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Time to Break the Mould

Fresh Options for First Nations' Fiscal Policy

Discussion Paper

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Ottawa Office
1405 - 130, rue Albert Street
Ottawa, ON, Canada, K1P 5G4
Tel/Tél: 613.238.7160
Fax: Téléc: 613.238.7990

Toronto Office
MaRS Discovery District
401 – 101 rue College St,
Toronto, ON, Canada, M5G 1L7

www.ppforum.ca | @ppforumca

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An Outdated Model

The main players in First Nations' public finance agree on one thing: The present fiscal regime is broken, and needs to be fixed. Many of the arrangements that govern aboriginal communities' revenues, borrowing and spending date back to the 19th century, and remain riddled with paternalism, uncertainty and inefficiency.

First Nations finances are on a far more fragile footing than other levels of government in Canada. The provinces and territories obtain a significant portion of their revenues through federal transfers -- such as the Canada Health Transfer, the Canada Social Transfer and equalization payments -- based on negotiated and pre-determined formulas. These jurisdictions, as well as municipalities, also generate substantial tax revenues from a variety of sources.

By contrast, the bulk of federal transfers to First Nations, totaling about $6 billion a year, takes the form of discretionary "contribution agreements". These transfers come with little long-term certainty and no legal protection. Each community is typically party to multiple agreements, allowing it little control over spending priorities and thus limiting leaders' ability to respond to their constituents' needs.

The Finance Department has maintained a 2% cap on annual spending increases for core services under these agreements since 1996, far below the 6% growth rate for the Canada Health Transfer. Annual increments for infrastructure spending are determined by population growth. They take no account of the one million acres of land -- and the extra infrastructure needs -- added to reserves since 1992 as a result of land claim settlements.

First Nations also have more limited taxation powers than provinces and municipalities. Yet the powers that they do have are unevenly implemented and, in many cases, not implemented at all.

Key Points for Discussion

The Public Policy Forum's forthcoming roundtable aims to lay the foundation for a wide-ranging discussion of reform of First Nations' public finances. The two most pressing areas of concern are:

- **Infrastructure funding**. There is an estimated shortfall of $8 billion in the provision of on-reserve public amenities, such as water and sewage plants, roads, schools and public buildings. The federal government currently spends about $1 billion a year on infrastructure on reserves, including social housing but excluding healthcare and policing. But a large portion of these outlays is earmarked for maintenance, rather than badly-needed new facilities.

- **Investment in large resource projects**. Without substantial and reliable revenue sources, First Nations will have difficulty participating in some of the large resource projects currently planned on reserves or in areas where First Nations claim title. Examples include: liquefied natural gas (LNG) terminals in British Columbia, gold and other mines along the so-called Ring of Fire in north-west Ontario, and valuable fishery licences in the Atlantic provinces.

Given these priorities and based on the analysis below, we propose that the roundtable focus on the following key questions:

- What are the impediments to more active private-sector involvement in financing First Nations' infrastructure needs?
- What modifications are needed in fiscal arrangements between First Nations and the federal government?
- Should private-public partnerships be encouraged on reserves? If so, how?
- How should governance and transparency issues in bands' financial management be addressed?
- How can communication on fiscal matters be improved between First Nations, the federal government and outside providers of capital, as well as among First Nations themselves?

The Barriers Facing First Nations

Putting policy limitations aside, First Nations' fiscal management starts at a basic disadvantage to other levels of government. Canada's 617 First Nations communities, with 460,000 on-reserve members, have a lower combined population than cities the size of Hamilton and Quebec City. Many have a population of just a few hundred.

Low incomes and sparse business activity severely limit the potential for more isolated bands to expand their tax base. On the spending side, most bands are burdened by unusually high expenses as a result of their remoteness from major service centres. For example, 34 out of 126 communities in Ontario alone are accessible only by air. These challenges have contributed to and are compounded by numerous other shortcomings, discussed below.

Inadequate credit information

One of the most fundamental handicaps faced by bands, businesses and individuals on reserves is their near-total exclusion from mainstream commercial and consumer credit rating systems.

Credit ratings and credit histories have become an integral part of almost every aspect of the economy. As a result, the absence of a credit file can seriously inhibit lending opportunities. This shortcoming makes it difficult for prospective borrowers to leverage assets for long-term loans at an appropriate cost. With little or no credit history, borrowers cannot benefit from a scrupulous repayment record, nor are they penalized for delinquency.

The result is that many lenders -- notably the big banks -- treat bands as risky corporate clients rather than more creditworthy public-sector entities. Financial institutions generally confine their on-reserve business to short-term loans carrying high interest rates, even though evidence suggests that the vast majority of First Nations borrowers have a sturdy repayment record and would thus qualify for high credit scores.

Budgetary constraints

As Harold Calla, chairman of the First Nations Financial Management Board observes: “You can’t raise debt if you don’t have revenue.” First Nations have more limited taxation powers than other levels of government, and even these are subject to tighter controls by outside authorities, notably the Minister of Indian Affairs and Northern Development.

Bands can levy property taxes under two laws: section 83 of the Indian Act and the First Nations Fiscal Management Act. The taxing authority under both statutes is subject to various conditions and approvals.

Since 1997, First Nations have also been able to opt into legislation that enables them to pass by-laws imposing a sales tax -- at first only on on-reserve sales of alcohol, fuel, and tobacco, and later on all taxable goods and services consumed on First Nations land.

Currently, 68 First Nations levy property taxes under the First Nations Fiscal Management Act, while 56 do so under section 83 of the Indian Act. A total of 26 bands now levy the First Nations goods and services tax. (All but five of the latter are in British Columbia and Yukon.)

Yet even bands with taxing authority often apply their powers unevenly. For example, some have actively sought to raise revenues from outside parties with on-reserve properties -- such as cottagers and retailers -- but have shown a reluctance to levy taxes and user fees on their own members. A policy brief published by the Institute on Governance in 2009 noted: “In general, both governance and service quality can be expected to suffer in a governance system that lacks the crucial tie of a direct fiscal reliance upon its citizens for survival.”[1]

The First Nations Fiscal Management Act

The First Nations Fiscal Management Act, which took effect in 2006, enables communities to leverage property taxes for on-reserve infrastructure development through co-operative borrowing in public capital markets. Using this system, the First Nations Finance Authority (FNFA) issued its first bond in June 2014, raising $90 million (see box) on behalf of 14 borrowing members.

Although the Act has brought marked improvements to First Nations’ financial affairs, its implementation has raised numerous questions. Bands’ legal borrowing authority remains unclear. Some practical constraints have emerged, such as the need for professional staff and

[1] “*In Praise of Taxes: The Link between Taxation and Good Governance for First Nations Communities”*, http://iog.ca/wp-content/uploads/2012/12/2009_February_policybrief32.pdf

improved financial and risk management systems. Many bands have only a rudimentary treasury function. Governance standards, relating to issues such as independence and conflicts of interest, are uneven.

A Pioneering Bond Issue

The First Nations Finance Authority, modeled on the Municipal Finance Authority of British Columbia, helps First Nations and aboriginal governments raise funds for businesses, projects and infrastructure needs (http://www.fnfa.ca/en/). The FNFA raised $90 million through an issue of 10-year notes in June 2014, marking the first bond issue backed by aboriginal governments. The proceeds will be used for infrastructure improvements and to fund native investment in resource projects.

The structure of the bond goes a long way towards addressing investors' concerns about the uneven quality of First Nations credit risk. Rather than each band borrowing individually, the FNFA pooled the needs of 14 bands in a single bond issue. To qualify for participation, bands had to be certified by the First Nations Financial Management Board (FMB) on the basis of their commitment to specific standards of budgetary discipline. Some require a number of years to meet those standards.

"The market acceptance is there", says one non-aboriginal banker. "The design of the program is such that it has met the standard that the institutional market imposes on borrowers."

The terms of the bond include a number of specific safeguards for creditors:

- Individual bands must earmark revenues for interest payments in advance.
- Two reserve funds provide extra liquidity and cushion investors from losses. The FNFA can withhold 5% of any loan to replenish a debt reserve fund.
- The federal government contributed $10 million to set up a credit enhancement fund, which can be used to offset temporary shortfalls in the debt reserve fund.
- A potential revenue stream can only be leveraged up to 75% of its borrowing capacity.

Moody's said in its rating commentary: "While borrowing members presently consist of a small pool of small issuers, which generates risks, this is somewhat mitigated by the positive financial results, relatively low debt and strong oversight of borrowers….(T)here is an extensive review process to become a borrowing member of FNFA. Additionally, the FMB, in conjunction with the FNFA, conducts regular monitoring of borrowing members and the FMB has the power to intervene in the finances of a member First Nation if necessary."

Moody's assigned an A3 rating to the issue. Dominion Bond Rating Service gave a provisional A (low) rating, while noting that most participating bands would qualify for no more than a weak BB- to BBB rating if they borrowed alone. (DBRS did not provide a final rating).

Cultural and social issues

With some notable exceptions, investors and aboriginal leaders have a limited understanding of each other's priorities and constraints. First Nations lack many of the skills needed to deal with commercial lenders, equity investors and government agencies. While band leaders' knowledge of local resources is extremely valuable, it needs to be complemented by technical capacity and financial expertise.

Conversely, outside investors generally have poor knowledge of on-reserve economies and customs. The remote location of many reserves raises costs for potential investors and exacerbates their unfamiliarity with local conditions. Many bands' relatively heavy dependence on the volatile resources sector is another disincentive to many investors.

Communication among First Nations themselves is less than satisfactory. The budgeting experience and resources of one band, which might be useful to others, is not easily communicated across the country. Among other deterrents, the high cost of travel, especially to fly-in communities, complicates regular and effective communication.

The bottom line

Seen from financial markets' point of view, investment in First Nations -- whether in the form of debt or equity -- typically involves a high degree of risk and uncertainty. Investors either refuse to invest at all, or demand a premium on normal market returns in the form of high interest rates, special guarantees and stringent conditions.

DBRS, the credit-rating service, listed the following "challenges" in its March 2014 provisional review of the First Nations Finance Authority bond issue:

- An untested legal framework and limitations in financial transparency.
- Uncertainty on the future composition of the FNFA's loan portfolio.
- Potential erosion of financial strength as bands' appetite for debt grows.
- A mismatch between the term to maturity of FNFA's assets and liabilities.

Echoing many others, the Credit Union Central of Canada said in a recent brief that "the federal Indian Act and its restrictions on the seizure of on-reserve property represent the single greatest obstacle to providing financial services to First Nations communities". Section 89 of the Act was originally intended to set aside reserve lands as a place of refuge for a First Nations person or a band that wanted to protect on-reserve property from seizure by non-native creditors. But the provision has had the unintended consequence of making it difficult for on-reserve borrowers to put up the collateral typically required by commercial lenders. It has also impeded the evolution of credit-rating systems essential to monitoring risk.

In contrast to this perspective, the Vancouver based credit union, Vancity, has worked with several First Nations communities and organizations to provide access to funds for infrastructure development. In a recent agreement between Vancity and Tsawwassen First Nation, an infrastructure financing deal valued at over $40 million, demonstrates one example of how financial institutions can move forward despite regulatory restraints. The deal is structured in two separate loans, both at $20 million and at prevailing market rates. The first is for a sewage treatment plant, which is scheduled for completion in mid-2015, and the second is for road works and associated utility infrastructure, which is scheduled in time for the opening of commercial developments in early 2016. This financial agreement demonstrates a departure from common lending agreements as it takes revenue streams such as property taxes and taxation revenue in to consideration and reflects a move towards treating First Nations Governments as local governments.

The Way Forward

The issues involved in First Nations public finance are complex, multi-dimensional and deep-rooted. They involve not only readily identifiable shortcomings in laws, regulations and governance standards, but are also the legacy of a long period of mistrust and poor communication.

Any discussion of First Nations' public finances will at some point need to take account of the landmark Supreme Court of Canada ruling in June 2014 granting aboriginal title to the Tsilhqot'in First Nation over more than 1,700 sq km of land in British Columbia. The judgment is sure to have wide implications for outside investors in resource development, especially on non-treaty lands.

The court recognized that benefits flowing from the use of resources on the territory in question must flow to the First Nation. The ruling could spur calls from First Nations for equity participation in numerous large projects, and access to funding that will make that participation possible. On the other hand, investors are unlikely to commit funds to such projects until they have firm assurances on the tax, royalty and equity participation regimes that apply.

The items below are all critical to moving forward. Drawing up priorities will be one of the roundtable's most challenging -- but also most important -- tasks.

A new federal-First Nations funding relationship

Predictable and sustainable sources of funding are essential to create the conditions for First Nations' economic development. Given the shortcomings of the present system, this requires a comprehensive overhaul of existing fiscal arrangements with the federal government. The present Indian Act is, by common consent, unequal to the task.

Federal government involvement is indispensable to aboriginal communities' ability to access capital markets. In reviewing the recent FNFA bond issue, Moody's noted that its A3 rating could be compromised in the event of "indications of lower support from the federal government". Conversely, the question needs to be asked: Can Ottawa realistically provide more support to facilitate First Nations' quest for outside investment?

The UK's Guarantees Scheme -- A Model for Canada?

One option for improving First Nations' access to capital markets would be a federal government guarantee on specific types of borrowing, for example, for infrastructure projects or to help First Nations gain an equity stake in large resource developments. Should roundtable participants consider this option worth investigating, one model could be the UK's Infrastructure (Financial Assistance) Act which was passed in 2012 and took effect on October 31 2013.

The law was designed to avoid delays in critical UK infrastructure projects caused by adverse credit conditions. It authorizes the government to provide sovereign guarantees of up to £40 billion to support infrastructure investments. The guarantee means in effect that the government lends its blue-chip credit rating to a project's commercial sponsor.

The scheme is open to major infrastructure in sectors such as energy, transport, communications, waste and housing that, in the government's words, "are seen as growth boosting projects that will help support the local and national economy".

More than half of the first crop of projects under consideration for guarantees are in the energy sector with the aim of "helping ensure that Britain develops a sustainable future energy supply". A guarantee has been provided to support £1 billion of borrowing for an extension of the London Underground's Northern Line. Housing also qualifies for support. Further details of the scheme can be found at: https://www.gov.uk/government/publications/uk-guarantees-scheme-prequalified-projects

One option is a federal government guarantee on First Nations' borrowings. A backstop of this kind would be a powerful weapon, especially from an entity with as strong a reputation in capital markets as the government of Canada. It would greatly boost borrowers' creditworthiness, giving them wider access to funds at lower cost. A guarantee has the potential to jump-start a wave of investment -- and thus economic activity -- in communities that could undoubtedly use such a boost. The UK introduced a similar scheme in 2013 (see box).

While such schemes have undoubted benefits, they also have drawbacks that cannot lightly be dismissed. The question arises whether a sovereign guarantee should be used to underwrite an investment in a potentially risky business enterprise. Furthermore, a blanket guarantee risks weakening a borrower's fiscal discipline and accountability by providing little incentive for self-examination or improvement. From Ottawa's point of view, guarantees would impose significant extra contingent liabilities at a time when the federal government is seeking to rein in budgetary spending and the public debt. The argument can thus be made that while a federal guarantee might help First Nations communities, it would run counter to the broader national interest.

While loan guarantees offer one means of reducing risk for investors and First Nations, other options are available which achieve much the same end.

Expanded FNFA borrowing

The success of the recent FNFA bond issue is proof that, with careful planning and productive cooperation, First Nations can gain access to long-term debt at reasonable rates. Mr Calla, the FMB's chairman, says: "It is the view of the board of directors of FMB that every community would benefit from FMB certification".

BC's Municipal Finance Authority, which was the model for the FNFA borrowing framework, provides a clue to the vast potential of the joint-borrowing model. Since its inception in 1970, the BC agency has raised over $5 billion for local infrastructure and other capital projects. It has a blue-chip triple-A credit rating. The agency currently borrows at an interest rate of less than 3.2 percent, compared with the 3.5 percent coupon on the FNFA bond, which carried a A3 rating. That gap represents a sizeable difference in interest payments on a $100 million loan.

Beyond access to long-term capital at reasonable cost, the FNFA model sends a wider message to bands across the country, namely, that by putting their fiscal houses in order, they can gain access to funds for badly-needed infrastructure and equity positions in large projects.

The FNFA is currently preparing its second bond issue. It cannot move ahead however, until the Financial Management Board is able to certify that a sufficient number of bands are in compliance with its conditions. The board has limited resources to perform this function. It took seven years to certify the 14 participants in the first bond issue and approved just three bands in the first six months of the current fiscal year. The roundtable may wish to discuss ways of encouraging more bands to submit themselves to the board's certification process, and ways in which accelerate the board's vetting of applications can be accelerated.

Boosting First Nations' tax revenues

The need for First Nations to gain access to new revenue streams is undisputed. The question is how best to achieve that goal.

Numerous bands are now collecting property taxes under authority granted by the Indian Act and the First Nations Fiscal Management Act. A few dozen are also collecting sales taxes. Others should be encouraged to follow suit. Other potential revenue sources might also be considered, for example, user fees and royalties from companies operating on First Nations lands. Another issue worth examining is whether taxes and royalties from a large project might give a community a more sustainable and predictable revenue stream than an equity stake.

First Nations will not be able to realize the full potential of their taxing powers -- present and future -- unless they can overcome their members' widespread aversion to taxation. The Institute of Governance policy brief observed in 2009: "Despite the substantial political hurdles of occupying tax room, a handful of First Nations have succeeded in raising taxes from their own citizens. The results have included new funds for projects of priority to the First Nation, a fresh emphasis on service quality, as well as a premium on economic development and increased citizen participation. The benefits are most obvious to First Nations with a large number of non-members living or travelling through the community. Yet even smaller, more remote First Nations gained significant revenue (on average, about 8 percent of total revenues)."

The authors offered the following advice, based on interviews with taxing First Nations:

- Link the introduction of a new tax to identifiable community projects (for example, a new community cultural centre).
- Add to the attractiveness of taxing by including non-members in the First Nations tax-base -- recalling that the beneficial effects arise from taxing the membership.
- Ensure non-member taxpayers fair treatment, effective service provision and adequate representation on decisions affecting them.
- Canvas first the experiences, both positive and negative, of other First Nations that have put tax regimes in place.
- Add taxes incrementally. A First Nation might begin by introducing property tax, then proceed to a sales tax.

Suitable incentives may encourage bands to expand their taxation authority. For example, they can already use property tax and other revenues raised under local laws to qualify for loans underwritten by the First Nations Finance Authority.

Improved credit ratings and credit history

A robust credit-rating and credit-history system is a basic building block of a sound public-finance system, yet one that is generally lacking among First Nations.

The irony is that many bands and on-reserve residents have impeccable payment records, and would thus undoubtedly qualify for strong credit ratings. However, setting up a credit-rating system in remote communities is a painstaking process. The credit-score formulas that usually apply in the developed economy are not easily adapted to remote communities without conventional property rights.

How One Band Is Moving Forward

St Theresa Point First Nation, a fly-in community 450 km north-east of Winnipeg, encapsulates both the recent advances in First Nations fiscal management, and the daunting obstacles that still remain.

St Theresa Point (pop. 3,100) last year became one of the 140 bands which have qualified for the First Nations Financial Management Board's financial performance certification, enabling it to participate in joint borrowings by the First Nations Finance Authority. The board has given the band three years to meet its certification standards.

The band gained its financial performance certification thanks partly to a concerted effort to maximize its own revenues, using powers granted by the Indian Act and the First Nations Financial Management Act. It collects rental income from outsiders such as the RCMP and the North West Company which lease land from the band. It also collects tobacco tax rebates, and is working towards levying property taxes.

The band was one of the biggest beneficiaries of the FNFA's recent bond issue, accounting for $17 million out of the total of $90 million raised. Much of the proceeds will be used to refinance existing debt at a much lower rate and with longer maturities. For example, St Theresa Point has been paying a double-digit interest rate on a loan from North West Co's property management arm that it used to build a small strip mall. The FNFA loan has brought down the interest cost to under 4%.

Still, the band's chief, David McDougall, says hurdles remain in putting the band's finances on an even keel. For a start, residents and their leaders need to agree on future funding priorities -- not easy given the many pressing needs. Chief McDougall estimates that the community needs another 300 houses. Thirteen people live in his own house.

The two-year term set for the chief and band councilors complicates the pursuit of long-term goals. Chief McDougall himself has been elected four times, but not consecutively, over the past 14 years. "Things are in full gear, and there's a changeover, and then they stop", he says, "because they're not a priority for whoever takes over."

Bureaucracy at Aboriginal Affairs and Northern Development Canada is another headache, Chief McDougall adds. The land registration process that must precede property tax collections has been "very cumbersome, very lengthy", he says.

The largest financial institutions, notably the big banks, cannot realistically be expected to take the initiative in setting up a more robust First Nations' credit-rating system. They are unlikely to consider a wholesale change in their systems to accommodate First Nations. Smaller groups -- notably, local credit unions and other aboriginal financial institutions -- are far better placed to capitalize on their local knowledge.

The Aboriginal Savings Corporation (Abscan) is in the throes of a promising experiment in Quebec. With support from the JW McConnell Family Foundation and the help of a local credit union, Abscan is working to develop an efficient residential real-estate market in the community of Wendake, QC. These steps include a revolving housing fund to provide mortgage loans; encouraging a diverse housing stock in each community; and setting up a land registration and title system, which could form the basis for credit checks and credit histories.

Public-private partnerships

Public-private partnerships, also known as P3s, have become one of the most popular ways for governments at all levels around the world to relieve fiscal pressures. Some P3s have been huge commercial and political successes, others costly failures. Much depends on whether citizens perceive the venture as bringing value for money, and on which party bears the risk in the event of cost overruns or other unexpected problems.

First Nations have had little experience so far with P3s. Even so, a handful of ambitious projects are taking shape:

- Plans are on the drawing board to set up a single water authority for 33 communities in Atlantic Canada. The new agency would oversee the maintenance and upgrading of water and sewage treatment facilities at an estimated cost of $250 million over 25-30 years.

  Once constituted, the authority would call for bids from private-sector companies to design, build and operate facilities in the participating communities. The 33 affected bands must still pass resolutions setting up the new authority and granting it rights over communal lands. In addition, the project will require majority approval in a vote by 66,000 members of the affected bands.

- The federal government's P3 Canada Fund, managed by PPP Canada, announced its first project with a First Nation in September 2014, in the form of a low-interest loan of up to $12.9 million for the Kokish River hydro-electric project in British Columbia. The loan will enable the 'Namgis First Nation to build an equity stake in the 45 megawatt development. Electricity generated by the project will be sold to BC Hydro, with part of the proceeds used to fund a 'Namgis community benefit fund.

- Numerous private sector groups, ranging from hedge funds to specialized renewable energy producers, have expressed interest in partnering First Nations in wind, solar and hydro-electric energy projects, especially in British Columbia and Ontario.

The Starting Point…Building Trust and Communication

As this paper makes clear, various promising initiatives are under way to overcome the many practical obstacles in the way of reforming First Nations finances. One enduring challenge however, is to overcome years -- if not centuries -- of mistrust between the federal government, First Nations and outside investors. Inadequate communication between First Nations and outsiders, as well as among First Nations themselves, hampers the drive towards an improved fiscal regime.

While First Nations' knowledge of local conditions is extremely valuable, it needs to be complemented by technical capacity and financial expertise. Conversely, many private investors have a limited understanding of First Nations economies, customs and business opportunities. The remote location of many reserves raises costs for potential investors and exacerbates their unfamiliarity with local conditions. Having more than 600 communities -- many remote and with very limited resources -- scattered across such a vast country makes it difficult to communicate lessons learned from successes (and failures).

One lesson that appears to have been learned in recent years is the benefit of a gradual approach. Demonstration and pilot projects -- whether public-private partnerships or new types of housing finance -- have been useful, not only in assessing whether a particular strategy works, but also in building trust. Roundtable participants may wish to consider further steps that would help publicize and accelerate the rollout of successful projects to a wider audience.

In general, we see the forthcoming roundtable as the start of a fruitful dialogue on a pressing public policy issue. Maintaining the momentum must surely be one of its prime goals.