joye, Glaeser, Butt and Kuczynski, hereafter Caplin et al (2003), examine the relationship between the market price of housing and the value of the inputs used in its production. In their view, a growing discrepancy between these - interpreted as a housing needs-production mismatch - is seen as an indicator of growing unaffordability for low to middle income households and as an opportunity to address the underlying source of the problem.

This mismatch, in turn, is attributed to what they describe as the extrinsic cost of land (p276) which is distorted by zoning regulations and/or land release strategies. On the basis of what they admit is a highly aggregated and relatively simplistic analysis, they argue against establishment of a centralised agency but do advocate State-based provision of model zoning codes that could be adopted voluntarily by

¹¹ This presumes that rental housing so funded is supplied by a non-profit provider so that all the tax benefits embodied in the equity bonds are passed through to renters in the form of lower rents than would otherwise be the case.

councils and call for more information on efficient ways of dealing with the legal complexities associated with the planning process.

A second solution, which mirrors that proposed by the 1998 NSW Ministerial Task Force on Affordable Housing is to allocate targets for new supply on a suburb by suburb basis. These would be based on size and density of current housing stock and environmental considerations inter alia. Fiscal support from the State would be tied to performance in meeting the targets. They also float the notion of an equity assurance scheme (based on emerging developments in the US) that would protect home owners from any loss of value in their residential investment as a result of the impact of undesirable developments associated with local governments meeting their supply targets.

Whilst most of these proposals are untested and whilst there are a number of concerns about the evidence used to justify the claims made, the reminder that supply side policies need also to be considered is important.

5.5 Australian Experience in Relation to Implementing Proposals to Increase the Supply of Affordable Housing¹²

Although none of the funding proposals described above has been adopted in Australia, over the last decade individual jurisdictions have experimented with small scale initiatives that aim to stimulate the supply of affordable housing outside of the traditional public and community housing sectors¹³.

The largest and most established initiative is the Affordable Housing Program (1994) operating in the redevelopment precinct of Pyrmont/Ultimo in Sydney's Inner West. The program's primary aim is to ensure that a socially diverse residential population representative of all income groups is maintained in the area, which is being redeveloped as a high quality mixed living and working environment (DOP, 1992; DUAP, 1995). Under the program, up to 600 units of medium density housing are being constructed or purchased over thirty years for renting to a mix of very low, low and moderate income households^{14,15}.

To facilitate the delivery of the program a new entity, the City West Housing Company Pty Ltd (CWH), was established by the NSW government in 1994. CWH is a not-for-profit public company limited by shares. The NSW Treasurer and the Minister for Housing each hold one of the two ordinary shares in the company. CWH develops, owns and manages the housing funded under the program.

¹² Section 5.5 was compiled by Dr Vivienne Milligan, Sydney AHURI Research Centre, based on her detailed research (Milligan (2004).

¹³ There was also a range of one off or small scale initiatives in the 1980s in Australia which are not referred to here because they have not been replicated or extended. Berry (2002) provides an overview of several of those innovations.

¹⁴ The target income groups are defined with reference to the Sydney region gross median household income as very low: less than 50 per cent, low: 50 to less than 80 per cent and moderate: 80 to 120 per cent.

¹⁵ By 2003, 340 units had been completed.

Three funding streams were established for the program: equity contributions sourced from the Commonwealth and State governments, respectively¹⁶ and developer contributions required under the planning instrument for the area¹⁷. In effect, the program has been 100 per cent equity funded up front, similar to the post 1989 funding model for public housing. There is no provision for any ongoing government subsidy. Rents, which must cover all long term property and tenancy management costs, are currently set at 25 to 30 per cent of household income, depending on the household's income band.

In 2002, following a broadly similar approach, the Brisbane City Council and the Queensland Department of Housing established and funded the Brisbane Housing Company Pty Ltd to develop and purchase housing for letting to public housing applicants at sub market rent levels in inner and middle ring suburbs of Brisbane. The Company's first four year business plan envisages acquisition of around 400 dwelling units of which about 100 have been secured using capital given to the Company by its two government shareholders (personal communication). While debt financing and developer contributions have been envisaged for this model, they have not been achieved to date.

A different approach to the generation of affordable housing has been taken by the City of Port Phillip, Victoria (formerly City of St Kilda) in partnership with the Port Phillip Housing Association, which acts as a tenancy and property manager. Operating since 1985/86, the Port Phillip Housing program has produced around 460 dwelling units¹⁸ for long term low cost rental in this rapidly gentrifying area of inner Melbourne. The program has been opportunity driven with projects initiated by the Council used to leverage Commonwealth and state government funding contributions under varying housing programs that have operated over the last eighteen years. Overall, Council estimates show that every \$1 of their contribution in the form of land or capital has leveraged \$1.63 from other government agencies for the provision of affordable housing (City of Port Phillip, 2003). Several projects have featured arrangements with the private sector that have reduced risks and/or up front costs to Council. Council has also used its role to achieve a range of local objectives in specific projects, including influencing the quality of urban design, encouraging tenant participation in project design, integrating community art projects and demonstrating ESD principles.

At O'Connor in Canberra, Community Housing Canberra Ltd (CHC)¹⁹ has completed the first mixed social and private housing development by a not for profit developer in Australia. The project, known as City Edge, was developed as a joint venture with a private sector partner on a former run down public housing site that comprised 143 hard to let bed sit flats with an average size of 30 square metres. Of the 126 new units developed, 15 have been returned to the public housing authority as consideration for the value of the site at the time it was transferred and 15 have

¹⁶ The Commonwealth's contribution was made through the Better Cities Program (1991- 1996). The State government is contributing a percentage of the proceeds of the sale of government owned land in the area.

¹⁷ Provision was made in the planning instrument for developer contributions to be either 'on site' or an 'in lieu' monetary contribution. In practice, all developer contributions have been monetary.

¹⁸ Total includes units currently planned or under construction.

¹⁹ Community Housing Canberra is a not for profit corporation (limited by guarantee) established in 1998 by the ACT government to provide an asset and property management capacity for the community housing sector. The government appoints three of seven directors to the Board of the Company.

been retained by CHC for sub-market rental. Those units were funded from a mix of surplus funds held by the Company²⁰ and their share of the profits of the development (personal communication). However, in the absence of any direct equity investment or subsidy support from government, a higher share of social housing units to replace the social housing capacity lost through the redevelopment could not be achieved in the development or off site.

There are only a handful of other local governments and non government organisations²¹ in Australia that have experimented with the development of innovative affordable housing options, usually in joint venture arrangements with state government housing agencies. Normally, the joint venture partner has brought land, capital and/or very small tranches of private finance to the project. Typical projects have been characterised by their small scale and long lead times in planning and development²².

In the absence of national strategic framework for growing affordable housing in Australia, the development of affordable housing projects has been largely experimental and fragmented, with most existing projects achieving only minor innovation and a low degree of leverage. However, the new housing companies are accumulating valuable unencumbered housing assets that, with appropriate subsidy support, could be used as collateral for further developments²³. To date, the range of affordable housing products developed has also been limited. While some diversification of tenant groups and dwelling types (for example, boarding houses) is evident, policy settings (on eligibility and rent setting, for instance) mirror those for public and community housing, with one or two exceptions.

Some of the barriers to up-scaling and diversification of the potential models identified by stakeholders include:

- The reluctance of most state housing agencies to support and resource a significant level of development and ownership of subsidised housing by existing non government housing providers;
- Declining funding for new housing supply;
- No pre-identified funding allocations for affordable housing providers which results in project opportunities being lost while funding is sought;
- Narrow policy settings and the absence of a strategic policy framework which stifles innovative responses; and

²⁰ CHC receives an annual subsidy from the ACT government to manage 209 properties transferred from public housing.

²¹ The leading examples of NGOs which have been involved in joint venture or independent housing developments are Ecumenical Community Housing Co. Ltd, Supported Housing Co. Ltd and Community Housing Co. Ltd, all in Victoria and Perth Inner City Housing Association Inc. For an overview of local government initiatives, see Gurran (2003). It should also be noted that in the aged housing sector, under Commonwealth policy that operated from 1954 to 1986, not for profit development of independent living units for older people was quite extensive in Australia (see McNelis and Herbert (2003).

²² Information from interviews with project proponents undertaken for AHURI Research Project No. 60191: A practical framework for expanding affordable housing services in Australia: learning from experience.

²³ For example, the housing assets of City West Housing were valued at over \$100 million in 2002 (City West Housing Pty Ltd, Annual Report, 2001/02).

- Limited recognition of affordable housing principles in planning policies combined with a widespread lack of experience with affordable housing projects in local government. These factors contribute particularly to difficulties experienced by not for profit development agencies in competing for sites and to costly delays in achieving planning approvals.

Where these barriers have been removed, such as in the government-initiated programs operating in Sydney and Brisbane (described above), projects have proceeded to plan without significant difficulty.

The situation of the non government affordable housing sector in Australia today can be compared with that in the United Kingdom, particularly England, two to three decades ago before the rapid expansion of the role of housing associations in delivering a range of housing products and services (as detailed in chapters 3 and 4). To summarise the earlier discussion, key factors contributing to the take off and continuing expansion of that sector in England were:

- Government policy favouring provision in the non government not-for-profit sector;
- The transfer of large amounts of local authority housing stock to housing associations, which, among other effects, increased their operating scale and improved their revenue base;
- Engagement of the private sector in extensive lending for social housing growth and refurbishment, in partnership with the housing associations;
- Substantial, long term capital and recurrent subsidy support for the sector;
- A specific regulatory framework which has evolved in line with the development and diversification of the sector; and
- In the 1990s, inclusion of mandated affordable housing requirements in the planning policies of local areas with an established shortage of affordable housing.

5.6 Lessons from the British Experience

Governments in both the United Kingdom and Australia are committed to supporting housing systems that deliver affordable and appropriate housing to all their citizens. In both countries recent economic and social developments have challenged this policy goal. In particular, the increasing globalisation of economic activities and the liberalisation of national economies are forces that have largely removed housing from its historically protected, even cocooned position. The general neo-liberal turn in policy in both countries, re-defining the role of government, has placed constraints on traditional loan and tax sources of funding for areas like housing while at the same time leading if anything to higher aspirations. This has led to a common interest in leveraging private investment into the provision of affordable housing – and to a necessary concern for identifying and pulling the appropriate policy levers.

However, the institutional histories, methods and trajectories applied differ markedly between the UK and Australia. Housing policy in the former has undergone significant reform over the past 30 years, with major policy innovations like Right to Buy, large scale public housing stock transfer, various forms of shared equity and s.106 planning instruments substantially changing the tenure distribution and ownership structure of British housing. Housing policy reform in Australia, by contrast, has been muted, largely confined to internal changes to the dominant social housing policy vehicle – the Commonwealth State Housing Agreement. The CSHA

was introduced over 50 years ago and continues to form the focus for housing policy debate in this country. Earlier attempts by governments in Australia (state and federal) to further boost home ownership have been wound back – an example of what Dalton (1999) termed ‘the withdrawal of the state’ from this policy terrain. The introduction (in 2000) by the Commonwealth of the First Home Owners Grant was ostensibly intended to offset changes to the general taxation system and not part of a rediscovered commitment to expand owner occupation. The one major housing policy innovation in Australia over the past 20 years was the expansion of Commonwealth Rent Assistance program delivered through the social security system. However, even here, it can be argued that CRA is, in fact, a form of income support or supplement for benefit recipients, rather than a transparent housing benefit tailored to actual housing circumstances, as is more the case in the UK.

Although the institutional and funding climate has been much more conducive to attracting large flows of institutional investment into social and affordable housing in the UK, it is true that this has overwhelmingly been with respect to private *debt* finance. In neither country has there been much interest by professional and institutional investors in committing *equity* funds. (However, in the UK, this may change under the central government’s proposed new Private Investment Fund’ program.) Expectations of continuing house price rises have been important in the preparedness of small landlords to accept rents below those necessary to meet the risk-adjusted returns required by institutions. Limited demand from those with capacity to pay, inadequate and incomplete market information on the real risks involved in rental equity investment, along with the absence of relevant secondary markets, have similarly been effective barriers²⁴.

What, then, are the main lessons or pointers the British approach has for Australia?

The first and most obvious point to make in answer to this question is that the UK Government has, and has had for many decades, a much more substantial housing role and funding commitment to social and affordable housing than the federal, state and territory governments combined. The scope and scale of housing policy is greater in the UK and entails a commitment to relatively generous levels of housing benefit for tenants; a high level of social housing grant (to local authorities and housing associations), a robust regulatory framework and an effective central government guarantee to private lenders to housing associations; and an aggressively interventionist land use planning system that mandates private developer contributions to affordable housing outcomes. That said, and as argued in this report, the level of the future government funding commitment to housing in the UK is problematic. In both countries the challenge of ensuring sufficient public funding for major policy areas like housing is intensifying.

If Australia is to follow the UK in leveraging private investment at a reasonable cost then substantial institution (and trust) building will be required. Private investors will need to be confident that the risks are transparent and manageable in order to price their involvement at a level that does not require politically impractical levels of subsidy or guarantees. As the parallel AHURI study by Milligan (2004) demonstrates, governments in Australia, especially at the state level, are loath to support and resource non-profit housing organizations, making it more risky for private investors to do so. However, as Milligan also argues, if governments in Australia were to follow

²⁴ These factors are discussed in detail by Crook (2000) with respect to the UK, Australia, Canada and the USA. For Australia, also see Berry (2002).

the UK lead and strongly favour provision by the non-profit sector, that sector's role and impact could grow progressively over the medium term in this country, supported by large scale private investment. Such an outcome would depend on both an adequate level and targeting of subsidies, on the one hand, and on substantial institution and capacity building, on the other.

*What is apparent from the relatively successful British experience is that **both** demand side **and** supply side subsidies are required at substantial and sustained levels to attract large, sustained inflows of private finance to the sector.* In Australia's federal system of split responsibilities this places a high premium on close cooperation between the three levels of government. It is unlikely that a successful affordable housing policy can be conceived and implemented at any one level in Australia. In this context it is worth noting that a standing committee of federal and state housing public servants is currently (mid-2004) developing a set of policy proposals for boosting the supply of affordable housing, drawing on instruments and commitments at each level of government. Nevertheless, as the UK experience amply demonstrates, a major advance on the large scale involvement of private finance will entail clever and committed institutional design. For Australia important questions remain. If a significantly larger role is to be taken by the non-profit community housing sector:

- would the regulatory framework follow the arms length UK model of a statutory regulator, *and*
- if so, would this regulator be located at the federal or state level, *or*
- would the state housing authorities perform the intermediary function, borrowing and on-leasing to the community sector?

The British experience clearly establishes that large financial institutions **will** invest in affordable housing provision **if** the right institutional and funding parameters are in place. The Australian and British financial systems are both highly developed and global in reach. The fact that one of Australia's largest banks, the National Australia Bank, has been a member of consortia funding the transfer of council housing to the housing associations in the UK demonstrates the potential for similar developments in Australia – but only if the current barriers described earlier can be overcome.

The second lesson is a negative one – it is very difficult to establish a private equity market for rental housing, especially at the affordable end. Only in the United States has this market developed to any extent and, even there, it is relatively marginal (and very costly in tax subsidy terms). Suggestions for overcoming the barriers have been made including the creation of tax exempt residential letting schemes together with the introduction of strong codes of practice setting minimum standards for the management and maintenance of privately rented dwellings and tax transparent REITS. Politically, this approach would be very difficult to introduce in Australia, where the trend has been the other way – viz. winding back special taxation arrangements. The other basic problems with attracting private equity investment into this sector are:

- the continuing contradiction between affordability and making a profit; equity investors normally bear the residual risk in return for the chance of appropriating unconstrained returns;
- it costs too much; the required subsidies from government will be higher than those necessary to attract debt finance;

- growing income inequality and increasing concerns about social change impacting on the demand for low income housing, including the prevalence of anti-social behaviour, which may increase the costs of landlordism.

If the full equity approach is too difficult to traverse, then Australia might learn from the British experiments in different types of shared equity arrangements to help access to owner occupation. The challenge in both countries here is to establish simple and transparent arrangements that will encourage private investors or non-profit housing providers to take up their equity shares and to build longer-term equity arrangements. We have argued (earlier in this chapter and at length in the appendix in relation to the Caplin and Joye model) that capital markets left to themselves are unlikely to move in this direction – this is especially the case at the current time given the general nervousness in both countries about the stage of the property cycle. However, as noted above, in the UK, there are some signs of an emerging appetite for an equity housing vehicle. Small scale and piece meal schemes are also unlikely to make a significant impact. To be sustainable and (in particular) to establish a viable secondary market for any private equity component a sufficient volume of transactions is required. In the UK the main shared ownership scheme relies on the housing associations to hold equity, underpinned by that sector's grant and loan system. Others require up-front government subsidy.

To work in Australia shared equity schemes would need to wait until there was a viable community housing sector, if the existing British approach is adopted. Alternatively, each State and Territory could establish a special-purpose vehicle to play the equity partner role. The key question then would be – how are these agencies to be funded and held accountable. If government wished to remain more at arms length and stimulate the growth of a genuine private shared equity market, it would have to deal with the current barriers identified with respect to the Caplin and Joye model and similar approaches. It is also worth repeating that the effective subsidy costs to government in attracting private equity are probably always greater than relying on existing private debt arrangements, because of the existing equity premium in capital markets. The final hint, in this instance, from the British experience is that purchasers demand the opportunity to 'staircase' – i.e. the option of increasing their ownership share over time to 100%. Given the important historic role of owner occupation in Australia, it is very likely that this option would be highly regarded here.

A third lesson for Australia might come from considering the debate and tentative developments in the UK around the re-introduction of the role of employers in housing provision. This currently focuses mainly on certain public sector employees in high value regions like London, although the basic approach is nationwide – and depends significantly on ownership of land and on the use of the land use planning to determine the value of that land. Since all three levels of government in Australia are large employers, this again suggests the need to coordinate and share such a role, which would entail an explicit recognition that the housing role of government extends well beyond supporting the private market and supplementing at the edges. Direct intervention in housing provision, by avoiding excessive deadweight cost, may be a more flexible, better targeted and less costly way for governments in both countries to deal with their 'key worker' problem in rapidly growing regional economies. However, any demand side subsidy would need to be matched by an appropriate new supply response.

A fourth lesson centres on the highly interventionist nature of the planning system in Britain. Land use planning has a number of not always consistent objectives, of which housing design and location are only two. Given the high environmental, social and economic costs (externalities) associated with unplanned urban development, it is inevitable that planning authorities will sometimes act in ways that constrain the supply of housing in relation to growing demand, with associated higher costs of land. Property markets, like other markets, fail in many situations, on both efficiency and equity grounds. If housing prices are not to be driven beyond affordable levels in situations of constrained supply, the planning system can be used to facilitate (require) affordable outcomes, both in terms of land provision and cross subsidy from market housing.

If Australian state governments move in this direction (as the N.S.W. government has tentatively demonstrated) they will have to find effective ways of amending or replacing existing legislative planning instruments and dealing with political opposition from 'the development lobby'. A single state government moving in isolation to limit new urban development in this way would also have to face the issue of inter-state competition for property investment and the potential economic and political costs entailed. One way to limit this 'bidding down' phenomenon familiar to the Australian Federation would be for the Commonwealth to broker a national approach to 'harmonise' the resulting planning changes across the States and Territories, as has occurred in other policy arenas like the Coalition of Australian Governments.

A fifth lesson stems from the growing British focus on the *macroeconomic significance* of housing markets and policy – both in terms of the market's effect on interest rates and macro volatility and an increasing concern about competitiveness. Elements of this issue have been brought home to Australian federal policy makers during the recent housing boom. The Reserve Bank of Australia has been carefully tracking the links between interest rate movements, housing investment, consumer debt and aggregate consumption demand in the economy. The current 'debt overhang' places 'speed limits' on the broad economy that may, in turn, feed back into housing investment and construction rates, with further consequences for housing affordability. In the current era of globalisation housing assumes a more central economic role than in the past and renders more complex the RBA's role of simultaneously achieving full employment, low inflation and external balance. Australian housing and economic policy makers can therefore learn from the extensive British research and policy developments in this field.

Finally, perhaps the most important lessons to be gleaned from the British experience is that housing is and will always be a central concern of good government, especially with increasing disparities in incomes and housing costs. As a corollary, it is clear that the development of appropriate institutional forms takes time. The current UK arrangements have emerged over a 30 year period. Long term policy development and implementation requires long term bipartisan political commitment, based on workable alliances between the key government, private sector and professional organizations. In relation to the private financing of affordable housing, potential private investors, especially the key institutions like the banks (and their peak associations, the Council of Mortgage Lenders in the UK and the Australian Bankers' Association), need to be consulted and comfortable with the emerging policy regime, especially where changes are being mooted. Political risk must be minimised in order to get private investors of all types – financial institutions, institutional equity and individual equity - to the table and to keep them there at a low cost to government.

6 CONCLUSIONS AND IMPLICATIONS

The research presented here reflects the fact that there are many differences between Australia and the UK. In particular, the institutional (and Constitutional) arrangements within which housing policy is delivered differ markedly, meaning that the question of the transfer of policy approaches needs to be treated with caution. Even so, there are many ideas that have resonance and lessons, both positive and negative that can be drawn.

The main conclusions and implications of this study are discussed in relation to the seven research questions posed in chapter 1.

6.1 Key Findings

Research Question 1: What is meant by “affordable housing” in Australian and British policy debates and developments? How has this changed in recent times? What impacts on policy are these changes having?

In Australia, affordable housing has been cast within a debate influenced by the issues of poverty and income support. The private rental housing sector has been seen as the locus of greatest housing stress or housing related poverty. Home ownership was generally seen to be the ‘normal’ destination for most households over their housing careers. A small social housing sector, dominated by the state housing authorities, provided housing of last resort to eligible households who were unable to move into owner occupation. Commonwealth rent assistance is provided to eligible private tenants but the level of assistance is not related to actual market rent levels across spatial housing markets. Income related rents are only levied in the public housing sector. In consequence, research has shown that a significant and growing proportion of lower income private renters are paying rents in excess of conventional affordability benchmarks. In Australia’s recent urban housing boom rents have tended to lag behind dwelling price inflation, in part due to the sharp investor-induced increase in the overall rental supply. However, this increase has been concentrated in middle and high rent segments of the private rental market; contracting supply in the lowest rent segments has reinforced affordability problems for low income households seeking to rent in these segments.

Over the past 20 years changes in the housing system and broader economy are both reinforcing the affordability problems faced by many private tenants and increasing problems of accessibility of lower income and younger households to home ownership. A slowdown in the growth of public housing since the late 1980s has put further pressure on the private housing market to respond. Affordability and accessibility problems now impact on a larger proportion of the population. Attention has begun to focus on the relationship of rent and house prices to household income levels.

The recognition of these wider concerns and growing impacts has begun to change the policy debate away from an exclusive concern with households in the lowest income quintile and facing multiple disadvantages – seen to be the exclusive focus of the state housing authorities – towards households higher up the income scale and falling into particular cohorts, especially under 35 year-olds. The ‘key worker’ argument has focused attention on the negative impacts of inadequate and unaffordable housing on regional economic performance. The drop in the first home ownership rate in the recent housing boom has sparked a national enquiry. The spatial dimension of urban housing markets has raised the spectre of social exclusion, which in Australia means the movement of lower income households to

peripheral urban fringe or non-metropolitan locations, away from jobs, services and social supports. Governments facing tight, politically imposed public borrowing and spending limits, have begun to look to private investors as a potential source of finance for affordable housing. The States and Territories have committed to developing this approach in the current Commonwealth State Housing Agreement. To date, a series of one-off and demonstration projects have been introduced, some dating from the 1980s (for details, see Berry, 2002). However, there has been no large scale, continuing program successfully implemented in any jurisdiction.

In the United Kingdom housing policy has long had the general aim of ensuring that all households achieve 'a decent home' at a price within their means. With a much larger social housing sector than Australia's, tenants enjoy 'as of right' benefits of below market rents and security of tenure as well as access to housing benefit. Private tenants with low incomes also have access to housing benefit as of right and that benefit is currently structured to ensure adequate after-housing cost income for those with full eligibility. Affordability outcomes are thus sought through the delivery of both supply side and demand side subsidies aimed at eligible households. The private rental market is both smaller than in Australia and less important as a tenure of last resort for households experiencing housing stress. Large proportions of lower income households are located in the social housing sector. Affordability is therefore defined not through the application of housing cost-to-income benchmarks but in terms of subsidy eligibility and coverage. Affordability problems are concentrated among households who, for various reasons, are ineligible for or fail to collect benefits. Such households are increasingly concentrated in the private rented sector.

Over the last few years the recognition that there are lower income employed households who cannot access owner-occupation but who will be poorly served by the private rented sector has led to a range of policies aimed both at such households in general and at key workers in particular. These schemes are relatively small in terms of impact but high profile in terms of the political debate.

In terms of provision, affordable housing, in this context, is aimed at:

- Permanent tenants – i.e. those who have incomes insufficient to sustain home ownership
- Aspiring home owners on lower incomes who are only able to access the lower value end of the market
- People with special and multiple needs

Historically, the main policy mechanism for delivering affordable housing has been, first, by way of central government capital grants to local government and the housing associations and, secondly, through housing allowances. More recently, the land use planning system (s.106) has been used through local government to require new developments to include a component of affordable housing. Indicators of needs include local housing needs assessments and affordability indicators. Following the recommendation of the Barker Review (2004) the government has now agreed to consult on a consistent long term measure of affordability at the local level.

Research Question 2: What are the scope, volume and impact of private investment in affordable housing in Britain, focused on the past 5 years?

Over the past 20 years the quantity of social housing provided has declined in both relative and absolute terms. Moreover, an increasing flow of private investment has been directed to the provision of social (and more recently, affordable) housing in the

United Kingdom. There were three fundamental institutional conditions present that underpinned these developments.

First, the local government sector owned almost a third of the housing stock, providing an option (taken up from the 1980s on) of transferral at subsidised rates to sitting tenants or housing associations, without recourse to additional current funding.

Second, in line with developments throughout the advanced western economies, financial markets were progressively deregulated and liberalized, providing the capacity to fund new social housing and a range of low cost home ownership initiatives, including the public tenant 'right to buy'.

Third, the existing land use planning system gave local government the power to mandate affordable housing provision as a 'material consideration' for land development and re-development.

On the demand side, the growth in (and certainty of) central government subsidies to low income tenants, public and private, reduced the risks faced by private investors and institutions engaged in affordable housing provision.

In consequence, developments in the UK over the past decade, in particular, have witnessed the reduction of direct public sector involvement and the progressive increase in the role of private investment and the restructuring of housing subsidies while maintaining a commitment to affordable housing outcomes.

From the late 1980s onward, housing associations facing uncertain and often declining levels of government assistance were able to leverage that subsidy (provided in the form of the Social Housing Grant) and borrow from mortgage lenders and in commercial bond markets to finance new housing additions. Typically, leverage which started at only about 10% has settled at around the 50/50 mark – with marked regional variations. Their capacity to access, service and repay private debt was facilitated by the introduction of some flexibility in rent-setting, the subordination of the government grant as a charge on HA assets after private creditors' obligations were met and the regulatory role of the Housing Corporation. The cost of private debt finance has, consequently, been relatively low, reinforced by a wide perception in financial markets of an implicit government guarantee on default.

The total volume of private financing in the social housing sector climbed throughout the 1990s and stood at around £34 billion in 2003. Annual investment flows have subsided somewhat since the first half of the 1990s but, early this century, still stood at around £2 billion annually. These figures include finance for the transfer of stock from local government to HAs (see comments regarding research question 7, below). Total spending has now been increased to £3.5 billion and we are awaiting the government's response (in spending terms) to the Barker Review. Broadly there has been apparent government 'buy in' to the view that spending should increase, not just as a gesture to welfare politics but because housing is an issue within the functioning of the economy. However much of the funding is also likely to be provided to achieve other objectives including, in particular, regeneration and sustainability which will increase the unit costs of provision. This market has over 150 active lenders across the UK but is dominated by a small number of large lenders. In England, banks provide about 60% of finance and building societies a further 20%. Un-hedged variable rate loans predominate. Smaller HAs join together to negotiate better terms from lenders. With the maturing of the market and the strong regulatory underpinning, lending margins and asset/income cover ratios have fallen. Risk appears keenly priced, some argue too keenly because of the lack of variation in rates between associations with very different asset bases that do not

reflect the real underlying risks entailed, especially in some of the later LSVTs and small specialist housing associations. The loan rate to HAs for new stock is around 30-50 basis points above the interbank lending rate. To date there have been no significant loan defaults.

In addition to the funding of HAs through a mix of grants and private borrowing, around 900,000 houses have been transferred from local government to the HA sector. The transfer is normally funded through 100% private mortgage loans, with the house prices discounted to reflect local market conditions, the state of the stock and the need for investment to achieve decent standards. Hence, there are, in fact, two markets for private investment in social housing in the UK. The first concentrates on the general funding of HA stock additions and the second on the specific transfer of local government stock to the HA sector. The latter market is dominated by a small number of large lenders and syndicates who typically provide finance in tranches exceeding £50 million.

Under the current Labour Government stock transfers have declined, in part as a result of liberalisation in local authority finance regimes and the creation of arms length management only organisations to manage the stock ownership remaining in the public sector. This option is increasingly popular with local authorities who have public housing stock in reasonable condition and access to central government capital funds for upgrade and maintenance. In response to the failure of some large wholesale transfer bids, the central government has increased the emphasis on partial (estate specific) transfers. The implication of both the decline in and the move to smaller transfers has reduced the demand for private finance for this purpose.

A recent review of the stock transfer scheme by the National Audit Office generally concluded that, although more expensive than conventional public housing, it delivered value for money in the government's own terms. In general, the early transfers have been financially successful and have generated operating surpluses and evidence of better management for receiving HAs, providing further comfort for private lenders in this market. An unanswered policy question concerns whether or not government should claw back some of these surpluses, which might, however, have the effect of increasing risk to lenders which would be reflected in the future cost of financing transfers.

The other major expansion in private debt funding for affordable housing has focused on government policies to expand home ownership. Central and local Government has supported low income owner occupation through:

- Large capital subsidies with respect to Right to Buy
- Use of the Social Housing Grant to help fund shared equity schemes through the HAs
- Use of s106 planning powers to direct land and subsidy to new provision
- Loans to support the purchase of low cost houses in high value regions

In each case mortgage lenders finance the balance after the discount (on Right to Buy dwellings), cash grant or HA equity (in shared equity) is accounted for. The risk to lenders is lower than it otherwise would be, due to the relatively low loan-to-value ratio implied.

Around 2 million public tenants have purchased their dwellings under the Right to Buy scheme since 1980 (80% in England). Much smaller schemes have been introduced covering the outright sale to housing association tenants.

A cash incentive scheme with grants, usually of around £10,000, to eligible tenants has assisted about 30,000 households into owner occupation.

There are three shared equity schemes in operation. The first relates to new houses constructed by HAs, financed by a mix of grant and private mortgage finance. The applicant's initial equity stake varies and can be increased to 100 per cent. Some 45,000 dwellings have been provided under this scheme. A second variant of this approach allows the approved applicant to purchase an existing dwelling (up to a value limit), resulting in a further 25,000 transactions to date. The third scheme, Homebuy, enables the purchaser to take out a mortgage on 75% of the house price and receives a 25% interest free 'equity loan' on the remainder repayable (with a share of capital gain or loss) on re-sale. About 5,000 sales have been funded in this way.

The most recent scheme to boost home ownership began with the Starter Home Initiative, focused on designated key workers and concentrated in high property value areas, such as the South-East. The assistance was initially provided as a grant but later versions deliver an equity loan, as in Homebuy. The scheme was slow to get off the ground but around 9,000 transactions will have taken place by mid 2004. However, this reflects a developing approach moving towards alleviating employment problems through housing initiatives as well as increasing accessibility and affordability and including broader concerns related to area regeneration, social mix, public services and employment. The greater scale and diversity of the successor Key Worker Living programme reflects the government's continuing concern and includes assistance for specified groups with incomes up to £70,000. Although there have been discussions with both lenders and employers the government ultimately went for a public funded solution (albeit beneficiaries also take out a private mortgage).

The glaring gap in the private finance of affordable housing in the UK, as in Australia, is the absence of private *equity* investors and indeed the means to develop mixed equity approaches. A number of small schemes have been tried – such as the Business Expansion Scheme and housing investment trusts – but have made little or no headway (Crook and Kemp, 1999). Grants to developers which are being introduced in 2004 may also suggest a way forward. Britain still does not have a large private rental sector with an active class of small landlord-investors, as in Australia – even though this element of the sector has increased by over 50% in the last decade. Overwhelmingly, private investment in affordable housing in the UK has focused on the role of large lending financial institutions operating within a highly regulated social housing sector and (less so) the owner occupation market. The recent growth in the Buy to Let market (individuals borrowing to buy homes to rent out) has been funded through mortgage finance (nearly £40 billion to date). However as portfolios grow we can expect to see more of these landlords inject equity.

There are some small equity based schemes emerging and one, Asset Trust, has recently set out its ambition to provide 10,000 homes over next five years (£1 billion on a mixture of rent and ownership schemes with City backing and run through housing associations).

The conclusions relating to research questions 3 and 4 will be summarised together in what follows.

Research Question 3: What were the barriers to private investment encountered and how were they overcome in the British case?

Research Question 4: *In particular:*

- a) what institutional reforms and capacity building were required in order to ensure greater private investor involvement? And what barriers/constraints still remain?
- b) What public policy levers were necessary/successful in stimulating appropriate investment and supply responses?

The main barrier to private investment in the social housing sector was the highly regulated structure of the sector. Local government had strictly limited financial powers circumscribed by central government control, while the housing associations were regulated under statute. Hence, the major providers of social housing did not have freedom of action to operate in financial markets. Throughout the 1980s and 1990s the regulatory framework was progressively altered to allow and encourage the growth of private lending for social housing construction and stock transfer, as described in chapters 3 and 4. Smaller schemes were introduced targeted on low income home ownership, the largest being the Right to Buy. Sporadic attempts to encourage private equity investment in affordable housing have, to date, been unsuccessful, in part because of the current institutional – especially taxation – regimes and the high risks relative to expected returns, in the absence of adequate government subsidies and/or guarantees.

In the early stages the unfamiliarity and novelty of the emerging social housing market caused both lenders and HAs to proceed with caution. However, as the market matured lending margins fell, reflecting the accumulation of market information and the increasing confidence with which lenders were able to price risk.

An initial and continuing risk faces investors – viz. the political risk associated with future changes in government housing and social policy. Housing in the UK is an important social good, the subject of changing government policies for a century or more. The viability of HAs – individually and as a sector – depends critically on the maintenance of an effective and robust regulatory framework and a continuing commitment to the payment of housing benefits. The risk is reduced to the extent that the average loan-to-value ratios are relatively low and falling with general house price inflation.

The limited stock of relevant specialist financial and management expertise in a highly fragmented HA sector, with a large range in the size, scope and efficiency of individual associations, has constrained the growth of private investment. This has to some extent been overcome by the continuing trend to concentration in the sector via mergers and collective arrangements. The HAs have had to become more professional in their approach and levels of accountability, in order to continue to access both the social housing grant and private loan finance.

These barriers have, as noted, largely been overcome through continuing institutional reform over a 20 year period. Without the strong presence of the Housing Corporation, as both grant agency and regulator, it is highly unlikely that financial institutions would have entered the social housing field and certainly not at the low cost of finance that has evolved as the market developed and grew. Likewise the payment of housing benefit remains central to HA viability and lender confidence.

A number of the favourable factors underlying the rapid growth of private financing in the 1990s, especially for social housing, have begun to change. The central government is phasing in a form of rent control, tying rent levels to local property values. This may, in some areas, impact on the capacity of individual HAs to match

rental revenue and costs, potentially raising the risk of default on loans, which may, in turn, adversely affect the volume and cost of private finance. The greater uncertainty facing lenders is compounded by the current pilot scheme that ties the level of housing benefit for private tenants to average rents in an area. Such a policy may be extended to the social housing sector.

Other institutional changes are in the wind that further increase uncertainty about the terms on which private finance will be engaged in the social housing sector. The multiple roles of the Housing Corporation are under scrutiny – in particular, it has been suggested that the regulatory function could be taken over by the Audit Commission. The move to greater devolution in government raises the prospect of the regional governance agencies gaining a greater role in the allocation of grants to HAs in their regions. The Housing Corporation has signalled that its grant allocations will favour a relatively small number of HAs, perhaps encouraging a new round of amalgamations or looser coalitions among under-performing associations.

To date, schemes for expanding low income home ownership have been piecemeal and relatively small scale. The rapid and continuing rate of house price inflation, especially in the South-East, has increased affordability and access problems for lower income households. The Labour Government has only recently, in the wake of the Barker Review into housing supply, expressed a strong desire to address this issue. The main policy levers to be used appear to relate to the planning system, including the use of 'some Greenfield sites' and the introduction of a tax on 'windfall' development gains and second homes. The Deputy Prime Minister indicated that most of the new housing would be for owner occupation but 'many tens of thousands' would be for social housing directed, in particular, at key workers in the public sector.

There are other remaining and, perhaps, intensifying barriers to the growth of the private finance market in social housing in the UK. They can be categorised as follows.

- (1) *Market demand.* Housing demand is changing in a very uneven geographic pattern. Rising demand in the South is occurring alongside stagnation and decline in parts of the Midlands and North. Unless population and job loss can be reversed in these areas housing over-supply and obsolescence will intensify there. HAs with stock concentrated in declining regions are particularly at risk (estimates suggest there are 189,000 units directly at risk involving some 295 HAs), as are their lenders.
- (2) *Scale and performance of housing associations.* To date, the private finance market for social housing has been a relatively undifferentiated one. This may change as government seeks to increase efficiency by directing subsidy and other support away from underperforming associations to those that meet demonstrable performance outcomes. Smaller associations, in particular, may face less favourable funding opportunities as lenders more finely price risk to reflect the changing institutional environment. The fact that the social housing grant is effectively a subordinated loan by government and repayable on dwelling sale means that it appears as a liability rather than an asset on the associations' balance sheets.
- (3) *Alternative lending opportunities.* The new banking regulatory regime to be introduced by the Bank of International Settlements (Basel 2) will further force financial institutions to recognise and more carefully price risk in areas like housing. In addition, HAs offer relatively low returns to match low risk (in

the current institutional environment). There is a limit to how much low return-low risk assets institutional investors will wish to hold in their portfolios, relative to the need to diversify adequately into higher risk and return alternatives.

- (4) *Consolidation in the finance market.* The process of mergers and takeovers characterising the financial sector in the UK will also place constraints on the loan exposure of institutions to both individual HAs and the social housing sector as a whole. On the positive side, larger associations will have increasing access to the bond market where the scale of financing (the average value of the transaction) is much greater than in the mortgage market.

The *key policy levers* that have been successful in encouraging private investment in affordable housing in the UK have, as noted above, been closely related to the construction of a robust regulatory system for social housing. In addition, the land use planning system has been used – especially through section 106 agreements – to earmark land for affordable housing construction. Housing associations are encouraged to form partnerships with house builders (who are also developers) to incorporate affordable housing components in new residential estates. The government is currently proposing to give social housing grant to developers though the details remain unresolved. Other policy levers currently under discussion include:

- *Tax relief.* Tax credits could be introduced, along US lines, and targeted to locations and tenants meeting explicit affordability criteria. Shared equity schemes could also be included in this approach. VAT relief on major housing renovations carried out by HAs and private landlords renting to the social housing sector on long leases would stretch the housing grant further and encourage existing dwellings back into social renting.
- *Savings scheme for first time buyers.* Savings tied to first home purchase could be income tax exempt and/or topped up by explicit grant, similar to Australia's First Home Owners Grant. Employers could contribute to tax efficient arrangements that boosted the savings of their employees for home purchase. The option of allowing employees to access their occupational pensions (superannuation savings) has been debated in both the UK and Australia. The concern with all demand side subsidies is that they simply push up prices. In the UK the supply side has to become more responsive if there is to be any such scale scheme introduced on a large scale.
- *Employer provision of affordable housing.* Employers in both the public and private sectors could partner with housing associations and developers in return for nomination rights for their employees in the housing estates constructed. Their contribution could be cash or particularly in land, subject in the case of public sector employers to the regulations surrounding the disposal of publicly owned property assets.
- *Mixed use development – i.e. provision of affordable housing on non-residential land.* This would entail extension of planning instruments like section 106 agreements to land not currently marked for housing. This appears to be the intention behind the recent statements of the Deputy Prime Minister (noted above). Such a move would be highly controversial and politically sensitive.

The relative success of private financing in boosting the supply of affordable rental and owner occupied housing in the UK should not be over-stressed. In spite of significant policy reforms and a large long term funding commitment by government, the demand for affordable housing appears to be growing faster than supply, especially in regions undergoing rapid economic change. The leverage of private investment has certainly helped meet the growing demand but, given the barriers that still remain, further expansion in this direction will depend on the continuation and strengthening of existing policy regimes and an expansion in relevant government subsidies. A fundamental problem is the lack of Social Housing Grant and therefore, even with private leverage, the impossibility of providing the levels of social housing required (Holmans, Monk, and Whitehead, 2004).

Research Question 5: What are the realistic future options and likely developments in private financing in Britain, in the light of the forecast need?

The changing nature of the financial and institutional situation described above will clearly open up new opportunities for lenders, and some HAs and owner occupiers, while just as clearly restricting the opportunities of others. Greater differentiation of the private finance market will place a premium on good market relevant information and efficient management structures. A more competitive environment is likely, including in the market for public housing stock transfers from local government. The role of ALMOs is likely to increase as some local governments seek to avoid the full transfer of ownership of their public housing stock.

The private finance market for social housing will continue to be very sensitive to the delivery of grant funds and the regulatory framework in place, as well as to the availability of housing benefit. Private finance of affordable home ownership will be critically dependent on the policies that central and local government implement concerning subsidies, land release and planning controls. Because of the significant level of political risk perceived by the financial sector, it will be necessary for policy reform and development to occur through an inclusive and timely process of consultation, if private investment is to continue to play an increasing role in the provision of affordable housing. Financial markets hate surprises!

For all the potential change and uncertainty in the debt market for affordable housing, the real unknown is *equity* investment. Even more than is the case in Australia, private equity investors have avoided the affordable end of the housing market in the UK (although there are a few signs of increasing interest now). In part this reticence follows from the inherent conflict between the profit making aim of the equity investor and the social goal of housing affordability. But there is, potentially, a role for equity investment here as long as the expected return matches the actual risks borne by investors. Shared equity arrangements may offer the most feasible option for investors, although liquidity would probably need to be assured through securitisation or similar avenues. The interim Barker Review report (2004) also suggested that there is merit in the government considering introduction of a tax-transparent vehicle like the real estate investment trust model in the US, as an equity investment opportunity for institutional investors²⁵. The government accepted this and has now published a consultation paper on possible approaches (HM Treasury, 2004)

²⁵ Interestingly, in view of current Australian debates, the Barker Review (2003, p. 11) also argues that the stamp duty regime in the UK is unlikely to be a significant constraint on housing supply, except with respect to some distortions at and near the threshold levels.

Returning to the debt market, bond financing may begin to offer investors further means of investing in the social housing sector. There are significant financial risks that must be managed by HAs in this market. Timing – when you go to the market to borrow – is critical, as are the conditions required by lenders. However, HAs can generally tailor their borrowing requirements more closely to their needs through bond market activity than conventional borrowing, though they need to be operating at a scale large enough to bear the transaction costs entailed (this can be managed through syndication as well as mergers).

Research Question 6 What are the main similarities and differences in the conditions and opportunities for private funding in Australia, compared to Britain? To what extent (in what ways) do British approaches fit the Australian investment and policy climates?

In both the UK and Australia active mortgage markets fund housing investment for owner occupation and private renting. Secondary mortgage markets have recently been established. Similarly, in both countries, private equity investment by the institutions has not been forthcoming. However, the differences in market structure and institutional form outweigh the similarities.

The social housing sector is very small in Australia compared to the UK, with respect to the latter's local government public housing and the thriving housing association sector. The state governments in Australia have not, in general, depended on private mortgage finance to build up their small public housing stocks and private lenders have not seen a viable market in the even smaller, highly fragmented community housing sector. Much of the affordable housing stock in Australia is provided as a residual outcome in the private rental market, dominated by small landlord-investors, though research has demonstrated that this stock is under increasing pressure due to urban gentrification and other upward filtering processes.

Greater private investment in affordable housing in Australia is constrained by the absence of institutional supports that effectively change the balance of risk and return for private investors to an acceptable level. The existence of a strong and well regulated HA sector with a strong unencumbered asset base in the UK has allowed lenders to develop their loan exposure to this market confident that the risks are low and calculable. Investors can also increasingly buy bonds based on this housing. This has allowed public housing to be successfully transferred from local government to HAs, again financed by private investors (using available equity values in the form of government discounts and, sometimes, subsidy). The HAs in the UK are, as just noted, also able to access the bond markets for further debt finance.

In Australia, by contrast, non-profit housing associations are not in a position to borrow significantly, and certainly not by selling bonds. State governments have shown little enthusiasm for transferring stock to the community housing sector on any large scale, due to a concern for high transaction costs and management incapacity. Peak groups like the Community Housing Federation of Australia and the Community Housing Forum of Australia have been actively seeking to redress these deficiencies but there is a long way to go. The state housing authorities and the governments standing behind them have sought to pay back debt over the past decade, rather than take on new debt. This reflects, in part, their increasingly parlous financial situation, as most of them are facing increasing structural financial deficits that they have managed in the short run by selling off stock (Hall and Berry, 2004). The general approach to public finance in Australia, in a period dominated by neo-liberal philosophy, has been for the Federal and State governments to reduce public debt and to look for off-balance sheet solutions to social provision. A similar trend is

apparent in the UK. However, there, in the case of housing and as argued at length in this report, the housing association sector provides a viable existing vehicle for transferring much of responsibility for delivering affordable housing outcomes. In Australia, on the other hand, a gradual reduction of direct government involvement has *not* been compensated for by any significant support of the still weak community housing sector nor by the private rental market; indeed, in the latter case, developments have further intensified affordability problems overall. If state housing was transferred to the housing association sector then it would help move that sector towards gaining the critical mass it needs to secured private finance at the best possible rates. To some extent this is a 'catch 22' situation – governments won't transfer stock until the community housing organisations are large enough to be efficient and accountable, the latter can't grow until they have stock transferred. *However, the key lesson of the British experience is that even if government grant subsidies and stock transfers are adequate, private investors will not play their part in financing the changes unless and until a robust and effective system of regulation is firmly in place.*

Land use planning controls are much more effective in the UK in allowing and sometimes ensuring that new developments in urban areas include an affordable housing component and in providing an element of cross-subsidy from land owners and developers to that housing. The British Government, unlike its Australian equivalent, has a strong housing and planning function. In Australia's federal system of government the States and Territories each carry primary constitutional responsibility in their own jurisdictions. Local government in Australia is relatively weak and most of the states have not established a legislative framework that would enable the planning system a more positive role in affordable housing provision. Similarly, the weak financial base of local government means that it is not able to use fiscal instruments to encourage affordable housing developments.

The very real differences in powers, history and institutional setting between the two countries means that there is little opportunity to simply transfer policy approaches from one country to another. For example, establishing the framework for a growing community housing sector in Australia would be a major long term project and one that would require a national approach. The federal, state and territory governments would need to agree on key issues like the structure of the regulatory framework (national or state based), training support for the growing sector, the division of funding responsibilities, monitoring and reporting regimes, and timing. In the British case, the housing association sector has developed to its current healthy state over a more than 20 year period of almost continuous policy reform and a long term commitment to grant and housing benefit funding.

On the other hand, the British experience in the use of the planning system could usefully be applied by the Australian states and territories. In order to implement planning-driven affordable housing policies, however, it would be necessary to strengthen and re-define the powers of local government through significant legislative reform.

Australian policy debates could also benefit from the much broader discussions in the UK concerning key worker and employer provided affordable housing and the more targeted use of fiscal, especially tax, levers. In addition, both countries might usefully look to the United States in relation to use of tax incentives to encourage the greater involvement of institutional investors in affordable housing provision. However, that is not a cheap solution.

The UK and Australia have much in common, not least in relation to legal structures. Both share a commitment to decent housing for all. The UK has moved its housing policy forward significantly in the last few years. Central to that change in emphasis has been the recognition that an efficient and effective housing system is a vital underpinning for a dynamic and competitive economy in a global market. Australia does not seem to have come to that conclusion – yet. It needs to do so and then put in place a coherent Federal/State housing agreement which takes on board the shared responsibilities and is realistic in funding terms. It should build on existing assets and arrangements but should also move to exploit the increased appetite for private investment in the housing system.

In the UK the government's response to the Barker Review of housing supply holds some prospect that more homes will be provided, that house prices may stabilise rather than rise and that government will sharply increase its level of support for affordable housing in the UK. It is an ambitious package and it will take some years before it is clear whether it will even be implemented, let alone work. Moreover, in the short run it will almost certainly reduce output levels. The central point is recognition of the link between housing and wider issues and the government recognising that spending on housing should help to deliver those wider objectives.

Research Question 7: What, in particular, determines the successful implementation of stock transfers between the local council and housing association sectors? What factors block or reduce the likelihood of such transfers? What implications for Australia, if any, do the British experiences have?

The key issue in making the policy desirable and feasible from government's point of view was the extent of equity that could be unlocked by transfer. On the ground, the most basic requirement is that there be unanimity in the council regarding the case for transfer. If ruling party councillors campaign against the transfer it is unlikely to get tenant support. Tenants understandably take the view that if the council cannot agree to it, with all the expertise available to it, they, the tenants, must say no. Councillor opposition can be softened in a variety of ways but not least by the knowledge of new funds coming into the council and the deal that has been struck with the new association (including with respect to existing council housing staff). Typically, stock is transferred to a new association rather than to an existing body. This again has eased the process because it is possible to move staff across to the new body and 'replicate' the existing service (hopefully with many improvements). Where an authority has been under severe financial pressure (and/ or where the sale of the stock is likely to generate a significant capital receipt) and where the stock is relatively small in relation to the total number of homes in the area there is likely to be positive councillor support. The bigger the stock and the smaller the direct benefit the greater the anti pressures tend to be.

For Australia stock transfer most obviously applies to the state housing authorities. State housing is a considerable asset that could generate a receipt for use elsewhere in the Budget (assuming the Federal Government did not seek to claw back its prior grant and loan advances). Transfer to a housing association(s) would also move the cost of the rental subsidy from the state to the Federal Government, assuming that the HA tenants accessed Commonwealth rent assistance. As these comments suggest, there are a number of uncertainties here as to the costs and benefits. It is clear that state authorities have been unable to secure sufficient state or Federal resources to both properly maintain and expand their state housing services (Hall and Berry, 2004a). This being the case, transfer makes considerable sense if private finance could be levered in. However, the rents would need to rise to service the

private debt and this would mean more subsidy. In addition, the housing association (community housing) sector would need to demonstrate management and operational capacities well in advance of current levels. In particular, the size and structure of housing associations taking over ownership and/or management of the public stock would need to be appropriate to the task and the management capacity available to the growing sector raised sharply and quickly. A system of ensuring and monitoring the performance of the HA sector would need to be introduced, along with protocols established for dealing with under-performing associations. Agreement over the subordination of claims over the HAs asset base would also be secured.²⁶All this requires detailed consideration. As in the UK, both Federal and state governments also need to consider this question in the widest context and look at how such moves might help secure a range of both Federal and state objectives over the longer term.

²⁶ Current developments in Victoria seem to be moving in this direction, with new legislation being considered by the State Parliament to establish a number of new large (by Australian standards) housing associations to manage (if not own) transferred public housing stock. It remains to be seen whether the associations formed and the regulatory structure created will be acceptable to private investors and encourage them to fund further growth.

Appendix: A Critical Analysis of the Australian Models

This Appendix provides more information on the AHNRC Bond Model and a more detailed critique of the proposals emerging from the Prime Minister's Taskforce. As such, it supplements the summary material presented in Chapter 5.

Affordable Rental Housing: More on the Consortium Bond Model

In the AHNRC approach outlined in Chapter 4, State Housing Authorities (SHAs) may, at any stage, decide to retain the acquired stock by re-financing (selling more debt) or committing its own tax revenues. In addition, the Commonwealth and a State can at any time agree to launch another subsidised loan transaction to maintain or expand the dwellings under management. These decisions are made through time in the light of perceived housing need, available Commonwealth funding and the willingness of the State to bear the risks involved (see below) and/or commit its own funds to 'topping up' the scheme. Hence, it is important to note that this approach does not depend on the implementation of a single 20-year transaction, at the end of which nothing by way of affordable housing remains. Rather, the aim is to introduce an effective and cost-efficient method of continuously matching the changing need for affordable housing – in scale, housing form and location – with housing provision through continuing collaboration between the Commonwealth and state governments by way of the introduction of a staged series of individual transactions²⁷.

The fact that the stock managed under each transaction progressively falls after an initial period and eventually totally sold into the private sector means that the Commonwealth and state governments *must* continue to jointly monitor real housing conditions and needs across the jurisdictions *and* be prepared to intervene by introducing new, targeted 'tranches' of funding in subsequent transactions aimed at increasing the stock of affordable housing when and where required. This approach requires the SHAs to be active managers of their stock, buying and selling housing according to the actual demand and requirements for affordable housing in their respective jurisdictions. The fact that the stock provided by any one transaction is, by default, declining through time, poses a continuing challenge to the SHAs to effectively manage their operations and to the Commonwealth to adequately subsidise the resulting housing programs of the states. This is to be contrasted with the current situation where the SHAs end up managing a static, residualised stock of a type, size and location which may bear little relationship to the current and changing needs of households in need.

The size of the Commonwealth subsidy to each state is dependent on key factors: in particular, the relative rates of tenant turnover in the stock and the level of operating costs in each jurisdiction. The higher a SHA's costs, the greater the gap between net revenue and interest costs on the borrowed funds and the larger the subsidy required to 'break even'. Similarly, the more rapid the turnover of tenants in public stock, the more quickly the dwellings are sold into the private market and the faster debt is repaid, reducing the interest payments that have to be made and the size of the required subsidy over the term of the transaction.

²⁷ This point is of critical importance. Overseas experience demonstrates – e.g. the phasing out of the so-called 'section 8' housing subsidies in the United States – that subsidies targeted to dwellings with a termination date tend to create financial and social costs for tenants dispossessed at the end of the subsidy period, unless mechanisms are in place to effectively re-house those people at that time.

The model, under the given assumptions, delivers a substantial leverage of private funds. For a \$1 billion capital acquisition program across the States and Territories:

- 7,500 dwellings can be added to SHA stock and rented at affordable levels to eligible tenants
- the gross subsidy payable by the Commonwealth is \$220 million – or a weighted national average of \$2,288 per assisted tenant per year. This varies from a high of \$3,413 in NSW to a low of \$790 in W.A.
- once the flow back of income tax revenues from debt holder to the Commonwealth treasury is included, this subsidy per tenant per year falls to \$908 and the total net cost to \$90 million (although Treasury also presumably foregoes taxation that would have been payable on the investments the institutions would have invested in if they hadn't purchase the bonds in question).

Hence, for every gross dollar of government subsidy, \$4.50 of affordable housing can be acquired. Put another way, the end result (until the phased sell down impacts) is four-and-a-half times as much extra affordable housing as if the government funds were directly committed to acquiring stock, as currently occurs under the CSHA. This, of course, assumes that there is no 'displacement effect' in the low-rent end of the private rental market – i.e. that investors do not react to an increasing supply of low cost dwellings by switching some of their investments out of this market segment. If this happened then the increase in public supply would be partly offset by declining private supply. In fact this is highly unlikely to happen. The current low-rent housing segment is a residualised sub-market in chronic excess demand. An increase in supply is therefore unlikely to reduce existing rent levels and spark investor withdrawal. In addition the scale of the proposed increase in supply would barely offset the annual decline in public housing additions over the past decade; net annual additions to the stock provided through the Commonwealth State Housing Agreement have fallen from more than 10,000 to less than 5, 000 in that period.

Whether or not the states have to subsidise the arrangement depends on the various risks involved and how they manage them. If, for example, property values increase more slowly than forecast over the 20 years, then there will not be enough money realised when all the dwellings are sold off to repay all the remaining debt; this deficit will have to be met by the State. If the SHA manages its operations efficiently and reduces its costs below levels estimated in the transaction, then the surplus can be used to offset any deficits that arise from forces outside its control (like changes in housing values, inflation or interest rates). Therefore, the states have a very strong incentive to be efficient: if they are not, then their Treasury pays.

Apart from the high degree of leverage achieved, this model delivers a number of benefits:

- It establishes a firm basis for long-term cooperation between Commonwealth and States around housing issues of national importance and can thus form part of a larger national housing policy framework.
- The Commonwealth is able to cap its total subsidy exposure upfront, with the knowledge that the states have a strong incentive to manage the affordable stock efficiently and target it effectively to those in need (if they don't, it costs them).
- Each state retains control over the stock and receives subsidies tailored to the conditions in its jurisdiction.

- This model meets the Consortium's four key criteria for an acceptable model – it is equitable (targeted to need), efficient (high leverage), promises to deliver a high volume of extra affordable housing and is feasible, both with respect to the requirements of private investors and nature of contemporary fiscal politics in Australia

In reality, the Consortium model reinvents public borrowing for social housing. But it does so in a very transparent way that imposes a strong discipline on governments at both levels to efficiently match available housing assistance to real housing need and continually monitor outcomes to generate maximum reach.

The research (Hall and Berry, 2001; Berry, 2002; Hall and Berry, 2002) clearly demonstrates that this model:

- has the capacity to more than double output compared with current policy – that is, double the number of households in need achieving affordable housing for any level of government subsidy – in Sydney and Melbourne and deliver excellent outcomes in Adelaide.
- is clearly the least-cost way for government to quickly stimulate a substantial expansion of the affordable housing stock.

It is very likely that an overall policy that mixes this approach with the existing measures of rent assistance and capital provision through the CSHA will have efficient outcomes in most if not all the major housing markets in Australia²⁸. The Consortium model is therefore best seen as complementary to, rather than a substitute for, existing housing assistance policies.

Affordable Home Ownership; Contributions to the Prime Minister's Taskforce

Whilst much of the concern with provision of affordable housing in Australia over the past decade or so has focused on provision of rental housing, issues associated with affordable home ownership can be seen to be as equally critical. Declining home purchase rates amongst middle income younger households result in increased pressure on the private rental market and have the potential to add to the displacement of lower income households from affordable rental housing.

Since 2000 the Commonwealth government has spent more on providing direct assistance to first home owners through various versions of first home owners' grants than it has in providing direct assistance to fund provision of public housing and almost as much as it has in providing rent assistance to private renters. It has provided significantly greater amounts in indirect assistance to established home owners. Issues of whether scarce resources should be used to assist in providing affordable home ownership and, if so, how this assistance should be provided, become increasingly important as the ability to access to home ownership is increasingly limited to only the better off in society.

(i) The Caplin and Joye proposal: a critique

A flurry of activity surrounding affordable homeownership for low income households emerged in mid 2002 with the use of the media to release proposals for shared ownership models developed for the Menzies Research Centre by Andrew Caplin, a professor of economics at New York University, and supported by

²⁸ For details, see the comparison of optimal (cost effective for government) housing assistance mix for the eight State and Territory capital cities in Hall and Berry (2004b).

Christopher Joye, a postgraduate student (Caplin and Joye, 2002a). Media interest in this was enhanced towards the end of 2002 by the 20th September announcement of the Prime Minister's Home Ownership Taskforce, to be chaired by Liberal Party Treasurer, Malcolm Turnbull. The Task Force brought down its report in mid 2003. Amongst other things, the task force was charged with examining proposals for changing and/or reforming housing finance in Australia with regard to improving the affordability, availability and flexibility of housing, particularly for those households on lower incomes. In particular, it was to concentrate initially on partnership arrangements such as that proposed by Caplin and Joye.

The "partnership markets" that underpin the Caplin and Joye proposal rely on a combination of debt and equity finance of housing. The debt component is based on current conventional mortgage finance, although the amount financed in this manner is reduced by the equity component. Under current financial arrangements, the borrower provides equity in the form of a deposit. At present borrowers are assisted in this through the FHOG. This debt funded component of the borrower's contribution would continue, but on a reduced scale as a result of an equity sharing arrangement with an institutional investor. Under the proposed arrangement, a supplementary equity component is provided by "a passive institutional partner who contributes capital for the dwelling in exchange for a share of the sale proceeds". For potential entrants into the housing market, the immediate effect of such a contribution is to reduce the size of the mortgage that needs to be financed and the amount of deposit that needs to be provided by the household. For existing owners, it provides them with a means of divesting themselves of some of their housing equity. Under this arrangement, the household would retain complete control over the property, including the right to determine when to sell.

A letter of support provided by 11 of the 22 members of the academic executive and advisory committees at the time the initial proposal was floated focuses on benefits to households of not being forced to acquire 100% of equity, "nor single-handedly bear the burden of the vast financial responsibilities inherent in owner-occupation" and on the claim that there is a sizeable valuation wedge between the prices placed by occupiers and investors on a residual stake in the residence (Menzies Research Centre, 2002). The basis for this will be considered below.

McColl (2002) summarises the key factors for occupiers and investors that indicate how the joint ownership housing would work as follows:

The occupier:

- shares ownership with institutional investor.
- retains decision-making rights to alter, maintain and sell the property.
- can increase or decrease equity stake.
- limits exposure to performance of a single asset.
- gets a share of dwelling value when sold (less than original contribution)²⁹.

²⁹ With the exception of this point and its equivalent in the investor list, these dot points are taken from McColl's Business Review Weekly summary of the Caplin and Joye proposal. McColl, however, listed a pro rata share of capital gain rather than a pro rata share of dwelling value in his list and did not add the qualification in parentheses in the list reported here. These two minor changes to McColl's overview make a significant change to the interpretation of how the scheme operates.

The passive investor:

- shares ownership with owner-occupier.
- can increase, decrease or sell equity stake.
- gets a share of dwelling value when sold (greater than original contribution).
- gets access to new asset class uncorrelated to shares or bonds.

In this "Partnership Market", the household is seen as the "Managing Partner" and the passive investor as the "Limited Partner". Because such an arrangement can provide the household with the ability to consume more housing than they are able to afford by means of purchase and to diversify their asset base should they wish to do so, the potential benefits to the household are intuitively obvious. The price they pay in return for these benefits and the potential benefits to the passive investor are less intuitive. These will be discussed in the section below on the technical aspects of this proposal.

A survey being undertaken to determine community attitudes to such a proposal uses an example of an original investor share of one third of the value of the dwelling in return for forfeiting half of its value when sold (with corresponding, but unstated, adjustments for smaller initial owner-occupier contributions) (Walsh 2003). Respondents are asked whether they think this is fair. The results of this survey have yet to be released. The survey, however, does raise the question of whether respondents understand the financial implications of this proposal. One of the critiques by participants in the earlier State based shared ownership schemes was that they did not understand the implications of the decisions they were making despite the availability of a considerable amount of plain English information.

Caplin and Joye (2002d) claim their proposal will reduce the cost of home ownership, increase average family's disposable income, increase expected wealth at retirement and, as a result, increase choice regarding investment in housing. In their view it addresses: problems of saving for down payment in early stages of life cycle, affordability problems from repayments and maintenance, concerns with committing 90% of wealth into one illiquid asset and the asset rich and cash poor status of a high proportion of elderly households. All of these are attributed to the indivisibility of housing as an asset.

Achievement of their objective would require the creation of what they describe as a "sophisticated secondary market in real estate equity". Whilst the authors claim their proposal needs no explicit support from the government, they do suggest that government assistance might be needed in order to remove some of the impediments to setting up market in real estate securities. In particular, they see abolition of stamp duties as a likely requirement. (O'Loughlin, 2002).

Critics of their proposal have expressed concern that it would put upward pressure on house prices (McConnell 2002), that it would operate only in housing markets where there were high expectations of capital gains (Spiller 2002), that it is unlikely to provide an adequate return for investors, that it requires considerable institutional change before the appropriate structures are in place (Girdis, quoted in McColl 2002) and that it has been tried before and failed (Connolly 2002; Kelly, quoted in Videnieks 2002, Spiller 2002).

In response Caplin and Joye (2002c) have responded that any upward pressure on dwelling prices will be short term. They suggest this would be offset by a supply response in the longer run. They categorically deny that the proposal is dependent upon rising dwelling prices and claim, instead, that the innovation is “cycle independent” with market conditions being irrelevant. Their confidence in the attractiveness of such an instrument is based on evidence that suggests residential real estate has outperformed equities on a risk-adjusted basis even when rental yields are excluded) over the past 20 years or so and that “it is a highly ‘uncorrelated’ asset category, which affords prospective participants with extraordinary diversification gains.” They reject claims that it has been tried before, arguing that “there is no precedent for that which we propose” but claiming a considerable amount of sophisticated academic research justify the claims made by its proponents.

1) Technical aspects of the Caplin and Joye proposal

Whilst the specific details of the proposal outlined above have only been sketched broadly in the primer (Caplin and Joye 2002a) and Questions and Answers document (Caplin and Joye 2002b) made available on line with the press releases at the launch of the proposal, greater detail of the ideas that underpin it can be found in an earlier publication by Caplin et al (1997) on Housing Partnerships. A subtitle for this book was why "the second half of your home may be the worst purchase you will ever make". This can be supplemented by material prepared by Joye in collaboration with other authors (Joye 2002a; Joye 2002b; Joye 2002c; Joye and Butt 2002).

The proposal takes modern portfolio theory as its starting premise. This theory suggests that, for a given level of risk, expected investment returns will be maximised by a diversified portfolio. The portfolios of most home owners, however, are dominated by a single asset - namely, the family home. This is seen as a risky asset because of its illiquidity.

In the author's view, this risk is exacerbated by property price volatility, because prices are related to labour market earnings, because most households are highly leveraged and because of the dominance of housing in the average household's portfolio (Caplin and Joye 2002a, p8) but see also Caplin et al. (1997, chapter 5).

Some observations on this claim are as follows:

- Asset price volatility tends to be an issue only for those wishing to trade their assets; it therefore tends to be relevant for home owners only if they have no control over the disposal of their asset. This could arise, for example, from threat of foreclosure arising from failure to meet mortgage repayments. In this case, however, a key issue may be the lack of insurance rather than the price volatility. It could arise from households wishing, or forced, to relocate for whatever reason or it could arise from households wishing to trade down or up. In this case, however, they do not need to sell their existing asset if it was not financially advantageous to do so. The costs are those associated with waiting until an appropriate point in the cycle. The key issue in this case might be the availability or otherwise of suitable rental housing in their new location. Mills (2000) suggests that, for low income households with negative equity who are forced to sell, house price risk is negligible since they can walk away from a property with little risk of pursuit. The only concern might be the impact of such a decision on their credit rating.
- Asset price volatility is less of a problem for those concerned with long term investment. It is a presumption both that a "lock in" effect impedes residential mobility and a "lock-out" effect prevents households from refinancing in order

to benefit from falling interest rates that concerns Caplin and Joye. This latter applies only to those with fixed rate mortgages. Whilst the fixed rate mortgage dominates the US market, for which these proposals were initially developed, it serves only a small percentage of borrowers in the Australian market.

- Any positive association of house prices with labour market earnings is a problem during an upswing only for those who are not yet owners; it is a problem during a downswing only for those whose income declines to a point where they cannot meet mortgage repayments.
- High leverage tends to be a characteristic of the majority of households only in the first decade or so of ownership. It is not the leverage per se that is a problem; it is the debt associated with high leverage and the capacity of the household to meet its mortgage payments and other housing costs that is the problem.
- In general, housing does not dominate a household net assets at the household's point of entry into the housing market when equity is generally very low. It tends to do so over time because it is a good investment. Amongst other reasons, the strong investment returns associated with it, in turn, can be attributed to the tax treatment of owner-occupied housing. This point tends to be ignored by Caplin and Joye.

Caplin and Joye's solution to the perceived problems associated with this illiquidity is to create a market that will assist households to diversify their portfolios and, as a result, reduce the risk associated with volatility (but particularly downturns) in house prices. This market will trade in liquid financial instruments that are backed by the equity held by passive investors in owner-occupied housing. In other words, these instruments would be an equity equivalent of the debt based mortgage backed securities that have underpinned much of the recent innovation in housing finance markets. A by-product of the existence of such instruments is that households no longer need to have an all or nothing equity stake in owner-occupied housing. This potentially generates an improved access to home ownership as a result of a lower threshold for entry and a capacity to consume more housing services than provided by the household's investment in owner-occupied housing.

From the household's point of view, this proposal presumes that the second half of the dwelling does not provide the same benefits as the first half. Caplin and Joye argue that "the asset defined by the second half of the residence is not worth much to the current owner, since it is perfectly correlated with the first half and provides no diversification benefit. .. The difference between the value of this asset to the home owners and its value to investors defines the gains from trade." (Caplin and Joye 2002a, p11). One question that is not addressed, or even raised, in the material circulated in 2002, nor covered in the Caplin et al (1997) version of the proposal, is whether this presumption is robust once the tax favoured status of owner-occupation is taken into account.

Whilst the argument in favour of this arrangement is presented in terms of the benefits it provides to the household as the Managing Partner, its success depends not just on there being households wishing to enter such an arrangement. Its success also depends on the existence of passive investors prepared to provide the equity finance. Their involvement will depend on the benefits that they perceive from this investment. A more detailed discussion of the incentives for both investors and households is provided below.

2) Investor benefits

The benefit to investors comes from two main components; reduced risk and increased return. The most tangible of the return component is the direct return that such an investment provides at the time of the sale of the property. The value of this will depend on the extent of capital gain and on the extent of the gearing generated by a pro-rata share in the sale price that exceeds the contributory equity share.

In the example provided in the survey of community attitudes (Walsh 2002), the Limited Partner would receive half of the value of the property on sale in return for a one third equity share (with the higher pro rata return on sale being in compensation for no rental return on investment prior to sale).³⁰ At face value, this suggests quite significant direct returns are possible for the Limited Partner.

Consider, for example, a property purchased for \$300,000 with two thirds of this financed by the household and one third financed by a passive investor in return for a half share of the property on sale. If the house was sold after one year in a market with a modest 5 per cent nominal house price inflation then, in the absence of transaction costs and taxes, the equity share an investor would receive half of \$315,000 or \$157,500. This represents a 57.5% pa return on a \$100,000 investment. With the same rate of inflation, after two years, the investor would receive of half of \$330,750 or \$165,375 which represents a high but lower annual rate of return of 28.5% pa over two years. Presumably in recognition of the decline over time in the annual rate of return (for a given rate of house price inflation), Caplin et al (1997, p162) suggest the possibility of contracts that allow for an increase in the equity share of the Limited Partner if the asset is held longer than a defined time. Because of this gearing effect, positive returns are possible for the Limited Partner even when house prices are declining. If, for example, the \$300,000 dwelling was sold after one year for \$250,000, the Limited Partner would still received \$125,000 for a \$100,000 investment. An underlying presumption of these examples is that the Limited Partner would receive a greater share of the sale price as compensation for no income on its investment prior to sale. Whilst the possibility is not canvassed in Caplin and Joye, Caplin et al (1997, chap 6) suggest that it is not essential that the Limited Partner pays for their portion of the final sales price at a discount. It is possible that they will do so at par or at a premium.

This arises because the introduction of a new asset class based on equity in owner-occupied housing can improve the risk-return characteristics of an investor's overall portfolio because of its low covariance risk. Because its returns are only weakly correlated with returns on other asset classes (such as stocks or bonds), investment in residential property provides a very effective hedge against fluctuations in financial markets. In other words, a key component of the returns from such investment arises from the impact that it has on the overall portfolio, rather than from its own intrinsic worth. Joye (2002b, p16) suggests that, from the investor's point of view, the relationship between the share of proceeds received and the equity share the investor is prepared to contribute will be influenced by the extent of house price inflation, the contribution that diversification into a new asset class makes to the underlying return of the investor's portfolio, the investors' degree of risk aversion and the length of time over which returns are optimised. In his example, this relationship is defined in terms of the discount on the par or issue price of the underlying financial instrument. In his simulated examples for a 10 year investment horizon with different

³⁰ This example with a one third equity share in return for half of the proceeds on sale is similar to the numerical example in the technical material provided by Joye (2002b).

risk aversion parameters, investors would demand only this asset class in their portfolio when the discount is more than 50%, but demand falls off sharply after this. A discount of less than 50% implies an investor share of no more than 50% in return for 100% of the sale price.

Given the underlying framework of competitive markets on which this proposal is built, a reasonable presumption is that the discount will be determined in such a way as to reflect the market based risk adjusted rate of return. The only issue that remains is what determines this value. This point is returned to below.

The development of a secondary market based on purchase and sale of shares in bundles of individual equity contracts can provide the liquidity needed for investors and assist in reducing individual house price risk for investors. Returns can be pooled geographically and by dwelling type or any other desired characteristic. Caplin et al (1997, p145) envisage the emergence of what they persuasively call PREFERS (Partnership Real Estate Funds with Equity Fund Returns). Risk can be further reduced for the investor if the market makers choose to add some form of credit enhancement to increase the attractiveness of such shares.

However, there is one important question that is not addressed, or even raised, in the original material circulated. From the investor's point of view, the question of whether housing will retain its characteristic of an uncorrelated asset with the introduction of financial instruments that allow it to be freely traded remains to be seen. As Caplin and Joye point out, this proposal is untested in relation to investment in owner-occupied housing.

3) Household benefits

The household pays for these returns earned by the investor in the form of a reduced equity share on sale. In the above example of sale of a \$300,000 dwelling for \$315,000 after one year with no transaction costs and taxes, the household would receive \$157,500 on a \$200,000 investment. For a sale price of \$250,000, the household would receive only \$125,000 on a \$200,000 investment.

These simple examples do suggest that, whilst the proposal has the capacity to reduce the dominance of housing assets in the household portfolio, the house price risk associated for the household is increased rather than decreased for this reduced equity holding.

In either of the above cases, however, the household has benefited from the rental services provided by a \$300,000 dwelling for the \$200,000 contributed and it is the value of these services that have to be compared with the reduced return on sale that determines whether or not there are gains from trade for the household. Alternatively, for a household who would otherwise not have been able to access home ownership because of income or wealth constraints, the household benefits from the ability to do so as a result of the opportunity provided by the role of the passive investor.

Joye (2002b) suggests that, in the same way as for the investor, the household derives additional benefits from the opportunity for portfolio diversification provided by the existence of a Partnership Market.³¹ Households are presumed to make

³¹ Presumably, this benefit arises only when households are not wealth constrained in gaining access to shared home ownership. Whilst numerical examples should be taken at no more than their face value, it might be seen as informative that the example given to illustrate the benefits to a household participating in the proposed arrangement begins with an assumption of household wealth of \$1million. With the exception of the choice of values for illustrative purposes, the arguments and analysis in Joye (2002b) follow identically those in Caplin et al (1997).

investment choices that maximise their wealth over a specified period, based on optimally allocating their portfolio into a component invested in owner-occupied housing and a component generated by the partial release of equity. The opportunity to occupy the whole of the house while investing in only a part of it is taken into account by specifying a minimum proportion of the portfolio that represents investment in owner-occupied housing. It is not clear how this takes into account the value of housing consumed by the combined Managing and Limited Partnership investment. This approach also appears to ignore the institutional reality that the return the household obtains on investment in owner-occupied housing is tax free whereas the return obtained on investment in other assets is taxed. The value of the equity released ("the second half of the home" in the populist terminology employed in the paper) is defined as the amount of money available for investment in other assets that precisely compensates for the loss of the 50% equity interest. The simulations presented in Caplin et al (1997, p96) suggest that this is always less than the market value of the dwelling. These result from an assumption that the household cares only about the average value and variance of its asset portfolio over its lifetime.

4) Evaluation

The Caplin and Joye proposal differs from most of the earlier and more conventional approaches to addressing affordability problems in that it focuses primarily on the role of housing investment in a household's portfolio rather than the role of housing expenditure in a household's budget.

It makes a number of positive contributions to the housing affordability debate. In the first instance,

- it places the question of home ownership clearly on the affordability agenda. In doing so,
- it re-introduces the concept of shared ownership as a financial solution to addressing affordability problems and it does so in an innovative way as a result of bringing finance rather than housing experts into the policy development process. Should such a proposal move from text book to reality,
- it would increase the choices available to households. However, it is not clear that there would be many households who would be willing or able to take advantage of this choice. Finally,
- it highlights a number of the institutional constraints that are likely to arise in attempting to implement it.

At the same time, it has a number of negative aspects.

- It is based on a highly abstract view of household preferences.
- It does not address the possibility that many households may have a strong attraction to outright ownership of their property.
- It does not discuss the implications of different planning horizons inherent in the question of whether such a proposal primarily targets young low income and low wealth households currently constrained from accessing home ownership or whether it targets older high wealth households seeking to release some of the equity in their dwellings.

- It does not address the question of how large the “equity premium” required by investors might be for the instruments developed³².
- For the Australian version at least, its illustrative returns to housing are based on highly aggregated sales price data that are not quality and composition adjusted. The absence of a readily available dwelling price index in Australia which does make such adjustments may well be a further institutional impediment to the successful introduction of financials instrument that depend on such information.
- It does not consider the possibility that there may be a considerable selection bias in the types of households interested in such a proposal and that aggregate dwelling price indices may not be representative of the price movements in the dwellings occupied by equity sharing participants.
- It does not consider the incentives provided by the current Australian pension system to retain equity in owner-occupied housing.
- It does not consider the question of whether the cost of mortgage finance will be affected by the introduction of an equity sharing arrangement that has the potential to reduce the underlying security for the lender. Currently mortgage finance is cheaper than unsecured finance because the lender has a mortgage over the property. Under the Caplin and Joye proposal, if the investor’s share of the sale price exceeds the initial equity share, the effect is equivalent to an increase in the loan to value ratio for the household, with a consequent increase in the security required by the lender (for example in the form of mortgage insurance as currently applies to high ratio loans or a higher interest charge).
- Despite being proposed more than 6 years ago by Caplin et al (1997) in the US, it has not been implemented in the US market which, in general, has a more innovative approach to the introduction of new financial instruments.

Unlike the responses from some commentators, it is obvious that this proposal does not depend on capital gains. For low income households with no assets, in the absolute extreme it could be equivalent to paying off a mortgage equal to part of the value of the dwelling instead of paying rent. It would involve taking on the maintenance risks associated with owner-occupied housing in return for obtaining occupancy rights for a defined period of time. It is possible that the household would end up with little or no housing assets. There might be circumstances in which this is seen as preferable to the insecure tenancy rights available in the private rental market.

3. *Historical development of shared equity schemes*

The proposal by Caplin and Joye can be placed in a broader perspective by pointing to a historical lineage of selected Australian schemes all of which, one way or another, have aimed at improving affordability by separating the investment component of home ownership from its consumption component. These, in turn, have had their precedents in an even broader range of actual and proposed financial instruments designed to address the different issues of the time. These issues range

³² There is a considerable literature on the existence of an equity premium in relation to stock holdings. Mehra (2003) provides an overview of the current status of this literature. Kocherlakota (1996) provides an earlier overview. Any risk premium associated with equity investment in tried and tested instruments is likely to be even higher in an untested instrument such as that which underpins this proposal.

from perceptions of inadequate standards of living for those on old-age pensions to the difficulties of meeting the front loading costs of mortgage finance in an inflationary environment.

The breadth of issues that have led to innovations in the past points to the need to identify just what it is in the current environment that renders housing unaffordable for lower income households.

Clearly the issues are different for younger compared with older low income households and for those with no asset backing compared with those with considerable asset backing. Over the past few decades there have been a number of equity release or reverse mortgage schemes that have attempted to address the needs of older households who were asset rich and income poor. Kendig and Paris (1987, p105) report that the several small schemes, which operated prior to the mid 1980s and which provided older households with an income stream paid for out of household's estate, were relatively unsuccessful. This was attributed to the reduction in pension payments that arose because of the income so provided, because the annuity payments were small unless the applicant was very old and because older people preferred to save their assets for inheritances, even when they were living close to poverty and their children may have been well off. Somewhat more successful have been the government sponsored and subsidised schemes introduced in the 1990s. In broad terms, however, these were targeted more to older households wishing to gain access to their housing capital for maintenance or redevelopment of their housing asset. By the mid 1990s, the Australian Urban and Regional Development Review (1994) was claiming only limited success for a number of one-off programs such as the (then) Department of Social Security's Equity Conversion Loan scheme and various state based equivalents.

More obvious comparisons with the Caplin and Joye proposals, however, can be made with the various shared ownership schemes that emerged in Australia in the mid 1980s.³³ These explicitly targeted lower income households with no housing assets who were constrained from entering home ownership as a result of the high inflationary environment that emerged in the 1970s. Like the contemporary debt based indexed lending schemes that subsequently received so much bad press³⁴, these schemes addressed the constraint on access to home ownership that arose from the front loading associated with conventional mortgage instruments. This constraint arises because borrowing capacity is assessed on the basis of current rather than expected future income with repayments being determined in nominal rather than real terms. In the same way that Caplin and Joye suggest their proposal is designed to address a basic market constraint arising from the indivisibility of housing as an asset, the shared ownership (and indexed lending) schemes of the 1980s were designed to address a basic market imperfection arising from incomplete markets reflected in a general inability to insure against unpredictable future incomes.

Unlike the Caplin and Joye proposal, the shared equity schemes that emerged in Australia in the 1980s were based on a rental payment (often subsidised) on the partner's equity share and on a pro-rata share of sale proceeds. Households were

³³ The Australian schemes were preceded by several small UK based schemes. The basic idea behind all of these, however, was similar.

³⁴ This was well deserved in those schemes which failed to account for inflation risk or, more importantly, which passed far too much of this risk back to borrowers poorly able to manage it. However, these schemes did effectively address a critical front loading problem that was a key factor influencing access to finance and they were successful in assisting thousands of low income households into home ownership.

not required to give up some of their equity share to provide an acceptable return to the passive investor and would retain their initial equity contribution as long as the dollar value of their dwelling did not decline. The more successful of these earlier schemes relied upon government intervention. Improved affordability (and increased access to home ownership) arose both from the subsidy provided on the rental component and from the use of indexed lending arrangements that reduced the front loading component of mortgage based finance. This finance, in turn, was underpinned by government guarantee.

This approach in Australia differed from the UK shared equity schemes, in which the household's contribution was funded by conventional mortgage instruments and which, by allowing for stepped increases in the household's equity share over time, created a surrogate for an indexed lending instrument and, in so doing, provided increased access to home ownership in an inflationary environment. Yates (1992) provides an overview of these schemes. When targeted at low income purchasers, such schemes can require subsidies to ensure that households are assisted in building up equity in home ownership. Yates (1989) provides a framework for proposals which integrate the need for income support to meet rental payments when income falls below a level at which even rental housing is unaffordable with an equity sharing arrangement. The need for such support is ignored in the Caplin and Joye proposal but is a key feature of the Gans and King proposal to be considered below.

4. Comparison of current and earlier proposals

Both the Australian and UK versions of shared equity schemes served to separate the consumption from investment components of housing. Households were able to purchase a part of their dwelling and rent the remaining part. Because they generated a conventional dividend and capital gain return for the passive investor, these shared equity differed from the Caplin and Joye proposal both in the way in which the return on the investor's equity is derived and in the risk characteristics associated with the schemes. In the shared equity schemes that have been implemented, both household and passive investor shared the house price risk (according to their shares in the property). In the Caplin and Joye proposal, a considerable proportion of this risk is pushed back onto the household through the discount at which the final equity share in the property is purchased. Caplin et al (1997, chapter 17), however, suggest that households could insure against this through the use of a price index futures market.³⁵ The cost of such insurance, however, could offset any affordability advantages arising from the shared ownership proposal, particularly for lower income households.

Income risk in Australian shared equity schemes was borne in part by the public sector in the form of a rent subsidy and in part by a guarantee on the household's mortgage. In the Caplin and Joye proposal, it is met by the flexibility provided by an ability to trade equity in owner-occupied housing, at least while the household still has some equity remaining.³⁶ With the same qualification, interest rate risk can also be covered by the Caplin and Joye proposal.

A more recent proposal which, like the Caplin and Joye proposal, exists only on the drawing board, shares characteristics of both schemes. This is a proposal developed by developer David Chandler for the NSW Ministerial Taskforce on

³⁵ As above, this would require the existence of a more robust sales index than is currently available in Australia.

³⁶ In both cases presumably existing mortgage assistance schemes would operate in relation to household debt in the same way as with conventional housing finance schemes.

Affordable Housing in 1999. Chandler proposed an arrangement in which affordability problems were addressed by separating the ownership of dwelling into its land and structure components. He envisaged community title over the land on which rent would be paid. Passive investors would fund land purchase through an intermediary similar to that proposed by Caplin and Joye. The household would own the structure which would be purchased either outright or through partial or full debt finance.

As with the Caplin and Joye scheme, the household would be responsible for all costs associated with occupation and maintenance, would have control over timing of sale and would have full occupancy and development rights over their dwelling. Without additional investment in their dwelling, they would own a depreciating asset and would be liable for rental outlays on the land component, which has the potential for appreciation with no additional investment. As with the Caplin and Joye scheme, Chandler envisaged development of financial instruments that would provide liquidity for investors in the land component of his scheme. Access to home ownership would be enhanced because the household would not need to finance purchase of the land component of the dwelling and land package.

5. *The Gans and King proposals*

As indicated, the Menzies Research Centre initiative that is embodied in the Caplin and Joye proposal reviewed above, led to the establishment of a Prime Minister's Home Ownership Taskforce. Reports from this Taskforce are now available.

In one of these, Gans and King, two of the academic members of the Taskforce, raise doubts about the Caplin and Joye proposal suggesting that something more is needed than their market based solution. "It makes little sense to rely on market-based policies to assist individuals and households who have no access to the market. Thus, some government commitment, through funding and/or risk management is needed." (Gans and King 2003, p68). Gans and King develop two broad proposals. The first addresses affordability problems faced by high income risk households; the second addresses those with longer term affordability problems with a similar variation on the Caplin and Joye proposal as that proposed by Chandler and briefly outlined above.

Gans and King point to asymmetric information as a major market imperfection in both financial and rental markets that lead lenders and landlords to rationally discriminate against low income households on the grounds that these households are too risky because of their perceived inability to maintain mortgage or rent payments under changed economic circumstances. A further source of market imperfection is the inability of low income households to insure against the risks associated with short-term income loss.

The first of their proposals, a housing lifeline, addresses income risk. This is considered below.

(1) *Housing Lifeline*

Individual income risk is associated with income volatility and, in particular, with income loss which can arise for a range of reasons, typical of which are unemployment and household dissolution. Whilst income loss can create difficulties for all households it is perceived as creating greater difficulties for lower income households who have fewer economic resources to call upon and who, in Gans and King's words, "will not have access to the risk protection available to more affluent households." Some aspects of income risk can be reduced by insurance but this is

seen as being less available or more costly for low income households who, in any case, are less able to afford the costs of self insurance.

Gans and King introduce what they call a “housing lifeline” solution to income risk with a form of housing benefit to cover rent or mortgage costs whenever the household faces a short-term fall in income. No eligibility criteria would be imposed on this benefit (ostensibly to reduce poverty trap effects) but it would be subject to limits on the weekly payments (the example given in the paper is \$200 per week) and would stop once a defined maximum is reached (the example in the paper is \$20,000). It would be paid in the form of a loan on which a long term government bond rate would be charged and it would be repaid once income recovers and reaches a defined level, in a manner similar to HECS repayments. Except for the suggestions that repayments be tied to income through the tax system, this proposal is not unlike the forms of mortgage assistance currently provided by some State governments.³⁷

Gans and King see this as addressing affordability problems for households whose inadequate income arises from a short term loss of income rather than as addressing general affordability problems for households with permanently low incomes. They do, however, suggest that it might reduce housing costs by making lending or renting to lower income households less risky. In the short run, such a scheme would require additional government funding when it was introduced, but over time it should become self-financing as earlier loans are repaid. Current mortgage assistance schemes operate on a revolving fund in this way.

Evaluation

The aim of this Housing Lifeline proposal is to reduce some of the potential risks associated with income loss. Borrowers can avoid foreclosure and can protect their credit rating. Both borrowers and renters can avoid relocation costs. As such, this proposal has considerable merit and the importance of such an underpinning of any scheme that encourages home ownership amongst marginal and vulnerable households in an era of considerable economic and social instability has been an important theme in the last decade or so. See, for example, Berry et al (1999), and Greive et al (2003) for Australian material and Maclennan et al (1997), Ford and Wilcox (1998) and Ford and Quilgars (2001) for UK material. Such proposals were also included in the UK Housing Green Paper (UK OPDM, 2000). As articulated, the Gans and King proposal addresses only income risk. Ford and Wilcox (1998) express concern over solutions that do not address interest rate risk as well as income risk.

Gans and King recognise that their proposal requires some consideration of design issues, such as liability in case of household dissolution and potential differential treatment of single and multi-person households. They do not acknowledge that similar policies are already in place in Australia and they do not relate it to the experience of relatively well established mortgage insurance schemes that in place in other countries.³⁸ A systematic review of the effectiveness of such schemes is currently underway in the UK and is due at the end of 2003. Background material for this review can be found in Baldwin et al. (2002) and in Quilgars and Coucher (2003).

³⁷ The NSW Mortgage Assistance Scheme, for example provides low income purchasers with a short term loan to meet mortgage payments in cases where income loss is expected to be temporary.

³⁸ A market based mortgage payments protection insurance scheme, MPPI, for example, is well established in the UK although Ford and Wilcox (1998) suggest take-up is no more than 30% of borrowers and there is no relationship between take-up and risk.

The issue of how such assistance should be funded is one which could be given more consideration, particularly in light of the possibility that benefits are targeted at purchasers rather than renters. Apart from initial seed funding, the Gans and King proposal, like a number of Mortgage Assistance Schemes seed funded through the CSHA, are effectively user pays schemes with the ultimate cost being borne by those who, with hindsight, have benefited from it. They result in an increase in debt for those who call upon it. Alternatives are possible. Yates (1989), for example, proposed a tenure neutral housing benefit scheme with a compulsory mortgage insurance component to be paid for by all home purchasers, whether they were likely to be at risk or not. MacLennan et al (1997) suggest funding mortgage insurance from capital gains.

Gans and King recognise that their proposal does not provide new housing solutions for low income families. It protects the existing housing status of households when their income circumstances temporarily change.

(2) Land value risk

Their second proposal addresses problems faced by low income families are unable to access home ownership because of affordability problems.

Their solution to this problem is a variation on the Caplin and Joye proposal and is similar to Chandler's proposal to the NSW Ministerial Taskforce on Affordable Housing several years ago. As proposed by Chandler, they suggest it is possible to separate land and dwelling ownership through a shared equity arrangement to aid low income households. In their version, which is only sketched out in their paper, the household would purchase the dwelling and the government would fund purchase of the land on which the dwelling was situated. The sale of land occurs with dwelling at a time chosen by dwelling owner. They give no explanation of why it is essential for the government to be the equity share holder but one reason could be that they intend no rent to be paid on the land as with the Chandler proposal and have no inbuilt gearing possibilities as with the Caplin and Joye proposal. Except in extraordinary circumstances where anticipated land prices were sufficient to yield a market return in the absence of any rent yield, government ownership is required because of the implicit subsidy built into their proposal.

They see the split between land and dwelling as allowing relatively easy valuation because of the existence of a well developed land value profession. They suggest this proposal removes uninsurable risk associated with land price variations from low income households. Instead, it exposes the government to land value risk but they argue that the government can pool this risk and so faces a lesser risk than an individual land owner. They claim that moral hazard problems associated with rental housing because of a lack of incentive for the occupier to maintain the dwelling are removed by leaving dwelling ownership with the household.

In the absence of more detail, it is not possible to provide a critical evaluation of this proposal. However, as indicated above, on the information provided it appears there is a potentially a significant public subsidy built into it, particularly in light of the implied suggestion that it would operate in rural areas hit by falling land values.

6. The Caplin et al supply side proposals

The basic Caplin et al argument is that slow land release policies and zoning restrictions are major contributors to housing affordability problems. Without zoning, the problem of fixed supplies of land would be addressed by a capital land substitution with increasingly high density construction.

The Caplin et al supply side conclusions are derived from a highly aggregate analysis based on median dwelling prices and construction costs. These data ignore composition mix and ignore spatial aspects of housing. Their arguments ignore infrastructure costs that amount to a high proportion of the value of developed land, and which, in large part, are provided publicly. Considerably more detail on the costs of production can be found in the Housing Costs study undertaken by Travers Morgan more than a decade ago. They also ignore the differences in construction costs for high rise dwellings and conventional domestic housing.

A number of other potential weakness in the Caplin et al argument that will not be developed further entails a lack of explicit consideration of the fact that:

- the land price gradient tends to increase as city expands; policies need to focus on ways of reducing gradient as well as lowering the overall cost of supply. Indicative policies which can do this are better transport, development of new regional centres within urban areas, improved urban amenities in fringe locations and so on.
- urban infrastructure (e.g. roads, water and sewerage) cannot sustain increasing demands made by continual increasing density. The costs of upgrading existing infrastructure can exceed costs of putting new infrastructure in place.
- distributional issues are endemic. Even one bedroom high rise apartments in the city are unaffordable for those with low incomes and inappropriate and inadequate for those with families.

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