# Challenges and opportunities in financing affordable housing in Canada

**Background Brief prepared for the Federation of Canadian Municipalities**

**By Steve Pomeroy, Focus Consulting Inc.**

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## Issue

In recent advocacy, and through their submission to the consultation on a national housing strategy, FCM (and other stakeholders) have advocated for the federal government to invest in the protection of Canada's social and affordable housing stock, placed at risk by the expiry of long term funding agreements and, in addition, for the expansion of new affordable housing. FCM have also advocated for support to facilitate increased production of moderate rent rental housing production.

FCM welcomed the Budget 2016 announcements of increased funding together with new financing initiatives for affordable rental production.

To the extent that new funding was identified as part of a broader commitment to social infrastructure investment, FCM is concerned that subsequent proposals for the Canada Infrastructure Bank (CIB) might dilute or reduce some of the funding believed to be intended for affordable housing renewal and expansion. At the same time, there may be a potential role for the CIB to support objectives of expanding the production of affordable and moderate rent rental housing.

The purpose of this research is to examine the current state of funding and financing for affordable housing in Canada. To what extent is the supply of and access to low cost financing an impediment to the expansion of affordable housing? How do subsidy programs such as capital grants under Investments in Affordable Housing (IAH) relate to, and reinforce, financing (including both public finance, as proposed in Budget 2016 and private lender financing)? And is there a potential role for the CIB and a proposed Canadian Housing Financing Authority (CHFA) to invest into and support renewal and expansion of the affordable housing stock?

## Setting the context: how funding, equity and financing inter-relate

Multi-unit rental development, both in the private rental market and under non-profit models involves a mix of owner/developer contributions (land and/or cash) together with mortgage financing. This relies on cash flow from rental income to both service debt (financing) and to provide a return on invested equity. Developers typically seek to minimize their contribution and maximize the amount they borrow (a concept labelled as leverage).

Lenders largely rely on CMHC underwriting criteria to establish how much they will provide in financing toward to total capital cost, and the remainder must then be covered by equity investment. CMHC and lenders look to the rental income as the basis for repaying the loan and seek to ensure that the project generates sufficient rental income to prepay the loan. The net income is also the key determinant of the property value, which is also a form of security for a lender (who could foreclose and sell the asset to recoup loan funds).

Where the project does not generate sufficient free cash (after operating costs) to cover debt service as well as a minimal return on the investor equity, lenders will not lend, investors will not invest, and rental housing will not be developed.

The critical elements of new rental production are cost: land construction costs and related soft costs (professional fees for architect, engineers, legal, interest and taxes during construction, various permit and development fees); and net rental income after operating costs, usually labelled net operating income (NOI). Affordable housing generally involves modest quality but even then the potential to build at low cost is limited by competition for key inputs – materials, labour and land. So income leverage and equity must add up to cover these costs.

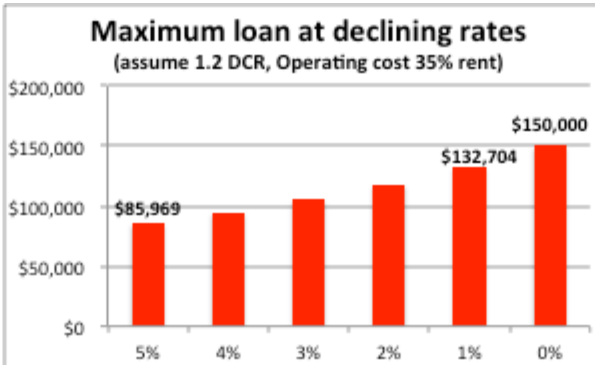
This frames the essential predicament for affordable housing. With an objective is to keep rents low and affordable, such projects generate low net operating income (NOI). As such they have constrained capacity to support financing or to generate return on any invested equity. With less capacity for leverage, they depend on capital subsidy to cover the difference between maximum financing and total cost.[1]

Low rents directly impact capacity to finance (and thus the residual equity or grant required). First the NOI is the basis for valuation of the asset, so with low rents, it has low value. CMHC and lenders limit the loan to 85% of "lending value".

Second, with low rents (and low NOI) the amount available to make mortgage payments is lower and this limits how much the project can borrow (the concept of debt coverage or debt service ratio, DCR). In commercial multi-unit rental loans lenders typically require a minimum DCR of 1.3; for CMHC insured affordable housing, CMHC will permit DCR as low as 1.0, although in order to generate some operating reserves a DCR of 1.15 is more prudent and typical. So for example if the NOI per unit is $600, at a DCR of 1.2 there is $500 available to support debt service, while the remaining $100 is retained as an operating reserve.

The DCR compares cash available to service debt and the actual debt costs, so it is sensitive to the mortgage rate. At lower interest rates, a larger loan is possible with a fixed payment (thereby reducing required equity and enhancing return on equity). This is shown in Fig 1A.

[1] The alternative to capital subsidy is to permit a higher level of financing (up to 100% of cost) and then commit to subsidize the ongoing debt service costs. This was the traditional model used in social housing up until 1994 and this modeled continued under some provincial programs, notably in BC and Quebec beyond that time.



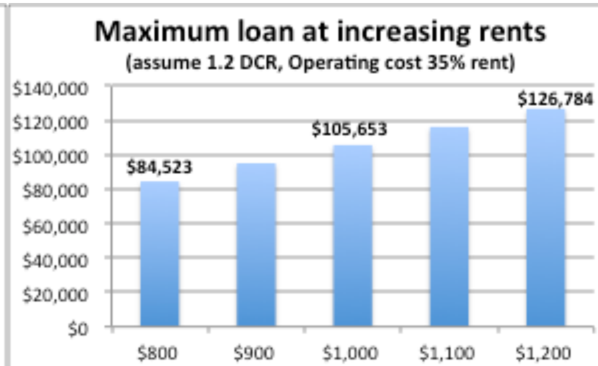




**Figure 2A: Leverage at lower interest rate (fixed rent)**

**Figure 1B: Leverage at higher rent (fixed mortgage rate)**

In a market where the average market rent is $1,000, but new properties can command a rent at 120% to 140% of AMR, the potential leverage is much higher as rents increase. Increasing rent from $800 to $1200 per month increases potential financing by $50,000 per unit (Fig 1B).

In most instances, without public subsidy (or some benevolent source of equity) projects targeting low affordable rents (at or below 100% AMR) cannot secure mortgage finance.

Low rent affordable housing projects (rents below AMR) are dependent on substantial levels of grant equity and for this reason the IAH framework permits grants of up to $150,000 per unit (combined federal and provincial). The total amount of the IAH funding in recent years has been relatively small and has consequently supported development of only 4,000-6,000 units annually.

So the limited amount of grant equity may have been a more serious constraint than lack of financing. To the extent that IAH and other federal programs expand this grant funding, as was done in Budget 2016, there will be increasing demand for financing and capital. This includes both financing to support new development and capital to repair and modernize aging social housing assets.

## Main sources of funding and financing currently used for affordable housing

A number of key stakeholders were interviewed to determine the nature of constraints on access to and availability of financing for both new affordable housing and financing of stock renewal (see appendix A).

As noted above, most affordable housing developments use some combination of IAH grant and mortgage financing. In some cases this is augmented by additional sources of equity such as land (especially where existing sites are being redeveloped or intensified), cash contributions (from accumulated reserves or private investors) and various types of in-kind contribution such as waiving municipal fees and charges, discounted land via land leasing and density bonusing to effectively provide land at no cost for the affordable units.

Some provinces have developed financial programs to facilitate access for non-profit and co-ops seeking to undertake new development.

BC Housing has for many years provided a range of partnering services to enable and support proponents of social and affordable housing. This includes a direct lending function under which BC provides financing for construction loans (at very favourable rates). Once projects are complete and occupied BC Housing tenders takeout financing through competitive bulk loan packages, which also achieves competitive rates (recently around 2.6% on 10-yr terms). For the lenders, this represents a low risk loan as all of the construction risk has been removed and the loans are insured under CMHC loan insurance (indemnified by province). In performing this intermediary role, BC Housing has established a specialized expertise and has a strong understanding of the program and product. They have already completed detailed underwriting review and due diligence prior to offering the loans to lenders, so the lenders level of effort in reviewing and approving these loans is minimized.

With this long-standing financing intermediary service in place, access to financing for affordable housing development is not a serious challenge in BC.[2]

As in other jurisdictions, however proponents still need to provide an equity contribution to cover total capital costs. It is this equity or grant component that may be the larger challenge, although recent events in BC have also helped to generate new sources of equity:

- First, through their housing asset transfer, the BC government has sold $355M in existing public housing assets to community-based non-profits. This has generated a large pool of capital that is now available to BC Housing to assist community non-profits and co-ops in new initiatives.
- Second the imposition of a new sales tax on foreign buyers has generated significant revenues and these are allocated to a Housing Priority Initiatives special account and are also available to fund new affordable initiatives. This account now holds in excess of $500million revenues and has become a significant source of funding for new affordable development.

So the constraint of grant equity is currently less an issue in BC than may be the case in the rest of Canada.

The province of Quebec via SHQ also plays a significant role in facilitating access to financing. The affordable housing development program in Quebec AccèsLogis, provides capital grant

[2] There is however a cap on the amount of the loan pool that can be outstanding in construction loans at any point in time ($160M) and a limit on the insured loan volume. If BC were to expand the volume of development financing these caps would have to be negotiated, so could conceivably become a constraint.

funding to cover roughly half of approved capital costs for affordable housing targeting rents below 95% of AMR. Proponents must then contribute or assemble from community sources of between 5-15% equity toward the cost. This leaves a financing requirement equal to only 35% - 50% of project cost.

SHQ further facilitates financing by providing a guarantee on these loans (like BC via the loan insurance agreement Quebec also uses CMHC mortgage insurance, a policy that lenders are familiar with) and manages a competitive process to select a primary lender each year (usually the Desjardin Credit Union or the National Bank) to fund all the associated loans. So there is a high degree of comfort for the lender under this process and financing rates are very competitive (currently under 3%).

The provincial budget for affordable housing has been reduced in recent years, falling from a target of 3,000 units to 1,500, so the primary constraint on new affordable development is the limited amount of capital funding under the AccèsLogis program. By comparison, access to financing is not an issue

Ontario implemented a new conduit for affordable housing finance in 2008 by adding the affordable non-profit rental asset class to the categories that could be financed under the province's infrastructure lending agency Infrastructure Ontario (I/O). Like BC, this provides both low rate construction financing as well as takeout loans. In this case these are usually fixed rate long-term loans, rather than the five-year rollover mortgage that is more common in the Canadian residential finance market.

While available to non-profit developers in Ontario (it is not open to for-profit developers, even when participating in the IAH affordable housing program), this financing facility has not been extensively used, despite very favourable loan rates. The key impediment has been the somewhat restrictive underwriting criteria (higher DCR and requirement for corporate covenants and extensive documentation requirements), although I/O is now looking to adjust and reduce some of these criteria to make their lending product more attractive and competitive.

For the loans I/O has done (on average around $10milion per year last few years) they have found the largest challenge for potential borrowers is assembling sufficient equity (grant and other sources such as municipal land, waived in kind fees etc.) to balance out the maximum financing based on targeted rents.

With I/O supporting only a low volume of financing, most affordable projects in Ontario tend to be financed by mainstream lenders and the chartered banks or in some smaller communities the credit unions. RBC and First National have tended to be quite supportive of affordable housing loans and have developed a solid understanding of the nature of such loans and borrowers. Such lender specialization and understanding facilitates the loan process, both for lender and borrower.

Using CMHC insured loans, in todays environment most proponents are able to achieve relatively low interest rates. For the smaller municipalities with less to offer in the form of in kind support, and small allocations of IAH/SIF funds proponents do face some challenges in assembling sufficient equity to make projects financeable.

Other provinces especially the smaller ones do not have such provincial financing supports in place. The total volume as well as typical loans are generally smaller and most community based providers tend to use the bank or credit union with whom they do their banking, so have an ongoing relationship with a lender than has some familiarity with the borrower.

Some jurisdictions, such as Saskatchewan and Alberta tend to allocate a larger amount of equity such that the first mortgage is at quite a low loan-to-value ratio. Saskatchewan contributes the IAD finding as a subordinate forgivable 20-year loan, which is forgiven if the proponent remains in compliance with targeting conditions for the term of the agreement (usually 20 years). As noted the scale is very modest at only $10-12 Million annually, supporting development of fewer than 100 units. And all first mortgage financing is secured through local landers (often credit unions) that already have a relationship with the non-profit.

Recent developments in Alberta have been awarded grant funding covering just over 50% of cost and grant funds have been advanced early to facilitate land closing. The province required all units to have rents at or below 90% of the local AMR. In these cases with a low loan to value ratio, well established housing providers have not had much difficulty is securing financing through chartered banks and mortgage lenders.

In the co-op sector, CHF Canada has developed a refinancing program in partnership with credit unions. This usually involves a form of blend and extend under which existing mortgages with higher rates (long-term fixed rate CMHC loans) are renegotiated with a new larger loan at a lower rate and extended amortization. This enables the coop to payout the current loan and raises additional capital to cover regeneration of the existing asset, with no increase (and often a reduction) in ongoing mortgage payments.

Facilitated by a formal supported refinancing program managed for its member coops by CHF, this provides an intermediary service and form of credit enhancement for lenders and helps to overcome the limited capacity of the borrower co-op. To date this has raised over $100 Million to refinancing more than one dozen co-ops. On this basis officials at CHF confirm that access to finance is not a serious challenge or impediment.

While these examples confirm there is not a serious challenge in securing mortgage financing for most projects, lower interest rates, such as those proposed under the 2016 budget affordable rental financing initiative would help to stretch the limited grant funds further (details on how this financing will be structured are expected to be released shortly by CMHC).

Municipalities are not directly involved in financing, but their policies and practices can impact on project viability. The municipal role varies across the country with some larger cities such as Vancouver, Toronto and Montreal having a long-term proactive involvement in enabling affordable housing. Following local responsibility realignment in Ontario in 1999, Ontario municipalities now have a statutory role to both support and fund social and affordable housing and have become the conduit for IAH funding in Ontario.

In other jurisdictions municipalities have voluntarily become more active. Many provide contributions in the form of land (discounted or leased), various forms of inclusionary policies which effectively generate land or funds to help support affordable development policies, waiving of development fees and charges, planning relaxations such as reduced parking where sites are proximate to transit and expedited review and approvals for affordable housing.

Some municipalities (e.g. Toronto) offer a property tax exemption where projects meet affordability criteria, which has the effect of increasing NOI and thereby increasing the loan amount that can be borrowed. [3]

## Key challenges and gaps in current financing

Based on feedback from interviews it is clear that availability of debt financing is not generally a serious issue or impediment to affordable housing.

A range of provincial financing conduits have been established and in addition a variety of chartered banks, mortgage lenders and credit unions appear willing to provide project financing on IAH assisted developments, especially when such loans are insured by CMHC.

There may be some challenges in securing financing for smaller providers, with minimal financial capacity or expertise and no existing assets as collateral. Many are unfamiliar with standard loan application and underwriting criteria and are easily frustrated by what they perceive as an onerous process. Typically these potential borrowers lack the security and cash flow to support the loan amount they seek, and have insufficient equity to make the development viable. The larger and more experienced organizations have a greater awareness

[3] While exemption from property tax has an important impact on NOI and leverage it can also create unintended impacts. By requiring all units to be at or below an affordable threshold (AMR) is precludes options such as mixed market development where some units are above AMR and contribute revenues to cross sub-seize affordable targeted units.

and understanding of the lender requirements and are more comfortable in working through the process.

There are a number of issues related to the process of project financing, especially around timing.

While BC Quebec to Ontario have established financing conduits there are gaps across other provinces and for smaller projects.

Neither provincial IAH programs nor lenders will advance funds until project approvals are in place and a building permit is issued. This means proponents must fund an array of pre-development expenses, including professional fees to consultants, architects engineers, legal fees and often land costs. Some larger non-profits may have reserves or existing assets against which they can borrow, but smaller and new providers lack such options.

In some cases, especially for supportive and deep affordable projects, proponents are charities and propose to fund raise to assemble the proponent contribution. However, they require an extended period to undertake and achieve fund raising so they often lack resources in short-term to cover upfront costs (working capital). It is necessary to negotiate bridge financing to cover this period. Again experienced providers and those with unencumbered assets have collateral to support bridge finance, but small organizations do not.

The revised CMHC seed funding, with larger loan portion could potentially help but currently this is not available to proponents accessing IAH grant funding. An alternate source of bridge financing could assist this process.

In addition to the affordable project rent structure being unfavourable to lending (targeting affordability generates insufficient net income to support debt), the capacity and competence of the operator may also be a concern to lenders, especially when there is no longer ongoing subsidy (as there was in social housing) to ensure operator had funds to sustain mortgage payments.

So this issue is not so much about lack of capital or availability of financing, it is about the inability to qualify for and access finance (a function of both provider scale and capacity, size of developments and loans, and a prevailing practice and culture that prioritizes affordability, and thus undermines financeability).

Private lenders are less interested in small developments with small loans, as processing effort and cost are high on a per unit basis, compared to larger loans. Also smaller groups that are not experienced in development and lack capacity require more patient lenders willing to help them understand the lending process (and why they may not have a viable business case). In this context there is a potential role for specialized intermediaries to help guide les experienced providers, similar to the role CHF plays for its members under its refinancing initiative.

That said, it is debatable whether enabling small-inexperienced non-profits to develop new units is a sound practice from the perspective of a strong sustainable social housing sector. The sector is already characterized by many small fragmented unprofessional providers. Under this structure, it is difficult to leverage the asset base created by 50 years of public funding. These assets are individually small and of limited value – the value is in aggregating a number of property assets to create a stronger balance sheet, as well as economies of scale in operations.

So any new attempts to facilitate financing should beyond project viability to sector sustainability, capacity building and professionalization. This can be achieved by focusing efforts to establish fewer larger organizations where economies of scale and expertise can be centred.

Few proponents to date have explored the concept of a mixed rent with a blend of rents above and below AMR. Most pursue affordability objectives and seek to get rents lower, circa 70% of average market rent (AMR). However, this then constrains loan amounts. So there is a dynamic tension about affordability versus viability versus optimizing leverage – both to secure debt finance and to attract equity investment.

Traditional social housing providers appear reluctant or have disinterest in exploring mixed rent concepts that could ultimately establish more sustainable portfolios, generating surpluses and reserves to cross subsidize low rents, provide funds to cash flow new development and to invest in expansion.  In some cases the private sector lobbies against these approaches, arguing that non-profits are being subsidized to compete and therefore represent unfair competition. And often public funders, provinces and municipalities in Ontario create restrictive policies that preclude more viable mixed rent projects (e.g. a condition of receiving funding is that all units must be below 90% of AMR).

Alongside a need to expand affordable housing opportunities there is a need to increase production of market rentals, especially in the intermediate market (rents between 100% AMR which are assisted by IAH programs, and below the full market at 140% and up that developers are creating. This is a space that the non-profit sector might fill a void and generate rental revenues to broader their affordable goals.

Although there are irritants and some process issues in financing, access to finance is not the critical constraint.  The larger challenge for most proponents is securing an allocation from the major grant fund programs under the provincial/territorial variants of IAH, and assembling additional layers of proponent equity.

As noted below, there is greater potential to introduce and attract equity investment from institutional patient investors in the intermediate market (as distinct from low rent targeted developments) as cash flows are more favourable and con serve the required return on investment that these institutional investors require.

Recent proposals to create a specialized intermediary and equity funds might provide some assistance to help address these gaps and issues.

## Recent proposed affordable housing sector bank, equity fund and Canada Infrastructure Bank (CIB)

A consortium of larger housing stakeholders has recently proposed the creation of a specialized lender for the affordable housing sector. Initially suggested as a housing bank, this has been reframed as the Canada Housing Finance Authority. Its role would be a specialized intermediary that understands the affordable housing product and sector to play a valuable role in assisting less experienced groups to develop a sound business case to support a loan on their development.

It is proposed that some form of guarantee be provided to these loans (e.g. by federal government or CMHC), and this would effectively emulate the current policy of waiving CMHC mortgage premiums for loans meeting affordability criteria (CMHC affordable rental flexibilities). This would add a form of credit enhancement to the loans. A number of such loans could then be packaged and sold to investors or into the capital market as an aggregated pool of mortgages in larger bundles of $50-$100 Million. With the strength of specialized underwriting and a loan guarantee, these would command bids at relatively low rates of interest, comparable to CMHC insured loans and the rates currently achieved in BC Housing competitive tendering process.

With a specialized expertise and role the authority would also provide economies of scale in processing costs. Such an intermediary would be a useful addition to the current institutional framework, especially in jurisdictions that do not currently have access through a specialized conduit as do BC and Quebec (and less effectively, Ontario).

To the extent that the larger issue identified is the amount of equity and grant capital to balance out debt financing, there is also potential to augment public investment (capital grants) by seeking to attract equity investment (such as patient capital from institutional investors).

This option has been explored and reported in a recent research paper by the National Housing Collaborative.[4] It suggests that private equity might consider investment into affordable

[4] National Housing Collaborative Rental Supply Options Research Paper Prepared by: Derek Ballantyne, November 2016

housing, if the targeted projects can generate sufficient cash flow to provide a reasonable return on investor equity. As described in the NHC paper, this requires that rents be established at higher levels, at least at average market rents (with a mix of market units at higher rents and affordable units below average).

The NHC also proposes a housing allowance or benefit to further improve affordability to lower income households in some of the units in each project, while retaining rents at realistic levels. In order to provide a sufficient rate of return to attract such equity investment, the project will need to have sufficient cash flow to both cover reserves (capital replacement and operating) some level of debt financing and to service investor return. As such it is difficult to embed this approach into deep affordable projects, especially if rents are constrained over time. It could however have some utility at higher average rent (100% AMR) and in mixed rent and intermediate market projects (i.e. rents between 100%-140% AMR).

At a much larger scale, the Advisory Council on Economic Growth has recommended the creation of an infrastructure development bank (Canada Infrastructure Bank, CIB). This is intended as a conduit to attract private and institutional investment into large-scale infrastructure initiatives. It is also identified as a way to free up federal resources for other municipal and social projects that cannot be financed with private capital.

To the extent that the CIB diverts capital from funds previously allocated for social infrastructure this may negatively impact critical grant investment in affordable housing; however, if it frees up traditional federal infrastructure capital it may be beneficial. The CIB could potentially also plays a role as an investment conduit for funds into an affordable housing equity fund.

Typically affordable housing projects would not fit with the investment criteria of a CIB type organization, mainly due to their small size. However if an aggregated avenue were made available, this may create a better fit.

The experience with Infrastructure Ontario has been instructive. While mandated to provide financing for affordable housing, I/O has not reconciled that mandate with its larger infrastructure-financing role. Its underwriting criteria and process were found to be overly onerous and the volume of loans minimal. This suggests that there could be a useful role in creating a specialized subsidiary, such as the proposed CHFA, both to intermediate and facilitate debt finance as well as to aggregate investment options for an equity fund.

As described in the NHC paper, laying in some equity investment would not replace grant funding, but could effectively augment and complement such public investment, while generating a new asset class for private and institutional equity investment.  Correctly configured, affordable housing could represent something closer to secured senior debt rather than conventional property market risk.

## International insights

Private equity investment is widespread in the US, but this is a result of a tax credit program that provides a generous tax credit to investors in affordable housing. They generate their rate of return primarily on the basis of tax savings over a ten-year period. The project yield from cash flows is coincidental, although does help to enhance the overall return on investment. This investment is also driven by a policy context under which regulated lenders are required to invest in underserved areas under the Community Reinvestment Act. So there is a well-established system of sticks and carrots underpinning this model in the US, as well as well established market for tax based financing products.

In both the UK and Australia government have sought at various times to attract institutional investment into affordable housing. In the main they have not met with much success, although continue to pursue opportunities.

In the late 1980's and early 1990's various stimulus programs such as the Business Expansion Scheme and Housing Investment Trusts were created in the UK to stimulate investment in rental supply, but neither gained much traction and were abandoned. Efforts to establish REITs through regulatory reform in 2012 have also had little effect (Williams 2017).[5]

In the UK, as in Canada, private lenders have traditionally been involved as lenders into the social housing sector and there has been some investment in affordable housing through purchase of bonds issued by some of the larger non-profit housing associations. Moody's currently rates ten housing associations in the UK, whose ratings span from Aa2 to A1 with stable outlooks. They are high investment grade ratings reflecting the rating agencies positive view of the sector and specifically the strong regulatory framework and high government support for the credit strength of the sector.

The UK also has an intermediary, The Housing Finance Corporation (THFC) similar to the authority being proposed in Canada. This is a non-profit aggregating funder for the housing association sector. Its approach allows smaller housing associations (now known as registered providers – RPs) to access the institutional bond market through the aggregation of individual

[5] Peter Williams, 2017, *Rebuilding the rented sector in the UK; The role of Buy to Let and Build to Rent and Housing Association*s presentation to the University NSW, Australia February 2017

debt requirements so that they reach a quantum that is acceptable to the institutional market (Williams et al 2011).[6]

While debt finance and bond finance are well developed this is not the case for institutional equity investment. UK institutional investors currently have very little equity ownership of social housing. Although their total assets exceed £3 trillion, and property assets well over £150 billion, equity investment in social housing accounts for only £0.4 billion of investment, a tiny fraction of the value of social housing in the UK.

A recent research report on prospects for institutional investment identified key barriers to more equity investment, from the investor perspective: [7]

- Lack of understanding of the sector and the risks involved;
- Concerns about reputational risk;
- Scale and accessibility/deliverability of investments; and
- Due diligence requirements.

A number of researchers and sector organizations have explored opportunities and surveyed institutional investors on the concept of equity investment, but these too have gained little traction, despite recognition that consistent cash flows indexed to inflation (as part of UK regulation of social rents) would offer a useful liability matching for institutional investors (a form of index linked return). It has also been noted that net initial yields on new build have been insufficient, without grant (a similar context to Canada). Returns might be boosted by open market rental or sale which recent shifts in policy in the UK are now encouraging. There will be a benefit if investors are happy to receive a total return, rather than initial yield, which can be serviced from surplus cash flows in the future (assumes rental or property sales income increase over time, with larger returns or buyout of equity in the mid term).

By comparison to Canada, the UK is populated with many more large very professional social housing providers (as reflected in bond ratings), and a strongly regulated system that acts to strengthen their credit worthiness. Yet despite being a strong sector with a long history, there remains a lack of understanding and reluctance from institutional investors.

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[6] Peter Williams, Nick Salisbury and Robin Caven, 2011. *Opportunities For Institutional Investment In Affordable Housing*, report to the Housing and Communities Agency.

[7] Investment Property Forum (IPF), 2015. *Prospects for Institutional Investment in Social Housing*

UK Housing associations are equally reluctant to venture into this type of investment expressing a preference for debt finance, reinforced by current low rates as well as concerns about capacity to service prescribed payments to satisfy equity investors. This concern has been heightened by recent reform to funding programs including reduced grant levels as well as constraints on the level of Housing Benefit, the rental allowance that enables tenants to pay full rent (and thereby generate minimal cash to service return to investors).

UK researchers noted that comparing the UK to the US experience, the key catalyst for equity investment in the US is a favourable policy and tax credit environment, which does not exist in UK, and it unlikely to be created.

Over the past two decades, researchers and advocates in Australia have also sought to attract institutional investment into the affordable housing space. And like the UK this has not been successful. The most recent effort, under the National Rental Affordability Scheme, sought to emulate the US tax credit approach. It too offered a ten-year stream of tax credits to reduce owner tax liability and enhance after tax rates of return. While this attracted some private developers and private investors, it did not attract institution investors). It is also important to note that the NRAS encouraged and enabled mixed rent development. Blending full market and affordable units, which enhanced potential return to private investor/developers.

Australian experts cite four major barriers to affordable rental housing investment from large institutional players: [8]

- Lower yields than for competing investment options
- A lack of industry knowledge of rental housing products and performance (related to the characteristics of the Australian rental market dominated by small investors owning only one or two rental homes).
- The small scale and fragmented nature of deals on offer, coupled with insufficient liquidity, and
- Changeable and uncertain or, in some instances, unsuitable government policy settings (including the termination of the NRAS after only 4 years).

The UK social housing sector is characterized by large scale (one fifth of all housing) and is a professional and highly regulated sector. By comparison, Australia is much more like Canada with a small and unprofessional "sector" (although moving more aggressively toward an accredited regulated one, copying UK practice). In Canada a strong consolidated sector does

[8] Vivienne Milligan, Judith Yates, Ian Wiesel and Hal Pawson 2013, *Financing rental housing through institutional investment Volume 1: outcomes from an Investigative Panel*, AHURI.

not really exist. We are characterized by a multiplicity of small-disconnected providers holding relatively small assets, alongside a small number of larger more professional organizations, although many of these are public entities (municipal non-profit subsidiaries), which are more constrained in borrowing ability (due to oversight by their parent municipality).

Moreover, the Canadian social housing sector is largely unregulated (beyond project operating agreements, and in Ontario a statutory framework). An effective regulatory and accreditation framework of social housing providers is a critical first step in attracting institutional investment. Regulation assists by providing assurance about, and reduces risk associated with, how residential assets are managed. Involving finance industry representatives in the development of a regulatory framework is desirable to ensure that the regulatory model provides potential investors with adequate assurance of high quality financial, property and tenancy management. UK research has identified some important first steps if the institutional sector is to be courted, and these are relevant to Canada. These include

- Set up a structure for bringing the social housing sector and institutions together to engage in a sustained dialogue with the aim of improving understanding of the sector.
- Preparation of a prospectus on the strengths and capacity of the affordable housing sector and the potential returns to institutions. This will require detailed work on yields and returns under the new rent regime.
- Specifically engage with local authority (e.g. municipal employee) pension funds.
- Undertake a detailed study of the costs and benefits of index linked financing for affordable housing providers.
- Take forward the exploration on equity investment in RPs. In particular the possibility of reclassification of existing social housing grant to facilitate equity investment and suitable governance structures could be explored.

To the extent that attracting institutional equity investment in the UK has been elusive despite a stronger well-regulated sector and frequent dialogue on the opportunity, it seems that achieving this goal in Canada and Australia may be a serious challenge, at least in the short term.

An approach that engages the institutional sector in debt financing (securing and selling mortgage assets) appears more fruitful than securing equity investment. It is primarily through this type of investment that the proposed CIB might have some potential to help expand the supply of affordable rental housing in Canada.

## Conclusions

The exploration of financing and funding issues with key stakeholders and experts has confirmed that the issue of finance (mortgage loans) is not a serious constraint for the expanded development of affordable housing.

That said, there are some irritants and challenges especially for smaller providers and in jurisdictions without a provincial conduit to facilitate financing. The creation of some form of specialized intermediary, such as the proposed Canadian Housing Finance Authority (CHFA) could add a useful element to the institutional infrastructure to support affordable development. Such an agency would provide specialized review and underwriting, loan processing and aggregation and could raise funds on the capital markets to finance pools of affordable housing loans (as CMHC historically did on social housing mortgage refinancing and BC housing currently does for new affordable development).

The more critical issue is the quantum of grant funding (as a form of equity to balance debt finance), both in total and on a per unit basis. With low rents, projects targeting affordability can support much less debt so require much more equity (grant). This then limits the number of new units that can be funded.

So the overall quantum of grant funding under IAH is critically important. The increased levels announced in the 2016 budget should be established as a minimum and ideally increased. Such grant funding should be protected through a specific carve out from overall social infrastructure funds. This would also protect against such funding being reallocated to the CIB, which may be less willing or effective in funding affordable housing.

It has been suggested (NHC 2016) that a new layer of private/institutional equity investment could be developed to help stretch public grant. However, based on similar efforts and a general lack of success in other countries with a more established and credit worthy social housing sector, it is unclear that the affordable product and participating non-profits would be sufficiently attractive to institutional investors in Canada. There are issues of scale (too small on a project by project basis), credit worthiness (lack of regulatory framework and accreditation) and minimal capacity of the targeted affordable rents to service a return on equity over the medium term (8-12 years).

The other opportunity is to reform the way public funding is provided into a portion of grant and a portion of equity. Funders (PTs and Federal government) would then generate a return on their equity portion (either as ongoing coupon payment or via future refinancing) and could then recycle a portion of grant funds for reinvestment.

A public equity investment model could also be a stepping-stone to prove the potential rates of return on equity for future institutional investors. Ultimately the public equity could be sold on to institutional investors.

Given the limited capacity of targeted affordable developments to service return on equity, there may be more potential with either a mixed rent or an intermediate market product in which rents at minimum are at AMR and ideally above (e.g. 100-130% AMR).

To the extent that municipalities are involved in setting rent policies for grant (the case in Ontario, and in Quebec where the province has delegated administrative responsibilities to Quebec City, Gatineau, and Montreal) FCM members can play an important role in helping to develop a policy framework that encourages mixed rent and intermediate rent development. In doing so FCM municipalities could help to nudge traditional providers into this new rent segment, which will help to establish the non-profit sector on a more sustainable and investable basis. Currently provincial and municipal policies, such as those Alberta (100% units must have rents 10% below AMR) or in Toronto (municipal incentives only available if all rents below AMR) preclude mixed rent development, and thereby constrain the capacity of the sector to become more sustainable.

It is not apparent that the proposed CIB would have much utility in the affordable housing sector, except as a debt investor on pools of aggregated affordable housing mortgages (a process that could be facilitated by an intermediary like the CHFA). It is likely that the CIB would invest only on a debt basis in large aggregated pools, and would not deal at an individual project basis. The loan pools would also require credit enhancement, such as a CMHC mortgage guarantee (with the CHFA then indemnifying the CMHC mortgage insurance fund).

Lessons from Ontario Infrastructure suggest that an infrastructure financing facility is unlikely to develop the specialized expertise and understanding to directly lend into the affordable housing space. However there is an opportunity for indirect investment via a specialized intermediary like the CHFA.

## Appendix A: experts and stakeholders consulted

**Provincial officials**

- Craig Crawford, BC Housing
- Doug Schweitzer, Sask Housing Corp

**Municipal officials**

- Margaret Eberle, Metro Vancouver
- Abi Bond/
- Luke Harrington, City Vancouver
- Sarah Power, City Toronto
- Sayad Saide, City Ottawa
- Steven Guistizia City of London
- Suzanne Lafreniere and Martin Wexler Ville de Montreal)
- Daryl Sexsmith, City Saskatoon

**Development consultants/experts**

- Stuart Thomas, Terra Consulting, Vancouver
- Tim Welch and Associates, Cambridge , Ontario
- Grahame Hussey, CCOC, Ottawa
- Allan Gaudreault, Consultant, Montreal
- Kim O'Brien Horizon Housing Alberta

**Other experts**

- Nicolas Gazzard CHF Canada
- Steve Rohacek Infrastructure Ontario
- Derek Ballantyne, consultant DKGI Inc. and Venture Partner of New Market Funds

**International experts**

- Peter Williams, Cambridge Centre for Housing and Planning Research, UK
- Hal Pawson and Vivienne Milligan City Future Centre, University NSW, Australia