Cbus Submission - The affordable housing bond aggregator

The purpose of this paper is to respond to the issues raised in the Commonwealth Treasury's consultation paper released in September 2017. This document provides feedback from Cbus in relation to the proposed Bond Aggregator.

Section 4: Issues for consideration
Treasury welcomes feedback on the issues raised in Section 4, including on:

1. ***Eligibility:*** *It is currently envisaged that the bond aggregator will only provide loans to Tier 1 and Tier 2 CHPs. Could there be benefits to expanding the eligibility criteria to include other stakeholders involved in the provision of affordable housing?*

2. ***Purpose of loans:*** *The bond aggregator's loans are expected to be primarily used for funding housing maintenance and turn-key purchases. Do stakeholders agree with this focus? Is there scope for the bond aggregator to provide construction finance or should the bond aggregator be prevented from providing such finance?*

3. ***Security for loans:*** *What forms of security should CHPs be asked to provide to access bond aggregator loans? Are there any circumstances where such loans could be unsecured? If security is provided, to what extent should it be collateralised against other assets owned or operated by the CHP? What forms of financial covenants from CHPs should exist alongside any security? If a CHP has multiple secured creditors, how should the security in favour of the bond aggregator rank?*

4. ***Complementarity:*** *How could the Government ensure that the bond aggregator complements and partners with existing private and public sector investment into CHPs?*

5. ***Bond issuance:*** *Could affordable housing bond issuance be expanded to the offshore market or the retail bonds market? What are the potential benefits and costs?*

6. ***Bond issuance size:*** *What is the likely preferred issuance size for large-scale institutional investors?*

7. ***Contracting out functions:*** *Are there potential benefits from contracting out bond issuance and back-office functions? What are the potential costs?*

8. ***Government guarantee:*** *How would a potential Government guarantee on NHFIC bond issuances impact the NHFIC's ability to raise and price funds? What are the risks associated with applying a guarantee and how could those risks be mitigated?*

Introduction

Cbus' adopts a total portfolio approach whereby there is less emphasis on individual asset classes and more on maximising total portfolio outcomes. The Cbus debt sector is currently split across Cash, Fixed Interest (Global & Australian) and Alternative Debt. Within the cash and Fixed Interest sectors, liquidity and defensiveness are key considerations. As a consequence, these sectors are heavily biased to highly rated securities and in the case of Fixed Interest are primarily exposed to Australian and offshore government bonds. Within the Alternative Debt sector, the Fund can accept lower rated securities and a lower level of liquidity, so long as it is adequately compensated from an expected return perspective.

The provision or not of an explicit Commonwealth Government Guarantee is likely to influence where these securities may sit within the Cbus portfolio. If issued with an explicit guarantee we would see the securities potentially forming part of the fixed interest sector and being viewed from a relative value basis against other existing Government securities (recognising liquidity differences until the bond aggregator established sufficient scale). Without some form of guarantee these securities would likely be assessed against the merits of investments within the Alternative Debt sector. We expect that most funds approach assessing such securities in a similar way.

Cbus has approximately $2.7 billion invested in the Alternative Debt sector and $2.6 billion in the Fixed Interest sector as at 30 September 2017. We note that the current allocation to Fixed Interest is low compared to the long-term targeted allocation, reflecting current very low bond yields and a preference away from this sector from an asset allocation perspective.

We comment more specifically on pricing, scale and maturity tenor of potential bond aggregator issuance throughout our submission below, with particular focus on providing feedback around questions posed in section 4 of the September 2017 Consultation paper by the NHFIC.

1. **Eligibility***: It is currently envisaged that the bond aggregator will only provide loans to Tier 1 and Tier 2 CHPs. Could there be benefits to expanding the eligibility criteria to include other stakeholders involved in the provision of affordable housing?*

   We are comfortable with the Bond Aggregator (BA) only being available to Tier 1 and 2 CHP's. We would expect that the CHP's are best placed to ensure social and affordable goals are met, including the provision of new stock for the sector.

2. **Purpose of loans:** *The bond aggregator's loans are expected to be primarily used for funding housing maintenance and turn-key purchases. Do stakeholders agree with this focus? Is there scope for the bond aggregator to provide construction finance or should the bond aggregator be prevented from providing such finance?*

   In regard to the permitted purposes for the lending, we would support the Bond Aggregator's role being extended to provide construction finance, noting that, according to the Ernst & Young report, 62% of CHPs indicated the preferred purpose for borrowing is construction, and we consider that if appropriately resourced and skilled, the NHFIC should be able to undertake construction loans.

   A Warehouse Facility could be extended for a tenor of up to 3 years and allow the CHP's to access funding on a progressive basis to fund refurbishments or construction.

3. **Security for loans:** *What forms of security should CHPs be asked to provide to access bond aggregator loans? Are there any circumstances where such loans could be unsecured? If security is provided, to what extent should it be collateralised against other assets owned or operated by the CHP? What forms of financial covenants from CHPs should exist alongside any security? If a CHP has multiple secured creditors, how should the security in favour of the bond aggregator rank?*

Please see our comment under question 4 in relation to Complementarity. If CHP's have need for funding separate to the Bond Aggregator close ties with the debt financing community will be required.

In relation to security we make the following observations:

1) In normal circumstances, if the Bond Aggregator is providing ongoing general corporate debt, it would want to take security over all the assets of a CHP. However, if other lenders are required for other facilities – and especially for construction debt it may need to limit the security it takes.

2) If the Bond Aggregator takes 1st ranking security (GSA) or mortgages over the CHP's assets the CHP may face difficulties raising other debt including working capital facilities or even payroll lines of credit. Construction debt would become very challenging for the CHP's to raise, as generally lenders would take into consideration and receive the benefit from existing assets and income of the CHP when providing construction debt facilities. The NHFIC could consider:

    a) A security sharing arrangement with the NHFIC / Bond Aggregator determining the total amount of debt that the CHP could borrow from any party. Banks or other lenders would need to obtain an acknowledgement or consent from the NHFIC / Bond Aggregator for the creation of any new debt.
    b) No security held by any party (and negative pledge not to grant any security), but again an agreed maximum debt level would need to be determined.

3) Standardised covenants may be difficult to define as even Tier 1 CHP's have different balance sheet positions and different revenue sources. Input from CHP's will determine if standard covenants are practical. If the goal is to create additional affordable housing any covenants put in place should be structured to enable CHP's to undertake new construction on assumptions that the new properties will lead to additional revenue sources for the CHP's.

Moody's, whose rating methodology is referenced in the Ernst & Young report, or S&P, should be able to assist the Bond Aggregator in relation to covenant ranges that would meet their respective criteria.

4. Complementarity: *How could the Government ensure that the bond aggregator complements and partners with existing private and public sector investment into CHPs?*

We consider that to answer this question the Government / Treasury would need to understand the granular details of how debt funding is currently provided to the sector. At present funding could include various sources of federal, state and local funding; support from religious or other charitable organisations as well as loans from banks and other debt providers.

We would encourage approaches that facilitate and promote the development of new stock for CHP's, as well as those that lower the overall cost of debt for CHP's.

5. Bond issuance: *Could affordable housing bond issuance be expanded to the offshore market or the retail bonds market? What are the potential benefits and costs?*

There is certainly potential for the issuance to be expanded. With regards to offshore markets it is extremely important to be a "well known entity", if attempting to raise funds globally. This is where a Government Guarantee can be most beneficial, as the Australian Sovereign backing is well understood in global wholesale capital markets. Without a guarantee, there would be additional marketing and a longer lead time to showcase the new issuer to the broader network of investors. This would increase the cost of issuance. Offshore issuance is primarily attractive to the issuer due to the potential scale benefits, particularly with regards to issue size and a longer maturity profile.

Accessing the US corporate bond market can provide funding in average sizes of $500 million to $1 billion. Most recently Australian banks have utilised this market. They have been able to secure 30-year funding in volumes well in excess of $1 billion.

Retail bond markets are obviously at the other end of the scale. Retail investors tend to need more education around new issuers, but once an allocation is made their investment tends to be more "sticky' when compared to wholesale market investors. Retail demand stems from listed bond offerings and the cost of listing a retail offering rarely compares favourably against wholesale issues. A government guarantee would likely be attractive from a retail perspective, but appropriate enquiries would need to be made in relation to the appetite for long tenor paper from retail investors.

6. Bond issuance size — *What is the likely preferred issuance size for large-scale institutional investors?*

Institutional investors tend to gain comfort around issuers and issues that are ultimately included in broadly accepted benchmark index. The main Australian index in the Australian fixed interest sector is the Bloomberg Composite Bond Index All Maturities. The Bond Aggregator should explore the requirements for inclusion in such indices as this will likely provide access to a broader investor base with increased scale.

We understand that $100M is the minimum size to be included in the primary indices, however a preferred issuance size would be expected to be in the order of $200-$300M, as this would allow greater potential secondary market activity.

7. Contracting out functions — *Are there potential benefits from contracting out bond issuance and back-office functions? What are the potential costs***?**

We don't have any strong recommendations in this area. However, we would encourage the Board of the NHFIC to consider optimising cost efficiencies, closely managing reputational risk, leverage of expertise and allowing greater focus on core business practices of delivering affordable housing.

8. Government guarantee — *How would a potential Government guarantee on NHFIC bond issuances impact the NHFIC's ability to raise and price funds? What are the risks associated with applying a guarantee and how could those risks be mitigated?*

We are supportive of the role of a Government Guarantee, believing that this will provide more attractively priced debt for the CHPs, and thus allow these entities to operate more effectively and ultimately create greater housing stock.

The positive impact of a Government Guarantee should be felt in two main ways:

- Firstly, through a lower cost of funding when compared to an unguaranteed NHFIC issue. Based on our high-level analysis, without a Government Guarantee the interest costs savings to the CHP's may not be sufficiently worthwhile when compared to other sources of financing available to them.
- Secondly, through access to greater size, tenor and frequency of issue.

There is a risk that once a guarantee is applied, it would be difficult to remove. A possible "period of guarantee" could be feasible, which would give the entity time to establish itself from a ratings and overall track record perspective. To further mitigate this risk the ability to access a guarantee could be written into the legal documents of issuance, which would give the entity some surety of re-finance should there be disruptions in wholesale funding markets.