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Shared Equity – Its Role in Meeting the Housing Affordability Challenge

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The problem

Australia today faces a serious housing affordability problem.

It is not going to go away any time soon.

Australia's home ownership rate has remained remarkably resilient at around 70% for the past half century at least, in the face of significant real increases in the price of housing over this time.

Home ownership ambition is a key driver of social capital inclusive of security in retirement and intergenerational equity and thus advancement in our community.

But our home ownership rate is likely to decline significantly unless some creative affordability solutions can be found.

A parallel development is the diminishing stock of low rental housing for low income families and the consequent upward pressure on rents. We desperately need creative solutions here too.

In my view, super funds have a key role to play in these solutions.

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‘Key workers’ in major metropolitan markets are increasingly priced out of home ownership, and their aspirations disappointed. These same workers are a key constituency of our super funds.

The ACTU

The ACTU was pivotal in the establishment and growth of universal superannuation in Australia.

Without concerted action by the union movement 25 years ago, the industry and indeed our national savings and investment base would be impoverished shadows of what they are today.

The union movement has been at the forefront driving down fees and charges in the interests of members, establishing the Industry Funds in partnership with employers, likewise Members Equity Bank and mobilizing financial innovation with a vigilant focus on end benefits to members.

The ACTU has an even longer history of involvement in housing policy and advocacy for suitable housing accessible to all.

Over the past four years this has largely been through the National Affordable Housing Summit group chaired by Julian Disney, whose membership includes ACOSS, the HIA, the Community Housing Federation of Australia and National Shelter.

The ACTU strongly believes creativity and shared responsibility must now be applied to meet the current challenge of housing affordability.

And we believe that superannuation funds as patient long-term investors can and will be part of the housing affordability solution. Residential property is an asset sub-class with tremendous potential to deliver good risk-adjusted returns in a diversified portfolio wholly consistent with the single purpose test to which fund trustees adhere.

The solutions

The housing affordability challenge extends right across the income distribution.

At the top end, in the top quintile where property incomes comprise a large portion of total incomes, some households are spending more than 30% of their income on mortgage repayments because they invested in high value property or have put the plasma, the boat, the heli-skiing holiday or whatever on the mortgage.

This is not a substantial concern for public policy.

In the middle income ranges where ordinary working families are found, and particularly for young individuals and households, real hardship is being experienced with 30% plus of their income is outlaid on mortgage repayments. Alternatively, they are forced to move further out - which is where their jobs and friends are not. Even there, on the urban fringes, infrastructure charges and fuel prices work against affordability.

Worse still the rapid escalation of real house prices in the capital cities has shut many aspiring home owners out of the market.

At the bottom end, in the bottom two quintiles of the distribution where reliance on transfer incomes predominates, the drastic shortage of affordable rental stock – due in large part to the evaporation of funding for public housing over the past quarter century – has delivered real hardship.

Housing affordability in the bottom and middle income ranges matters greatly for social cohesion. Creative responses are desperately needed, from both the public and private sectors.

Happily, ingenious initiatives and creative responses to the housing affordability problem are on the radar right now.

These innovations are on both the supply side and the demand side of the housing equation.

As I see it, they are complementary, and both offer investment opportunities for patient institutional capital.

The Rudd Government's National Rental Affordability Scheme [NRAS] is a welcome supply-side measure targeting the affordable rental stock problem at the bottom end of the distribution.

The ACTU has been a strong advocate of this scheme, through our membership of the Summit group, and I do not propose to say much about it today, other than this:

- The NRAS delivers 100,000 incentives for construction of that number of new dwelling units, to be let at a 20% discount to market rents to tenants who meet income tested eligibility criteria
- It delivers a secure stream of public funding associated with each new dwelling for a decade, leveraging private institutional finance by raising risk-adjusted returns to market competitive levels
- It is available for new stock only
- Boosting supply through this scheme will take several years

- Consortia - involving developers, affordable housing managers, state and local governments, and investors – are at the heart of the scheme and will be required to make the scheme work
- Previous demand-side measures such as Commonwealth Rent Assistance have not translated into more stock but have disappeared into landlords' returns
- For many families in this range of the income distribution, such as those with special needs or endemic joblessness, home ownership is a very remote prospect over any time horizon
- For others, including low paid workers on minimum wages, affordable rental accommodation can be a stepping stone to home ownership in later life, enabling them to save towards a deposit with a modicum of comfort and some security of tenure
- The NRAS is no panacea. It is part of the solution. It complements shared equity schemes, and I believe will develop into a transition route for low paid workers from rental accommodation to home ownership.

Across the middle and into the higher income ranges, which is where most working families and union members are found, the likelihood of additional public subsidies is constrained. First Home Owner grants and taxation arrangements deliver substantial amounts of public assistance already, and a $500mn Housing Affordability Fund has been established by the Rudd government. Nonetheless, governments may be receptive to using resources here to greater effect.

Shared equity innovations are a complementary part of the affordability solution and it is across the middle and higher ranges of the income distribution where they will take root and grow.

I have been vocal in expressing my support – and that of the ACTU - for shared equity schemes, for several years.

Australia has been at the forefront of research and new product development in this arena.

For example, the first mass market, private sector shared equity product was recently introduced by Rismark International in conjunction with Bendigo and Adelaide Bank in March 2007.

In the public sector, the SA and WA governments have introduced fully-fledged shared equity programs over the last 12 – 18 months.

The appeal of shared equity products is real and immediate:

- A shared equity loan delivers borrowers with an instantaneous benefit. With the currently available Bendigo/Adelaide Bank loans for example, borrowers can reduce their current mortgage repayments by 30% or more, which is a tangible thing in the current and prospective interest rate environment
- Many can move out of the rental market and purchase their first home sooner
- The housing market is stabilized if demand is maintained

But design matters, and it matters a great deal. In my view it is vital that:

- Home owners should retain the majority of the capital gains on their home
- The shared equity lender should also share proportionately in any arms-length capital loss
- The product should have a 20-25 year term like any normal home loan

- The borrower should retain all of the control rights associated with their home including the choice, after a set period of time, to buy out the equity partners.

Shysters and rip-off merchants can give any scheme a bad name, and these criteria are really fundamental. In this respect it is worth reiterating this simple fact:

Shared Equity does not mean Sub-Prime

It is important to understand the credit rating of ‘key workers’.

- These are generally workers with very secure, long-term predictable salaries, often in the public sector – eg teachers, police
- On average, key workers are good and practiced at budgeting and have low default rates
- Sub-prime is just poor US lending practice which has not been adopted in Australia. And notwithstanding concerns we have around both mortgage stress and dangerous levels of indebtedness our default rates are still only 1% of the market even with higher interest rates

I mentioned earlier that Commonwealth Rent Assistance has been criticized for being inflationary, and it has been argued that as shared equity initiatives are a demand-side measure they will have similar effect. I think this criticism is overdone. While the ‘sign’ of the effect might be the same, the magnitude is likely to be very small. For example:

- Suppose optimistically that super funds were to invest $2bn of new capital a year into shared equity products. This would equate to around 20,000 a year of new shared equity loans at $100,000 a piece

- In Australia today there are a million or more home loans originated each year
- Under this scenario shared equity loans would constitute 2% of the entire home loan market.
- Realistically, any impact on price deriving from such a market share will likely be dwarfed by the benefit derived by 20,000 new shared equity borrowers

What role for super funds?

A shared equity portfolio provides a well-diversified long-term exposure to the residential property asset sub-class. Thousands of properties, with 20-25 year terms.

If the major retail banks were to underwrite these products on their balance sheets, they would be making a direct investment in housing which would attract a full ‘capital deduction’.

In contrast, superannuation funds, with their long-term liabilities, are more immediately suited to invest directly.

Residential property is the largest single asset class in Australia, valued around $3.2 trillion. But for super funds it has been hard to access, because of the high round-trip transaction costs and ongoing maintenance costs associated with buying residential property direct, and because of fragmentation of the rental market.

In my view the National Rental Affordability Scheme has excellent growth prospects. I believe it will develop to delivering a tractable, consolidated portfolio of residential rental property delivering competitive risk-adjusted return to institutional investors.

Similarly, shared equity promises to provide investors with cost-effective access to the otherwise 'untouchable' owner-occupied housing market, which accounts for around 70% of the total residential stock in Australia. With home-owners managing their own properties, a close alignment of interests should be assured.

Residential property is definitely a market with sound prospects for institutional investors:

- In January 2008, ANZ Bank research noted that '*in risk-adjusted terms, residential property has delivered vastly superior returns to all other broad asset classes'* over the long term.
- Late last month BIS Schrapnel released forecasts projecting strong returns to residential property out to 2011.
- Residential property is an 'uncorrelated' asset class with respect to stocks, bonds and cash, and thus holds significant diversification advantages

In summary

Many members of super funds are exposed to residential property through ownership of their own homes and many who are renting, want the opportunity to access home investment.

We have all heard the facile argument that members of super funds are already exposed to residential property because of their ownership of their own homes and subsequent additional risk that investment in shared equity would pose.

This is nonsense when you consider that some members own shares in Telstra or ComBank, and some own no shares.

Rather, we know that members want their super funds to invest in Australian equities, in a large diversified portfolio, to manage the risks and give them diversification benefits with a healthy long-run return. We believe they would apply the same attitudes to residential property investment, particularly where beyond secure returns, this investment also has the potential to assist them, their children, or their grandchildren.

The same principle applies to residential property.

Super funds are increasingly acknowledging their social and community obligations. This is reflected in their signing up to the UN Principles for Responsible Investment and the Carbon Disclosure Project. By allocating a share of their investments to residential property – to a portfolio of shared equity assets, and a portfolio of low-rent housing – super funds can invest with genuine purpose consistent with the single purpose test. In doing so they would get:

- Long-term exposure to large asset sub-class, one they have previously not managed to crack because of inherent transaction costs, and market fragmentation; and
- Market competitive risk-adjusted returns; while
- Delivering tangible benefits to members and the community.

Super funds have been great innovators in Australia.

This is a great new opportunity for super funds and their members.

I commend the shared equity pioneers such as Rismark and Storehouse whom we have watched sustain interest in and advocacy on this matter. They have tilled new turf and opened a major new field for investors and consumers alike, and have done it without any explicit government assistance. They will pave the

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way for others no doubt but we wish them well and thank them for staying the distance.

I am confident that as super funds grasp the new opportunity, a new property asset sub-class will grow and help the nation meet its housing affordability challenge.

Melbourne, 2 July 2008