

Chapter 10

Housing finance, investor activity and macroprudential policy

10.1 During the inquiry the committee considered the relationship between housing finance and housing affordability, repayment affordability and 'mortgage stress'. This chapter considers whether Australians are unduly constrained in accessing housing finance, and the relationship between access to housing finance and housing affordability. The relationship between increasing house prices and the incidence of 'mortgage stress' is also examined.

10.2 In addition, this chapter weighs concerns expressed by some witnesses that excessive borrowing by investors is fuelling a speculative boom in housing prices, and fostering a build-up of risk in the financial sector more broadly. These concerns focused in particular on the Sydney and Melbourne housing markets, and the strong growth in investor activity in those markets. In considering these concerns, the committee also assessed what role, if any, macroprudential tools might play in helping to contain excessive speculative activity by housing investors.

10.3 This chapter also includes some brief observations regarding the impact of limited recourse borrowing for residential property by Self-Managed Superannuation Funds (SMSFs).

10.4 During the inquiry, the committee also received evidence suggesting problems in the availability of finance for affordable housing and urban regeneration projects. These issues are considered in chapter 23.

Access to finance and the mortgage industry

10.5 The ability of Australians to access housing finance was not a major focus of this inquiry. Nonetheless, the committee did receive some evidence suggesting that over-concentration in the housing finance sector might be limiting the product choices available to some consumers. In particular, the Mortgage and Finance Association of Australia (MFAA), pointed to the dominance of the 'Big Four' banks in the housing loan market as an impediment to innovation in the housing finance sector:

MFAA submits that lack of wide-spread competition across the housing lending sector is an inhibitor of the development of innovative mortgage products focussing on new buyers.¹

10.6 Although not addressing these concerns directly, the RBA told the committee that it was confident access to finance was not a significant problem for most

1 Mortgage and Finance Association of Australia, *Submission 42*, p. 2.

homebuyers. Dr Malcolm Edey, Assistant Governor (Financial System), told the committee that Australians enjoyed good levels of access to housing finance and that households are:

...not artificially constrained from borrowing as much as they can reasonably be expected to repay. I have already made the point that perceptions of affordability will differ across different types of households, but if there is a perceived affordability problem in Australia it is not due to a lack of finance.²

10.7 The RBA did acknowledge that tighter lending standards generally prevailed in Australia compared to the situation prior to the Global Financial Crisis. However, it maintained that these tighter standards were not an unreasonable constraint on would-be borrowers, but rather a welcome shift to more sustainable lending practices:

The experience of the United States in the lead-up to the financial crisis demonstrates that it is not in the long-term interest of either borrowers or lenders to boost 'affordability' by enabling households to borrow ever-larger amounts. Lending standards in the Australian mortgage market were not as loose as those seen in the United States in the years leading up to the crisis. There were, however, some instances of risky practices in Australia, which have become less prevalent in recent years. This is a welcome development and should not be seen as an unwarranted constraint.³

Committee view

10.8 On the basis of evidence received, the committee is satisfied that Australians are not unreasonably impeded in accessing finance to purchase a home. The committee also notes advice from the RBA that, to the extent mortgage finance is generally not as easy to access as it might have been prior to the Global Financial Crisis, this reflects a welcome improvement in lending standards. This is not to suggest that some Australians do not have difficulty accessing housing finance. As discussed further in the next chapter, some groups of people, including low-to-moderate income first home buyers, may have particular difficulty in accessing housing finance. However, the evidence received in this inquiry does not appear to suggest that these issues are symptomatic of systemic failures in the housing finance market.

Owner-occupier mortgages and mortgage stress

10.9 Despite improvements in mortgage lending practices, a number of witnesses expressed concern that some households are taking on excessive levels of mortgage debt due to house price growth. While levels of mortgage stress appear relatively well contained in the current low interest rate environment, these witnesses cautioned that

2 Dr Malcolm Edey, Assistant Governor, Financial System, Reserve Bank of Australia, *Proof Committee Hansard*, 2 October 2014, p. 2.

3 Reserve Bank of Australia, *Submission 14*, p. 5.

increasing numbers of households are likely to be exposed to significant financial difficulty when monetary policy inevitably tightens.

10.10 Trends in overall repayment affordability, as DSS noted, are largely governed by changes to household income and interest rates.⁴ In the last two decades interest rates have been relatively low and income growth relatively strong, which has somewhat benefited repayment affordability.⁵ The RBA told the committee that on the measure of repayment costs on a typical new housing loan expressed as a ratio of disposable income, affordability had 'fluctuated around a broadly stable average over the past three decades, with average repayments varying between about 20 and 30 per cent of disposable incomes'. As Dr Edey explained:

...the ratio of housing prices to incomes now is at the top of its historical range but over time this has been more than offset by falls in financing costs, so that the typical repayment burden as a share of income is currently not particularly high.⁶

10.11 In April 2014, the ABA observed that despite historically low interest rates for variable and fixed rate home loans, there had been little movement in the size of the average home loan made by banks to owner-occupiers in the three years to the end of 2013. It should be noted, however, that the same source used by the ABA to make this point also showed significant increases in average mortgage sizes between the mid-1990s and 2009.⁷

10.12 The RBA suggested that while some households would always struggle to meet their repayment obligations, the available evidence suggested that mortgage stress was not widespread. Nor was there evidence of systematic excessive lending beyond what borrowers could afford to repay:

Arrears rates are low and have fallen since their 2011 peak. Most personal bankruptcies are unrelated to mortgage debt, and they have also declined in recent years, as have home repossessions. Lenders have been willing to extend hardship relief to households that face temporary difficulties in repaying their loans, for example due to the floods in Queensland in late 2010 and early 2011. In addition, many households have built up buffers of excess repayments through offset and redraw facilities. These buffers provide those households with a cushion of prepayments that can be drawn down to avoid falling into arrears. By implication, these households'

4 Department of Social Services, *Submission 198*, p. 11.

5 Ms Felicity Hand, Deputy Secretary, Disabilities and Housing, Department of Social Services *Proof Committee Hansard*, 30 July 2014, p. 1. Ms Hand's comments related to lower interest rates since the early 1990s, and did not refer to income growth.

6 Dr Malcolm Edey, Assistant Governor, Financial System, Reserve Bank of Australia, *Proof Committee Hansard*, 2 October 2014, pp. 1–2.

7 Australian Bankers' Association, *Submission 197*, p. 5.

required mortgage repayments are affordable given their current financial circumstances.⁸

10.13 In its most recent *Financial Stability Review*, released on 25 March 2015, the RBA noted that indicators of household financial stress remain at low levels, with borrowers continuing to take advantage of low interest rates to pay down debt more quickly than contractually obliged and build up 'mortgage buffers'.⁹

10.14 However, the RBA also acknowledged that household financial stress could 'start to increase if labour market conditions weaken further than currently envisaged'.¹⁰ Moreover, as Dr Edey told the committee, the general stability in repayment affordability did not mean that particular types of households in particular markets were not experiencing affordability problems.¹¹ Similarly, DSS noted that the 'absolute increase in the size of mortgages, as opposed to simply the amount that is required to pay off a mortgage, has significantly increased the level of risk taken on by households entering the housing market'.¹²

10.15 Some witnesses suggested that the current low interest rate environment was in fact disguising the extent to which many Australians were exposed to severe repayment affordability issues. For example, Professor Stilwell underlined what he regarded as the risks created by households engaging in excessive borrowing in a low interest rate environment to chase ever-rising home prices. Such behaviour, he suggested:

...has some awesome historical equivalents, such as the sub-prime mortgage market collapse in the United States that precipitated the global financial crash of 2007–8. That was the terrible fallout of a process that involved people on modest incomes seeking to borrow to buy houses—and vigorously encouraged by lending institutions to do so—without due regard to their capacity to service the debt. Where future incomes are unreliable, especially because of insecure jobs, this can be a disastrous recipe for the individuals and families caught up in this process, as well as for the macroeconomic situation more generally.¹³

10.16 The committee also heard from a number of community service and housing providers who reported growing levels of mortgage stress, particularly in suburbs on the urban fringe of major cities. For instance, a submission from community legal centres located in Melbourne's outer-western suburbs referred to high rates of

8 Reserve Bank of Australia, *Submission 14*, p. 6.

9 Reserve Bank of Australia, *Financial Stability Review* (March 2015), pp. 2, 37, 39.

10 Reserve Bank of Australia, *Financial Stability Review* (March 2015), pp. 2, 37, 39.

11 Dr Malcolm Edey, Assistant Governor, Financial System, Reserve Bank of Australia, *Proof Committee Hansard*, 2 October 2014, pp. 1–2.

12 Department of Social Services, *Submission 198*, p. 11.

13 Professor Frank Stilwell, *Submission 25*, p. 1.

mortgage stress being experienced in its local communities. Some of the reasons for this, the centres offered, included 'unscrupulous lenders, interest rate increases, unemployment, family breakdown, death of a spouse, illness or injury'. The centre recommended that the Commonwealth fund 'mortgage stress clinics made up of [community legal centres] and financial counsellors to assist residents suffering mortgage stress'.¹⁴

Borrowing by housing investors and potential macroprudential tools

10.17 As discussed in earlier chapters, a large number of submissions expressed concerns that highly leveraged housing investors were driving up house prices and pricing first homebuyers out of the market.

10.18 In response to heightened investor activity in certain housing markets, the RBA has indicated a degree of concern that housing investors are assuming too much risk. For example, in early September 2014 Governor Glenn Stevens noted that a monetary policy stance aimed at encouraging business investment and generating employment amid global economic weakness also creates increased risk in the housing market:

As for things that monetary policy should try to avoid, we are also cognisant of the fact that monetary policy does work initially by affecting financial risk-taking behaviour. In our efforts to stimulate growth in the real economy, we don't want to foster too much build-up of risk in the financial sector, such that people are over-extended. That could leave the economy exposed to nasty shocks in the future. The more prudent approach is to try to avoid, so far as we can, that particular boom-bust cycle. It is stating the obvious that at present, while we may desire to see a faster reduction in the rate of unemployment, further inflating an already elevated level of housing prices seems an unwise route to try to achieve that.¹⁵

10.19 The RBA also told the committee that while it was mainly concerned with the imbalance in the Sydney and Melbourne markets, it was not confident that other markets would not suffer in the event of a downturn in those markets:

[W]e would see the imbalance as being primarily in the Sydney and Melbourne markets. But of course what we do not know is whether the down-swing will be quite so concentrated. ... [A]t the moment the increase in house prices is primarily concentrated in those two cities. To be honest in some other parts of Australia house prices are rising a little bit faster than incomes but not by a whole lot and not by the kind of growth rates that would cause you to be too concerned. But it is part of a general cycle in

14 The Western Community Legal Centres (Wyndham Legal Service, Footscray Community Legal Centre, Brimbank Melton Community Legal Centre and Western Suburbs Legal Service), *Submission 44*, pp. 12–13.

15 Governor Glenn Stevens, Address to CEDA Luncheon, 'The Economic Scene', Adelaide, 3 September 2014, <http://www.rba.gov.au/speeches/2014/sp-gov-030914.html>.

house prices and we are worried about what the downside of that house price cycle might look like.¹⁶

10.20 In late September 2014, with the release of its *Financial Stability Review*, the RBA indicated that it was in discussions with the Australian Prudential Regulation Authority (APRA) regarding the potential use of macroprudential tools to counter excessive speculative activity by housing investors, particularly in Sydney and Melbourne (as discussed below). Whereas traditional prudential policy, often referred to as 'microprudential', focuses on the safety and soundness of individual financial institutions, macroprudential policy is concerned with the stability of the financial system as a whole. To this end, macroprudential policy seeks to use regulatory instruments, referred to as macroprudential tools, to reduce systemic risks that can develop in boom-bust financial cycles.¹⁷ Such tools, as they apply to housing finance, can include loan-to-value limits (LTV; or, commonly, 'LVR', for 'loan-to-value ratio') and debt-to-income (DTI) limits.¹⁸

10.21 Statements in recent years from the RBA have hinted at a general scepticism regarding the value of macroprudential tools in limiting housing price growth. For example, a 2013 paper by Dr Luci Ellis, the RBA's Head of Financial Stability, concluded that LTV and DTI restrictions are generally insufficient to counteract the price effects of low or falling interest rates.¹⁹ In July 2014, Dr Ellis stated:

By now it should be clear that the Australian authorities' views on this supposedly new toolkit are a bit different from those in some other jurisdictions. We view macro-prudential policy as something to be subsumed into the broader financial stability framework. We recognise that

16 Dr Luci Ellis, Head, Financial Stability, Reserve Bank of Australia, *Proof Committee Hansard*, 2 October 2014, p. 8.

17 Luis I. Jácome and Erlend W. Nier, 'Macroprudential Policy: Protecting the Whole', *Finance and Development* 49, no. 1 (March 2012), <http://www.imf.org/external/pubs/ft/fandd/basics/macropu.htm#author>. Dr Luci Ellis, the RBA's Head of Financial Stability, is critical of this supposed dichotomy between microprudential and macroprudential regulation, and suggests that most 'supposedly macroprudential policy tools are in fact the usual prudential tools long used by ostensibly "micro" prudential supervisors'. Luci Ellis, address to the Paul Woolley Centre for Capital Market Dysfunctionality Annual Conference, 'Macroprudential Policy: A Suite of Tools or a State of Mind?' 11 October 2012, http://www.afr.com/rw/2009-2014/AFR/2012/10/10/Photos/7acdc298-1333-11e2-b1c0-1b3f887c6e6e_Ellis%20speech%20on%20macroprudential%20policy.pdf.

18 Deniz Igan and Heedon Kang, IMF Working Paper, 'Do Loan-to-Value and Debt-to-Income Limits Work? Evidence from Korea' (December 2011), <https://www.imf.org/external/pubs/ft/wp/2011/wp11297.pdf>.

19 Dr Luci Ellis, Head of Financial Stability Department, Reserve Bank of Australia, 'Macroprudential policy: What have we learned?' <http://www.rba.gov.au/foi/disclosure-log/pdf/131413.pdf>.

quantitative restrictions were already tried in the 1960s and 1970s, and didn't always work so well.²⁰

10.22 In August 2014, Governor Stevens himself referred to 'dreaded macroprudential tools' as the 'latest fad, internationally' during his appearance before the House of Representatives Standing Committee on Economics. However, he also noted that he did not rule out the use of macroprudential tools or asking APRA to use them, if needed. That possibility, he stated, would 'remain on the table'.²¹

10.23 While Governor Stevens had at no point ruled out the possibility that macroprudential tools may be used, the RBA's September 2014 *Financial Stability Review* nonetheless suggested a shift in the RBA's thinking on the subject. The review noted a strong pick-up in growth in lending for investor housing, particularly relative to growth in lending for owner-occupied housing and businesses. It stated that with the strong growth in lending for investor housing:

...the composition of housing and mortgage markets is becoming unbalanced, with new lending to investors being out of proportion to rental housing's share of the housing stock. Both construction and lending activity are increasingly concentrated in Sydney and Melbourne, where prices have also risen the most.²²

10.24 The *Financial Stability Review* also discussed the risks associated with the strong growth in lending to housing investors, measures announced by APRA to help manage this risk, and discussions between APRA and the RBA on further measures that might be considered:

In the first instance, the risks associated with this lending behaviour are likely to be macroeconomic in nature rather than direct risks to the stability of financial institutions. Property investors in Australia have historically been at least as creditworthy as owner-occupiers, and mortgage lending standards remain firmer than in the years leading up to the financial crisis. Even so, a broader risk remains that additional speculative demand can amplify the property price cycle and increase the potential for prices to fall later, with associated effects on household wealth and spending. These dynamics can affect households more widely than just those that are currently taking out loans: the households most affected by the declines in wealth need not necessarily be those that contributed to heightened activity. Furthermore, the direct risks to financial institutions would increase if these high rates of lending growth persist, or increase further. In this environment, recent measures announced by the Australian Prudential Regulation Authority (APRA) [through the release of a draft Prudential

20 Luci Ellis, Head of Financial Stability Department, Reserve Bank of Australia, address to the University of Adelaide, 'Why Financial Stability Matters, and What We Can Do About It', 4 June 2014, <http://www.rba.gov.au/speeches/2014/sp-so-fs-040614.html>.

21 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, Brisbane, 20 August 2014, p. 21.

22 Reserve Bank of Australia, *Financial Stability Review*, September 2014, p. 1.

Practice Guide for housing] should promote stronger risk management practices by lenders. The Bank is discussing with APRA, and other members of the Council of Financial Regulators, additional steps that might be taken to reinforce sound lending practices, particularly for lending to investors.²³

10.25 These 'additional steps' were taken by observers to potentially include the use of macroprudential tools. Comments by Governor Stevens made in late September 2014 provided further insights into the RBA's evolved thinking on the potential introduction of macroprudential tools. Asked about his characterisation in August of macroprudential tools as a 'fad' and whether his views had changed, Governor Stevens responded:

[I]nvestment finance is growing at double-digit rates. It's nearly half the flow of new approvals. A lot of this is interest-only lending in an environment of rising house prices, especially in Sydney and Melbourne. I think it is perfectly sound and sensible to ask ourselves whether we might at least lean on that a bit. I see not much downside of doing so. The worst that could happen is that it doesn't have that big an effect, but if it had some, and that helps us to square in some small way all the conflicting things that we have going on, that is worth a try. I'm not naïve enough to believe that these kind of tools are, you know, any kind of panacea or a permanent solution. I'm old enough to remember the lessons of regulation in the past. But that doesn't mean you shouldn't use them for a period, if at the margin they might be helpful, and that's the kind of thing that's in my mind, nothing more. I don't think that's any kind of change of tune really. I've always said I have certain scepticism about macroprudential tools as a panacea, but I remain open to using them if it seems sensible to do so, and that's the kind of thing we have in mind right now.²⁴

10.26 On 2 October 2014, following the release of its *Financial Stability Review*, the RBA appeared before the committee and explained the thinking underlying the comments in the review:

The rate of growth of investor finance is significantly outpacing the growth in household incomes. Loans to investors currently account for close to 50 per cent of new housing loan approvals. Investor activity has been particularly concentrated in New South Wales and Victoria. In New South Wales, investor loan approvals have increased by about 90 per cent over the past two years. It is against this background that the bank said in its *Financial Stability Review* last week that the composition of housing and mortgage market activity is becoming unbalanced. The review also indicated that we are discussing with APRA steps that might be taken to

23 Reserve Bank of Australia, *Financial Stability Review*, September 2014, pp. 1–2.

24 Governor Glenn Stevens, Address to the Melbourne Economic Forum, University of Melbourne, 'Financial System Reform and the Monetary System', 25 September 2014, <http://www.brrmedia.com/event/127406/sp-gov-250914>.

reinforce sound lending practices, particularly for investor finance although not necessarily limited to that.

I emphasise that the banks in Australia are resilient and mortgage lending in this country has historically been relatively safe. APRA has, however, noted a trend to riskier lending practices and over the past couple of years has been seeking to temper these through its supervisory activities. There are also broader concerns with the macroeconomic risks associated with excessive speculative activity, since this activity can amplify the property price cycle and increase risks to households. Our discussions with APRA and other agencies on these matters are ongoing and there will be more to say about them in due course.²⁵

10.27 Asked about Governor Stevens description in August 2014 of macroprudential tools as an international 'fad', Dr Edey explained that the Governor was rightly expressing scepticism (as both he and Dr Ellis had previously) about 'highly prescriptive and overengineered approaches that are being advocated in some of the international debate'. Dr Edey emphasised, however, that the Governor had also stated that the RBA did not rule out the use of macroprudential tools in Australia.²⁶ Dr Edey added:

You have had people talking about setting up entirely new frameworks where you have new institutional arrangements and new oversight committees, trying to almost mechanise the relationship between instruments and objectives in a way that we think is unrealistic. We have talked in very sceptical terms about those kinds of approaches to policy. That is why I emphasise the continuity between what we are doing now and what we have said in the past. What we have always said is that we do not need a radically new approach in Australia. We have the tools and we have institutional arrangements that are capable of dealing with systemic risks as they arise. What we believe has happened over the past year is that a concentration of risk in the housing market has come up, it has gradually become more severe and, as that has happened, we have turned up the dial in the response to that, both in our rhetoric and in the way that we have engaged with APRA as to the sorts of supervisory responses that are needed.²⁷

10.28 However, the RBA also indicated in the same hearing that LVRs were 'unlikely to be in the tool kit' being considered by APRA, as they would be targeted at the wrong segment of the market. It further indicated that the tools that were being

25 Dr Malcolm Edey, Assistant Governor, Financial System, Reserve Bank of Australia, *Proof Committee Hansard*, 2 October 2014, p. 2.

26 Dr Malcolm Edey, Assistant Governor, Financial System, Reserve Bank of Australia, *Proof Committee Hansard*, 2 October 2014, p. 4.

27 Dr Malcolm Edey, Assistant Governor, Financial System, Reserve Bank of Australia, *Proof Committee Hansard*, 2 October 2014, p. 4.

considered would be directed toward the apparent imbalance 'in the form of excessive activity by investors in the market'.²⁸

10.29 Asked how macroprudential tools would be deployed given the diverse conditions in housing markets throughout Australia—that is, how such tools could be used to contain investor activity in Sydney or Melbourne without adversely affecting flat or depressed housing markets—Dr Edey responded:

I think we do need to be mindful of that issue. That is why I emphasised earlier that any measures we take have to be well targeted. Exactly how that is done will become evident in due course when the final decisions are made. We have to strike a balance between being overly prescriptive and trying to micro-manage the market and coming up with measures that could be broadly effective. I would just make the mathematical point that most of the growth in investor finance at the moment is coming out of lending into the Sydney and Melbourne market, so any measure that targets investor finance in total is going to have its major impact there because that is where most of the activity is. Whether we need to do something even more than that to target it even more tightly is something we will need to think about. As a general proposition, something that is targeted at the investor market is going to have its main impact in the areas where the largest imbalances are at the moment.²⁹

10.30 Subsequently, Dr Edey told the committee that the RBA was not hostile to housing investors, and any tools used would need to be directed specifically to addressing the 'excessive growth in risk exposure in the investor market':³⁰

I think there are a few principles that have to be kept in mind. One is that it has to be targeted. We have already talked a bit about what that means: identifying what the problem is and designing measures that specifically address that problem. It has to be proportionate. We are not trying to kill the investor market. We are not against investors; we are just against imbalance, so it has to be proportionate. Yes, I think those are the two main things really. It has to be well targeted. It has to be commensurate to the problem that we are facing.³¹

10.31 The committee received evidence from a number of witnesses (all of it received prior to the release of the September 2014 *Financial Stability Review*) arguing that the RBA and APRA should implement (or at least consider implementing) macroprudential tools to dampen speculative activity in the housing

28 Dr Malcolm Edey, Assistant Governor, Financial System, Reserve Bank of Australia, *Proof Committee Hansard*, 2 October 2014, p. 3.

29 Dr Malcolm Edey, Assistant Governor, Financial System, Reserve Bank of Australia, *Proof Committee Hansard*, 2 October 2014, p. 6.

30 Dr Malcolm Edey, Assistant Governor, Financial System, Reserve Bank of Australia, *Proof Committee Hansard*, 2 October 2014, p. 12.

31 Dr Malcolm Edey, Assistant Governor, Financial System, Reserve Bank of Australia, *Proof Committee Hansard*, 2 October 2014, p. 9.

market. For example, in order to address what it regarded as a speculative property bubble driven in part by excessive borrowing, Prosper Australia recommended carefully considered macroprudential regulation to 'restrain our current debt appetite'. Prosper Australia did stress, however, that the detail of such macroprudential tools would be critical:

The quality of those macroprudential regulations is everything. It is all very well to announce them and say that you have got some, but they need to be effective as well.³²

10.32 Professor Burke, meanwhile, expressed his frustration at the RBA's apparent unwillingness to countenance macroprudential interventions in the housing market. According to Professor Burke, while the RBA appeared to be solely focused on the interest rate, in countries including China, Malaysia and New Zealand the respective central bank:

...is actually interfering in the lending regimes of finance institutions to avoid housing bubbles. China, for example, has restricted finance to new supply. It has said that there will be no funds for investors who already own more than one dwelling. New Zealand has capped financing by private finance institutions for home loans at no more than 80 per cent of the value of the property. They are temporary arrangements that they put in place at the time of housing bubbles. We do not seem to have any discussion about the potential for those sorts of levers being used by the Reserve Bank and it almost looks as if you cannot touch the housing market. That puzzles me somewhat, that the Reserve Bank does not do that, except for jawboning saying we should not be investing because it could be risky. That does not seem adequate to me.³³

10.33 Other countries have in recent years introduced macroprudential measures directed toward reducing risk in the housing market. Notably, in May 2013 the Governor of the Reserve Bank of New Zealand (RBNZ) and the New Zealand Minister for Finance signed a Memorandum of Understanding (MoU) regarding macroprudential policy and operating guidelines. This MoU covered the application and operation of macroprudential policy. It provided that the RBNZ could intervene and apply macroprudential tools where 'significant risks are judged to be emerging'. The available macroprudential instruments included countercyclical capital buffers, adjustments to the minimum core funding ratio, sectoral capital requirements, and restrictions on high LTV ratio residential mortgage lending.³⁴ In response to rising house prices, in August 2013 the RBNZ intervened in the market by introducing a LTV ratio limit, so that residential mortgage lending with LTV ratios higher than

32 Mr David Collyer, Policy Director, Prosper Australia, *Proof Committee Hansard*, 9 September 2014, pp. 1–2.

33 Professor Terry Burke, private capacity, *Proof Committee Hansard*, 9 September 2014, p. 25.

34 Reserve Bank of New Zealand, 'Memorandum of Understanding between the Minister of Finance and Governor of Reserve Bank of New Zealand', 13 May 2013, http://www.rbnz.govt.nz/financial_stability/macro-prudential_policy/5266657.html.

80 per cent are capped at 10 per cent of a bank's new residential mortgage lending (subject to some exemptions).³⁵

10.34 In May 2014, the RBNZ conducted a counterfactual analysis of the effect of the LTV ratio limit on the housing market. It found that six months after its introduction, the LTV ratio limit appeared to have moderated house price inflation and credit growth. It also estimated that without the LTV ratio limit, or any other housing-specific shocks, house price inflation and household credit growth could have been 3.3 and 0.9 percentage points higher respectively. The analysis noted, however, that it was undertaken only six months after the implementation of the LTV ratio limit. As such, the analysis acknowledged that the findings probably reflected a transitional period, during which market participants may have reacted quite rapidly to the policy. New market participants, it added, might grow accustomed to the policy, and housing activity could consequently rebound leading to smaller effects over the first year.³⁶

10.35 Other countries that have also introduced macroprudential tools in recent years in response to house price inflation include Canada in 2008, and South Korea at various points between 2002 and 2010.³⁷

10.36 The RDC argued that while macroprudential tools could be used to manage systemic risk, they were only effective if the nature of the risk was properly understood. The RDC suggested that in New Zealand, decisions about macroprudential tools had been taken in the absence of adequate data on the levels of housing investment, and in particular foreign investment. As such, housing prices had continued to rise, and the macroprudential tools deployed had simply served to slow growth in the first homebuyer market:

The point is that, if we are to make those decisions, we need to do that not in the absence of the data that understands where we are heading in terms of the investment patterns, the supply that is coming through, the demand that is likely to be there and the foreign investment numbers. Those inputs into the equation need to be there if we are going to implement some of those macroprudential tools.³⁸

35 Reserve Bank of New Zealand, 'Limits for high-LVR lending', 20 August 2013, <http://www.rbnz.govt.nz/news/2013/5406716.html>.

36 Gael Price, Reserve Bank of New Zealand Analytical Note, 'How has the LVR restriction affected the housing market: a counterfactual analysis', May 2014, p. 13, http://rbnz.govt.nz/research_and_publications/analytical_notes/2014/an2014_03.pdf.

37 See Ivo Krznar and James Morsink, IMF Working Paper, 'With Great Power Comes Great Responsibility: Macroprudential Tools at Work in Canada' (May 2014), <http://www.imf.org/external/pubs/ft/wp/2014/wp1483.pdf>; and Choongsoo Kim, 'Macroprudential policies in Korea: Key measures and experiences', Bank of Korea, April 2014, https://www.banque-france.fr/fileadmin/user_upload/banque_de_france/publications/FSR18_Kim.pdf.

38 Mr Nicholas Proud, Executive Director, Residential Development Council, Property Council of Australia, *Proof Committee Hansard*, 10 November 2014, p. 54.

10.37 For its part, Home Loan Experts complained that current LVR limits were already too restrictive, and cautioned against moves to tighten the limits further:

Currently APRA has placed significant policy constraints on the banks. If they are required to reduce maximum LVRs (Loan to Value Ratio) similar to New Zealand, this will make it harder for first home buyers to enter the market since most tend to borrow around 90% of the property value. Limiting the LVR to 80% would require buyers to save up double the amount of deposit to make a purchase.³⁹

10.38 In contrast, Mr Cameron Murray argued in favour of New Zealand-style LVR limits, in order to reduce the effect of high-risk investors on the housing price cycle.⁴⁰

Recent developments regarding prudential policy and housing finance

10.39 In December 2014, APRA announced new measures to reinforce sound house lending practices following discussions with member agencies of the Council of Financial Regulators (CFR; including the RBA, which chairs the CFR). As the RBA explained, the measures:

...outline prudential expectations of ADIs' [Authorised Deposit-taking Institutions] lending behaviour regarding: the extent of higher-risk mortgage lending; the pace of growth in investor housing lending; and the interest rate buffers and floors used in loan serviceability assessments. The benchmarks specified are not intended to be hard limits, but rather to serve as a trigger for more intense supervisory action, potentially including additional capital requirements.⁴¹

10.40 In an appearance before the House of Representatives Standing Committee on Economics on 20 March 2015, the Chairman of APRA, Mr Wayne Byres, discussed the 'triggers' for intensified supervisory action by APRA, and the kind of actions the regulator might take to curb the growth of lending to property investors. Mr Byres indicated that APRA was considering an increase in capital levels for particular banks whose growth in lending to investors continued to exceed 10 per cent:

In this current exercise, we are going through, we are targeting those ADIs that are pursuing the most aggressive lending strategies and, to the extent there are additional capital requirements imposed, they will be imposed on those housing portfolios where the risks are and not on the other lending books that banks have.⁴²

39 Home Loan Experts, *Submission 5*, p. 1.

40 Mr Cameron Murray, *Submission 17*, p. 7.

41 Reserve Bank of Australia, *Financial Stability Review* (March 2015), p. 45.

42 Mr Wayne Byres, Chairman, Australian Prudential Regulation Authority, *Proof Committee Hansard*, 20 March 2015, p. 23.

10.41 As some have observed, this would likely be achieved through a lifting of the prudential capital ratio, which APRA sets according to the risks for each institution.⁴³ However, such moves would not be publicly disclosed. Mr Byres suggested that such 'below the radar' prudential regulation was important in maintaining public confidence in the banks.⁴⁴

10.42 Meanwhile, the Australian Securities and Investments Commission (ASIC; also a member of CFR) announced in December 2014 that it would conduct a review of interest-only housing lending. The review has been prompted by concerns by regulators about higher-risk lending following strong house price growth in Sydney and Melbourne. Interest-only loans, ASIC noted in announcing the review, have reached a new high of 42.5 per cent of new housing loan approvals in the September 2014 quarter (including loans for both owner-occupied and investment housing). ASIC Deputy Chairman Peter Kell stated that while 'house prices have been experiencing growth in many parts of Australia, it remains critical that lenders are not putting consumers into unsuitable loans that could see them end up with unsustainable levels of debt'.⁴⁵

10.43 In its most recent *Financial Stability Review*, released on 25 March 2015, the RBA explained that the recent steps by APRA and ASIC were directed at managing increased risks associated with the recent run-up in housing prices and increased housing investor activity:

In this environment of low interest rates and strong demand, it is important that lending standards do not decline, and the measures announced by the Australian Prudential Regulation Authority and the Australian Securities and Investments Commission in December are designed with that intent. While it is too early to see the effects of these measures in overall housing lending activity, the authorities will be monitoring an array of information in the period ahead to help ensure that the current risk profile in the mortgage market does not deteriorate.⁴⁶

Committee view

10.44 The committee notes and shares the concerns expressed by the RBA regarding what may be excessive levels of investor activity in the Sydney and Melbourne housing markets. As the RBA explained, it would appear that lending to investors has recently been growing out of proportion to rental housing's share of the market in the

43 James Eyers, 'APRA keeps macroprudential strictures on bank lending secret', *AFR*, 20 March 2015.

44 Mr Wayne Byres, Chairman, Australian Prudential Regulation Authority, *Proof Committee Hansard*, 20 March 2015, p. 7.

45 Australian Securities and Investments Commission, media release 14-329MR, 'ASIC to investigate interest-only loans', 9 December 2014, <http://asic.gov.au/about-asic/media-centre/find-a-media-release/2014-releases/14-329mr-asic-to-investigate-interest-only-loans/>.

46 Reserve Bank of Australia, *Financial Stability Review* (March 2015), p. 2.

two capitals, and this imbalance is inflating house prices and fostering a build-up of risk in the financial sector more broadly.

10.45 While the risks inherent in this situation are of concern, the committee would have serious reservations about the use of any overly blunt macroprudential regulations, including the use of LTV ratios such as these recently deployed in New Zealand. Throughout the inquiry, witnesses emphasised that there is not one Australian housing market, but rather many Australian housing markets, and indeed markets within markets. As such, the committee welcomes advice from the RBA that it is unlikely anything other than carefully targeted macroprudential tools would be deployed in Australia, and APRA would be quite unlikely to consider broad New Zealand-style LVR limits.

Limited recourse borrowing for property by SMSFs

10.46 Some observers have suggested investment in housing by SMSFs, including through the use of limited recourse borrowing, may be partially responsible for recent increases in house prices.

10.47 The Association of Superannuation Funds of Australia (ASFA) noted in its submission that the number of properties purchased by SMSFs in 2011–12 was possibly as low as 3000 out of a total 360,000 to 400,000 residential property sales that year. Moreover, the exposure of assets in SMSFs financed by limited recourse borrowings as at June 2012 was not particularly large at \$2.26 billion, at least relative to overall SMSF assets of \$438 billion (nor would all of this borrowing be for residential property). Nonetheless, ASFA noted that the amount of limited recourse borrowing by SMSFs was growing rapidly, from \$665 million in June 2010. ASFA further observed that these figures were based on ATO data available as of June 2012, and that since that time 'there appears to have been an increase in the activity of "property spruikers" strongly pushing residential real estate purchases by SMSFs'.⁴⁷

10.48 The committee also notes that in its September 2013 Financial Stability Review, the RBA suggested that the growth in property investments by SMSFs 'is a new source of demand that could potentially exacerbate property price cycles'.⁴⁸

Committee view

10.49 The purchase of residential property by SMSFs, including through limited recourse borrowing, was not a major focus of the committee's inquiry. As such, the committee is not in a position to assess the effect on housing affordability of property investment by SMSFs, including investments funded by limited recourse borrowing. Still, the committee believes this issue justifies close and ongoing observation, not

47 The Association of Superannuation Funds of Australia, *Submission 130*, pp. 3–4.

48 Reserve Bank of Australia, *Financial Stability Review* (September 2013), p. 49.

least because of anecdotal evidence of increasing activity by 'property spruikers' pushing real estate investments by SMSFs.