



# Raising Bank Finance

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## Introduction

Over the last few years Federal and State Governments have been pushing for community housing organisations to take out commercial loans. These are seen as a good source of funding for affordable housing, making use of 'lazy' assets without increasing national debt.

This paper summarises some key issues relating to bank borrowing, considers overseas examples, and makes practical suggestions for community housing managers, advisors and directors.

Kinetic White Papers provide an overview of key issues facing the community housing sector to stimulate debate and help decision making. The views expressed in this paper are those of the author.

## Key points

- ❖ The amount of debt that can be raised by the community housing sector has probably been over-estimated by policy makers.
- ❖ Only a few, large providers have the capacity to borrow even quite modest amounts compared to their value of their assets.
- ❖ Australia's lenders have been slow to enter the market to lend to the sector and are relatively cautious. This is now changing.
- ❖ The most important ratio that covers bank borrowing is 'interest cover' – i.e. is there sufficient cashflow to repay borrowing?
- ❖ Providers need to increase their knowledge of how to borrow, and put in place clear risk and treasury management policies.

## About the author



Tony Gilmour is an affordable housing consultant, working as Project Manager for Elton Consulting. In the academic field, Tony's doctoral research at the University of Sydney compared approaches to expanding the community housing sector in Australia, the US and Britain.

Prior to his work with affordable housing, Tony had a 20 year Investment Banking career in Britain, Asia and Australia. This included over a decade acting as a lending banker.

## Reflections from Britain

One of the main reasons to look at Britain is that currently Australian community housing policy is following their approach. With over two decades experience of bank lending to not-for-profit housing providers, Britain provides pointers as to what might be in store here. It also highlights some of the pain and pitfalls of this approach.

Traditionally Britain, like Australia, funded community housing through public grants. This all changed in 1988 when Margaret Thatcher's Government introduced private finance, moving 'housing associations' to a mixed model of public grants and commercial loans. As grants were progressively reduced, housing providers were compelled to borrow.

By 2008 the level of loans to British housing associations had exceeded public grants for the first time. Latest figures to March 2009 show loans to the sector standing at £40 billion (\$64 billion), more than double the level in 2002 when consolidated information was first published (TSA, 2010).

From the late 1980s until the start of the Global Financial Crisis (GFC) in 2007, Britain developed a highly competitive market for lending to housing associations by banks and building societies. Building societies are regulated mutual institutions initially established to write mortgages financed through retail deposits.

The relationship between British housing associations and banks is operated on a commercial basis. Associations decide how much they will borrow, from whom, what form that funding will take and what rate they will pay. While the Tenant Service Authority (as Regulator) reviews treasury management as part of their assessment of financial viability, regulations focus on ensuring a controlled approach to treasury risk rather than micro-managing housing providers' banking relationships.

Like private individuals, most British housing associations match their long term housing assets with long term borrowing, and are able to arrange facilities which are repaid over a period of up to 30 years. These are longer loans than normally made available to commercial borrowers.

Housing association bank facilities are provided to the organisation as a whole on a 'global' basis, secured against their entire portfolio, rather than for specific housing schemes ('project finance'). Lenders look at the general strength of the borrower rather than cashflows associated with a particular project. Most loan agreements allow an association to draw down funds for any purpose that they can legally undertake.

The growth in lending to housing associations has occurred because they have become viewed as safe borrowers. Associations have stable cash income from rents, backed by generous welfare support through 'Housing Benefit'. As in Australia, there is no shortage of tenants seeking affordable rental homes. Furthermore, as rent levels are government regulated, and have increased faster than inflation, providers have some protection against the rising costs of providing housing services and repairs.

If the Regulator is unhappy with a housing association's financial viability or governance, it can replace board members with nominees and remove failing executives. If financial difficulties occur, the Regulator normally persuades a stronger housing association to take over the failing organisations. If this happens the bank loans are moved to the stronger association, thus avoiding lender losses. Therefore, despite large scale lending to British housing associations, lenders have never lost money.

### Will we follow the British experience?

Australian policy makers have been captivated by the British approach of raising substantial bank lending to pay to refurbish social housing stock and building new affordable housing. However, there are a number of differences between the two countries that are important:

- ❖ British welfare payments supporting housing association tenant income are very generous, averaging nearly \$6,000 per household per year. This is far more generous than Commonwealth Rent Assistance (CRA). Also, CRA is based on household income, whereas Britain's Housing Benefit fills the gap between what tenants can pay and the rent housing associations are allowed to charge. Therefore the cashflows for British housing associations are much stronger than in Australia, and under-pinned by Government.

Note: The cash-strapped British Coalition Government is currently considering moving away from Housing Benefit. This is not surprising as this payment costs taxpayers \$25 billion each year.

- ❖ Britain has a much more competitive banking market than Australia, with some 600 banks and no 'four pillars' policy which has tended to encourage sector consolidation. Despite competition in Britain, it still took many years for lenders to become comfortable with the housing association sector and to charge more competitive rates.
- ❖ British lending to housing associations expanded during a favourable economic climate. The situation changed after the start of the GFC which led to the failure of a number of UK financial institutions and their rescue by government, most notably the Royal

Bank of Scotland and Lloyds Bank – both major lenders to housing associations. For several months during 2008 many lenders stopped making new loans to housing associations due to liquidity constraints and concern over property related risk. This was followed by a period when competition decreased and considerably higher interest rates were charged on new and re-negotiated loans.

Although Australia (and our banks) escaped the worst of the GFC, the general mood of lenders has changed. In particular they remain cautious about expanding their lending secured against property.

- ❖ Funding the development of new affordable housing in Australia is different to Britain with the introduction of the National Rental Affordability Scheme (NRAS). Although for community housing providers NRAS is more like a grant than a tax credit, it has led to the gradual emergence of financial innovation around attracting institutional equity. This makes Australia more like the US than Britain. In the US, only low levels of bank lending are possible and the main emphasis is on tax credit equity-style funding.
- ❖ Many Australian community housing organisations do not own all the properties they manage. This is changing, though quite slowly in some jurisdictions. By contrast British housing associations have long benefitted from stock transfers from the public housing sector and therefore own substantial assets to secure bank loans.
- ❖ British housing association regulation dates from the 1960s, whereas in Australia it is still being rolled-out.
- ❖ Finally, Britain's housing association sector operates at a much greater scale than in Australia. There are approaching 40 times as many housing association properties in Britain as Australia, making lending to the sector a larger market for lenders.

For these reasons, it is unlikely we will see the same the same level of bank lending to community housing providers in Australia as Britain, in absolute terms or compared to the size of the sector. Government aims are probably unrealistic, and based on misreading of the differences in the two countries' housing systems.

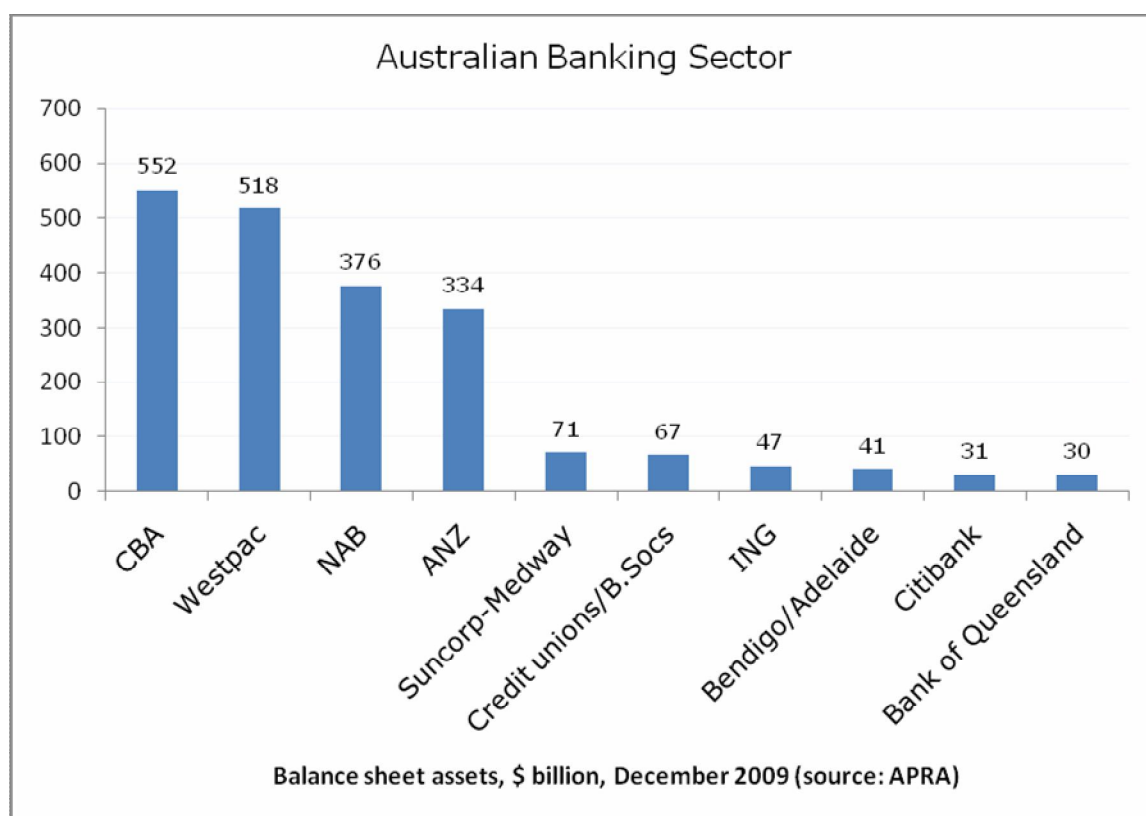
However, there is a likelihood that many of the larger community housing organisations – say those owning more than 1,000 properties - will at some stage look to the debt market. This will particularly be the case for those looking to develop or acquire new affordable properties. Many will arrange facilities on a 'global' basis secured against their total property portfolios, others may raise 'project finance' for specific schemes.

## Australia's banking market

Providers of finance for community housing organisations can be divided into three distinct groups:

- ❖ The 'four pillars', in order of size:
  - Commonwealth Bank of Australia (CBA), including BankWest
  - Westpac Banking Corporation, including St George
  - National Australia Bank (NAB)
  - Australia and New Zealand Banking Group (ANZ).
- ❖ Banking competitors – regional institutions such as Bendigo and Adelaide Bank, Suncorp-Medway, ING, Bank of Queensland and overseas banks with Australian operations such as Citibank.
- ❖ Credit unions, mutual building societies and others.

The relative size of finance providers is shown in the table, with 86% of the market dominated by the big four banks. Credit unions and building societies, when combined, are about one fifth the size of the smallest major bank. They have a customer base of 4.5 million people, often lower interest rates for borrowers and generally higher customer satisfaction levels. However they operate as individual organisations rather than as a single entity – 107 credit unions and 9 mutual building societies.



It is difficult to be sure about the community housing market share of various types of lenders as, unlike Britain, information is seldom made public. This makes it hard to know how loans are structured, what rates are charged and how terms and conditions differ. Lack of public information gives an advantage to lenders as it is hard for borrowers to know how much room they have for negotiation.

Based on anecdotal evidence, discussion with a number of lenders and a quick look at the audited accounts of the largest providers:

- ❖ The big four banks all lend to the sector, though their relative enthusiasm changes over time. NAB had an early lead, based on the experience of their UK subsidiaries in lending to housing associations. Both CBA and ANZ look to be increasing market share, with less activity apparent from Westpac.
- ❖ Of the banking competitors, Bendigo has established a strong market position based on a community ethos and de-centralised network. It has also arranged loans, for example a \$4 million facility for Unity Housing in South Australia.
- ❖ The credit unions have been active in promoting their services to the sector, sharing a similar not-for-profit status as community housing providers. They have captured market share for day-to-day banking, and deposit taking, though have been constrained by their size from making very large loans. The most prominent are:
  - **MECU** ([www.mecu.com.au](http://www.mecu.com.au)). As one of the larger credit unions – based in Victoria but with a multiple state presence - MECU have established lending relationships with several of the larger Victorian based providers such as Community Housing Limited, Housing Choices Australia and Loddon Mallee Housing Services.
  - **Community Sector Banking** ([www.communitysectorbank.com.au](http://www.communitysectorbank.com.au)) are owned 50% by 20 not-for-profit organisations and 50% by Bendigo and Adelaide Bank. Their role is to provide financial services to not-for-profit organisations.
  - **ME Bank** ([www.membersequitybank.com.au](http://www.membersequitybank.com.au)). Created in 1999 by an industry super fund, ME Bank is a not-for-profit organisation providing services for its super fund members. They have made a \$9 million loan to Yarra Community Housing in Melbourne.
- ❖ It is quite common for community housing providers to have multiple banking relationships. For example Housing Choices Australia from their 2010 accounts have a \$25 million loan from

NAB and a \$1 million loan from MECU. Similarly, as disclosed in their 2010 accounts, Port Phillip Housing Association in Melbourne have bank relationships with MECU, CBA and ANZ.

## Types of lending

Is the size of a lender important? All Australian finance providers are closely regulated and operate in a relatively conservative environment, therefore the chances of failure are modest by international standards.

The main impact of the lender's size is their ability to make large loans. Banks and credit unions do not want to 'put all their eggs in one basket', and the smaller ones may place a limit of (say) \$20 million on how much they will lend to a single borrower. This would be a problem for some of the larger community housing providers who may want to borrow more.

Problems surrounding the size of a loan a lender is prepared to make can be solved through different contractual arrangements. There does not seem to have yet been much innovation in community housing lending so far, though this will probably change as the market grows if we follow the example of Britain. The different options are:

- ❖ **Bilateral loan** – one finance provider lends to one borrower. The vast majority of community housing loans so far are like this.
- ❖ **Multiple bilateral loans** – two or more finance providers make separate loans to a single borrower.
- ❖ **Club deal** – normally two finance providers share the lending to one borrower in a structured transaction.
- ❖ **Syndication** – one bank acts as agent in arranging a loan for a borrower, with the lending provided by a number of finance providers (often including the agent bank as well). The borrower just has one relationship – with the agent bank.
- ❖ **Bond type arrangements** – several banks pool funds and make loans available to a number of borrowers.

For community housing lending requirements up to (say) \$20 million, a bilateral loan works well. Larger lending needs have so far been met in nearly every case through multiple bilateral loans. These require more effort on behalf of the borrower as there are a number of bankers to keep happy – and to supply information to. There can also be problems if the lenders have different lending terms, for example requiring different levels of interest or asset cover (see later in this paper).

The last three lending types in the list are suited to larger, higher capacity community housing providers. They involve more complexity, potentially additional risk, and will be more expensive to arrange.

## Borrowing basics

Most banks will provide borrowers with guidance on what is needed to apply for a loan. There are also a growing number of intermediaries who will search on your behalf for a willing lender – often charging a fee based on the size of loan raised. For many organisations help is at hand from their Finance Director/Controller, the provider's auditor, directors. Community housing organisations have skills based boards complete with accountants and bankers who can often provide guidance.

Of all the documents required by bankers, the most important will be a cash flow forecast. Although asset backing is important, it is from cashflows that interest will be paid and capital repayments made. Bankers are not alone in thinking that 'cash is king'.

The amount that can be borrowed is limited by a series of accounting ratios. These are often know as 'covenants' when tied into a loan agreement. A covenant is an agreement between a lender and a borrower that a particular accounting ratio will not be broken. The check on covenants will normally be every year, on publication of the audited annual accounts. If a borrower breaks a covenant (i.e. exceeds a ratio), the bank can normally foreclose on the loan.

There are two key ratios relevant to all property businesses, both commercial developers and community housing organisations:

- ❖ **Interest cover ratio** – this is the amount of cashflow available to pay interest divided by the amount of interest payable. It is calculated based on accounting profit, adjusted for non-cash items such as depreciation. For example, if an organisation has \$1.5 million of cashflow before interest is paid, and an interest bill of \$0.5 million, the interest cover is '3 times'.
- ❖ **Loan to value ratio (LVR)** – this is the amount that is being borrowed compared to the value of the property provided as security. For example, if a building is valued at \$1 million and there is a loan of \$700,000, the loan to value ratio is 70%.

For a commercial property company both these ratios are important, though for a community housing provider the greatest focus is on interest cover. This is because with social and affordable housing, although the

property value can be high (especially in the main capital cities), the amount of income from lower income tenants is quite modest.

The ratios can be converted into 'covenants', or the likely ratio that a lender will expect a borrower to maintain at all times:

- ❖ **Interest cover covenant** – most lenders expect a minimum interest cover ratio of 1.5 times (KPMG, 2010). The more conservative lenders, or where the borrower is less experienced, may expect 2.0 times. Potentially the top community housing sector borrowers could negotiate interest cover of 1.3 times.

The lower the interest rate covenant, the more that can be borrowed against a property and the greater the risk to both borrower and lender.

- ❖ **Loan to value covenant** – most lenders will not lend more than 70% against the value of property. The figure will be much lower if the property is being built due to the risks involved. Conservative lenders may lend less, perhaps 50% or 60% loan to value.

The higher the loan to value covenant, the more that can be borrowed against a property and the greater the risk to both borrower and lender.

Australian banks have become more flexible on their covenant setting over the last year, though still have a way to go to catch up with the British where interest cover covenants can be as low as 1.2 times. There is evidence that Australian banks are now better understanding the relatively modest risks in lending to community housing providers.

Lenders generally provide variable interest rate loans, though there are no clear benchmarks on industry standard rates. KPMG (2010) suggest banks look for 2%-3% above the bank swap rate – the marginal rate at which banks source their own funds. It pays to 'shop around', to find what rates are available, though in the longer term it helps to build a relationship with a lender who understands your organisation. Loan terms vary, though there are an increasing number of lenders prepared to lend with loan capital repayments over 20-25 years.

Anecdotal evidence, backed by modelling by KPMG (2009) indicates housing providers can only borrow modest amounts against asset values. For example, most modelling undertaken for NRAS proposals produces a loan to value figure of between 15% and 20%. Reinforcing an earlier point, our sector is constrained more by weak cashflows from tenancy management rather than by a lack of asset values.

## Risk management

Community housing organisations deciding to borrow from commercial lenders should ensure they have robust control systems in place. As many home owners with mortgages know, debt is one more form of risk. Directors should be satisfied that risks have been evaluated, and large providers should have in place a Treasury Management policy.

There are a number of risks to consider:

- ❖ **Interest rate risk** – will the organisation be unable to continue in business if the cost of borrowing through variable rate loans increases? Tenant rent payments are relatively fixed, whereas market forces can force interest rates to increase. Where providers are borrowing larger sums – say over \$10 million – interest rate hedging should be considered. Some of the borrowing could be fixed, or an interest rate cap purchased (this is a financial product which puts an upper limit on the interest rate paid).
- ❖ **Counterparty risk** – is the lender financially stable? Although credit providers are unlikely to be allowed to fail, there will be considerable instability if a rescue has to take place. Borrowers need to consider the risk of lenders in the same way as lenders consider the risk of borrowers.
- ❖ **Compliance risk** – if the loan arrangement does not allow enough leeway for unforeseen events, the loan covenants may fall into default at the annual review. This will provide a re-financing and potentially a default risk. As always, it is better to borrow prudently rather than the maximum amount possible.
- ❖ **Management risk** – larger and more complex loan arrangements require a high level of competence from a community housing providers' financial managers. Controls must be put in place through documenting procedures, and there should be a succession plan in case a senior finance person resigns.

Despite these risks, for most well managed community housing organisations borrowing is a relatively straightforward task, and has the benefit of helping allowing more affordable homes to be built sooner. Relationships with finance providers can work well, and be mutually rewarding. After all, banks are in the business of lending money and do not want their customers to fail.

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