Appendix 5

Factors contributing to household debt

The evidence presented to the Committee focussed on housing related debt and credit card debt. Although opinions differ about impact of the various contributing factors, most commentators agree that the primary factors behind the strong growth in household debt levels include:

- Freeing up of the financial markets, which meant credit became much more readily available;
- A prolonged period of low inflation and low interest rates gave consumers a feeling of confidence in the economy;
- Increased competition in lending, more advertising and promotion;
- A much wider range of products from lenders, including lines of credit and interest-only loans;
- The stockmarket boom in the mid-to-late 1990's followed by the real estate boom and the ability of consumers to borrow for investment purposes;
- The growing acceptance of the concept of debt used for investment as 'good debt', actively promoted by financial advisers promoting wealth creation strategies based on investment in equities and property;
- Increasing financial literacy and the realisation of the baby boomer generation that it would have to take more responsibility for funding a comfortable retirement;
- Rising asset values, especially in residential real estate, which gave home owners a feeling of increased wealth (so-called 'wealth effect'), and the ability to unlock that wealth through new financial products such as loans based on home equity;
- A sustained period of economic growth, low inflation, low interest rates, and falling unemployment.

Treasury sees the rise in household debt as:

> …a rational response to the deregulation of the financial system, allowing consumers to smooth their consumption more efficiently over their life cycle…Lower inflation, leading to lower nominal interest rates, has also made it easier for households to borrow more.

Treasury stated that the increased ability to borrow (which is a function of both deregulation and lower interest rates) probably helped drive up house prices, increasing the amount that households needed to borrow.[1]

The ANZ bank had a similar view, stating that debt levels had been driven by 'a sustained boom in house prices, a sustained low interest rate environment and solid growth in household incomes'[2].

The RBA's view is that the main reason debt has risen is that households can afford to borrow more in a low interest rate environment. The Bank also points out that in a low inflation environment, the real value of loans is eroded more slowly than when inflation is high; and financial deregulation has played a significant role, increasing lender competition and providing innovations such as home equity loans and redraw facilities.[3]

All commentators agree that increased investor activity in the housing market has further increased demand in the market, contributing significantly to increases in housing prices and household debt levels.

Some commentators consider that banks and other finance providers may also have influenced demand by increasing the amount of money available to the market, aggressive promotion of lending products and allowing lending standards to slip in a bid to maintain profits and market share. This view is disputed by lenders who maintain that the borrowing is entirely driven by demand factors, which the lending institutions merely find more creative ways of satisfying.

Wealth effects, whereby households feel encouraged to spend on the basis of perceived increased wealth resulting from increased house prices, may also have had an effect on debt levels.

The rise in household debt is also partly attributable to the increase in the number of additional people who have borrowed money in response to the above factors. The RBA notes that the number of households with owner-occupied housing debt appears to have increased by over 40 per cent since 1996, considerably faster than the growth in the number of households.[4]

The housing boom

As the Governor of the RBA observed in 2003:

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1 The Treasury, *Submission 13*, p. 7.

2 ANZ Bank, *Submission 17*, p. 1.

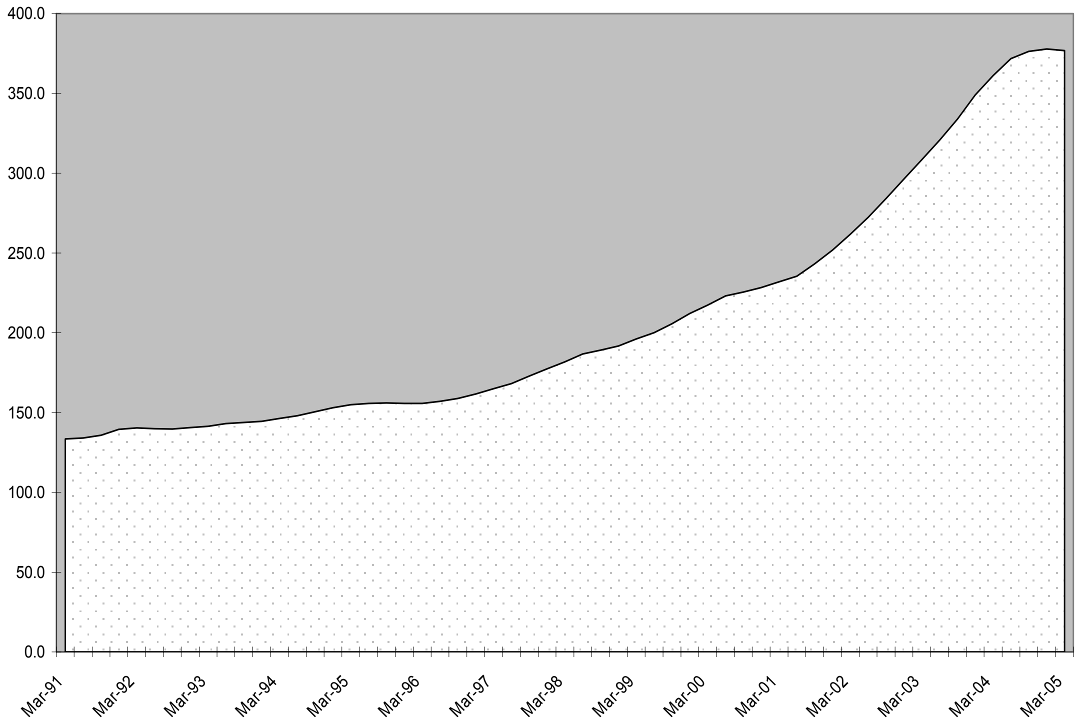
3 RBA, *Do Australian Households borrow too much?*, Speech by the Governor, Mr I.J. Macfarlane to the Sydney Institute, 3 April 2003.

4 RBA, *Financial Stability Review*, September 2005, p. 20.

> The story about household debt is largely a story about housing and, of course, is intimately tied up with the subject of rising house prices.[5]

Australian house prices are at a historical high, having more than doubled since 1996. This rise was particularly pronounced in the period between March 2001 and March 2004, with around 40 per cent of the rise in the last decade occurring in that period. Figure 1 below shows the rise in house prices since March 1991.

Figure 1: Median Price Established Houses Sold ($000)
Weighted average 8 capital cities – average of previous 4 quarters



Source: Parliamentary Library housing data derived from Real Estate Institute of Australia, *Market Facts*.

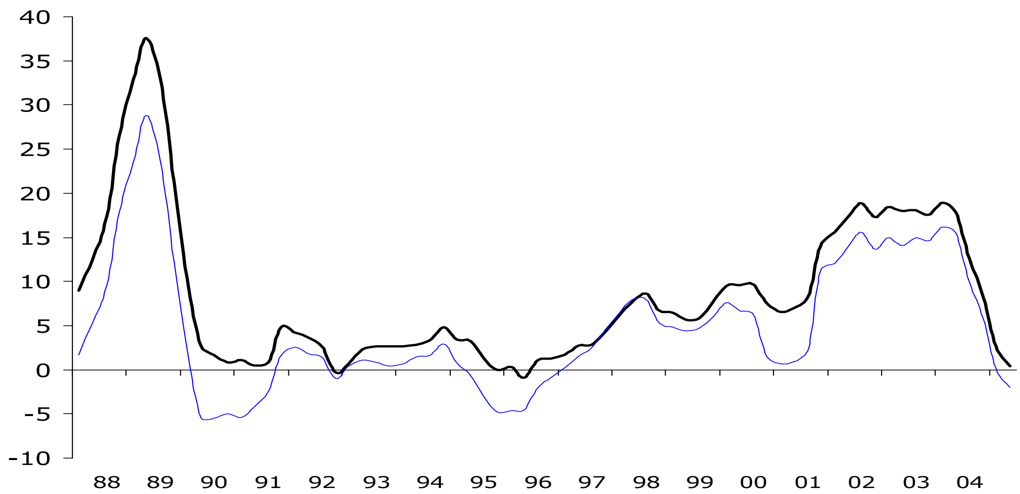
An alternative way of considering the increase in house prices is to compare how much these have changed from previous years. Figure 2 shows this change in prices as a percentage, expressed in nominal and real terms. The graph puts the recent increases in house prices in context, showing that this was not the first occasion when large price movements have happened.

In the massive boom of the late 1980s, prices increased in one year by 40 per cent. The rate of increase has been less during the current boom, but has been sustained over a long period. It has also been seen consistently across the country. As observed

5 RBA, *Do Australian Households borrow too much?*, 3 April 2003.

by the Productivity Commission, 'the upswing in housing prices since the mid-1990s has been bigger and more widespread than in previous cycles'[6].

Figure 2: House prices over the last 17 years (Nominal and real terms) showing the percentage change from the previous year.



Source: ABS, reproduced from Submission 17, ANZ Bank.

But why have house prices risen? Housing prices behave in accordance with the basic principles of supply and demand. Put simply, demand for housing forces prices up if supply falls short of what the market needs. During this boom, growth in demand has outstripped the growth in supply. Construction of new dwellings, while at very high levels, has not kept pace with the rise in the number of households and investors seeking to buy properties.

There is evidence that the boom in house prices has come to an end, and that a cooling off in the market is taking place. Treasury advised the Committee that the housing cycle is unwinding, and that as this market cools, growth in dwelling investment and consumer spending should ease and household saving rise.[7]

The RBA also believes that the boom in prices for housing has come to an end in most capital cities. In its August 2005 Statement on Monetary Policy, the RBA published the following table (Table 1), which shows a fall in Sydney prices and low or static prices except in Perth and Adelaide. A feature of this table is that the RBA is now able to publish statistics that are stratified by market segment, and are a more reliable indicator of what is happening in the market.

6 Productivity Commission Inquiry Report, *First Home Ownership*, No. 28, 31 March 2004, Key findings.

7 The Treasury, *Submission 13*, p. 10.

Table 1: Composition-adjusted house prices – percentage change

	18 Months to Dec qtr 2003	18 Months to June qtr 2005
Sydney	25	-7
Melbourne	20	0
Brisbane	62	5
Adelaide	35	9
Perth	33	19
Canberra	41	0
Australia	29	0

Source: RBA, *Statement on monetary policy*, August 2005.

The RBA also notes that lending for housing remains above its 2004 average, but has softened in recent months. While housing credit growth was still running at an annualized rate of 10.9 per cent in the six months to June 2005 this is half the peak rate of 2003.[8]

Deregulation of the financial system

The most fundamental change that occurred as a result of the deregulation of the financial section was that instead of governments attempting to regulate the operation of financial markets through supply-side measures, demand became the main factor influencing the amount of money borrowed. This was well summed up by the Australian Bankers Association (ABA) in its submission:

> A central tenet of the financial sector deregulation achieved in Australia over the past two decades has been the removal of iniquitous credit rationing that had previously prevailed, thereby allowing policy to influence credit through demand-side factors. [9]

Deregulation had a number of significant effects, including:

- removal of restrictions on lending;
- increased competition between lenders, further enhanced by the entry of foreign banks and non-traditional lenders into the market; and
- innovation increased, leading to a much wider range of financial products becoming available to borrowers.

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8 RBA, *Statement on Monetary Policy*, 8 August 2005, pp. 28, 36.

9 ABA, *Submission 16*, p. 3.

Enhanced competition between lenders resulting from deregulation has also reduced borrowing costs by putting downward pressure on interest rates and operating margins. Treasury advised that competition within the sector has brought about a reduction of interest rate margins from 3.6 per cent in 1994 to 1.8 per cent in 2004.[10]

Competition encouraged innovation, leading to the introduction of financial products that are more flexible and can be tailored to the needs of a wider group of consumers, making them more attractive to borrowers. Developments in the mortgage market are a good example. Treasury advised the Committee that in 1980 there were 26 types of mortgages available and that deposit-taking institutions were the main source of home finance. By 2003, approximately 3000 differentiated mortgage products were available to consumers.[11]

A number of new institutions also now offer housing finance, although banks retain 85 per cent of the market. According to the ABA, about 10 percent of all home loans are now provided by non-conforming lenders, that is, lenders who are not subject to APRA's prudential supervision because they do not take deposits.[12] This group includes lenders such as mortgage originators, of whom Aussie Home Loans is a well-known example. Non-conforming lenders raise money by issuing securities in the money market to raise funds for lending, a process known as securitisation.

The ABA argued that while the market share of non-conforming lenders is still relatively small, its influence is considerable, and has led to the introduction into the banking sector of a number of new financial products such as 'low-doc' loans which originated in the non-conforming sector.[13]

Mortgage brokers have also entered the Australian housing market and have made a significant impact. Mortgage brokers are essentially middlemen between borrowers and lenders whose role is to find and arrange home loans for customers. The ABA told the committee that this group now represent about 30 per cent of the housing loan market, and their presence has exerted downward pressure on interest rates:

> …I understand that mortgage brokers constitute about 30 per cent of the market…As a result of financial deregulation initiated by various governments, mortgage brokers are a fact of life. They have certainly assisted in the downward pressure on interest rates and, I guess from a customer viewpoint, they have proven to be a good thing.[14]

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10 The Treasury, *Submission 13*, p. 11.

11 *Submission 13*, p. 11.

12 ABA, *Submission 16*, p. 7. It should be noted that securitisation is not used exclusively by non-conforming lenders. Securitisation is also used extensively by more traditional lenders. 17 per cent of all housing loans are now securitised, a modest figure compared to the USA where the figure is in excess of 60 per cent.

13 *Submission 16*, p. 9.

14 *Official Committee Hansard*, 16 May 2005, p. E68.

Other significant innovations in the housing loan market include mortgage insurance, which allows a lending institution to lend where income-to-repayment ratios exceed 30 per cent, or where the buyer has less than the required deposit; and home equity loans, which enable a home owner to access equity and can be used for a range of purposes including the purchase of property for investment purposes.

A natural consequence of deregulation is that finance is available to many more people, increasing demand. As Treasury pointed out in its submission, this increased ability to borrow has probably helped to drive up house prices, which in turn increased the amounts households needed to borrow.

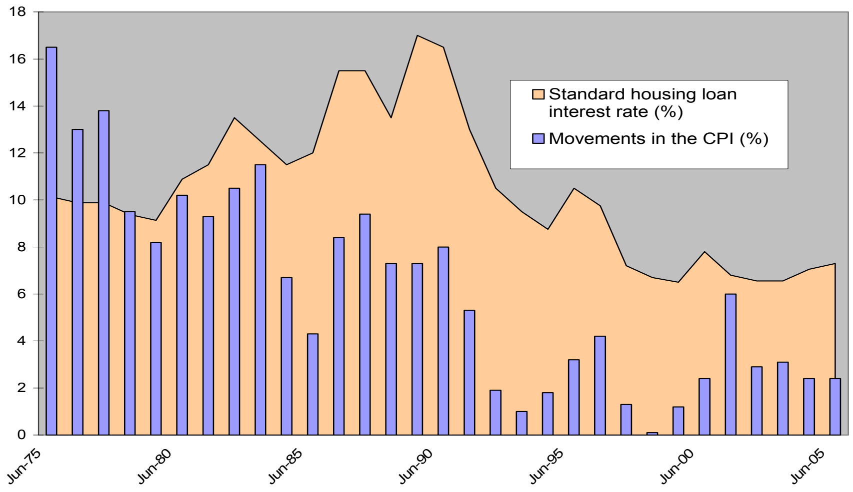
Interest rates and inflation

Australian interest rates have declined steadily for the last fifteen years, and have been consistently low for most of the last decade. As shown in Figure 3, interest rates charged by the banks for housing mortgages declined steeply from their 1989 peak of 17 per cent, and have remained low by Australian standards for most of the last decade.

This reduction in interest rates has a close relationship with the decline of inflation. As Treasury noted in its submission to the inquiry, lower inflation, leading to lower nominal interest rates, has made it easier for households to borrow more. However this increased ability to borrow 'probably helped to drive up house prices, thereby increasing the amount households needed to borrow'.[15]

15 The Treasury, *Submission 13*, p. 7.

Figure 3: Housing loan interest rate and movements in the CPI 1975 – 2005.[16]



Source: RBA

A fall in interest rates also places mortgage finance within reach of a larger proportion of the population, some of whom would not have previously qualified for a loan under the income tests that lenders traditionally applied to borrowers.

The ABA advised the Committee that traditionally, the standard income test that a bank applies is that the monthly loan repayment should not exceed 30 per cent of gross income. Higher income individuals may qualify for a higher ratio. This income test is applied 'conservatively', incorporating an interest rate buffer of one or two per cent.[17]

The Productivity Commission quantified the increase in borrowing capacity that has resulted from lower interest rates in its report *First Home Ownership*, observing that average borrowing capacity over the last five years was about 70 per cent higher than for the period 1983 to 1993[18].

There is evidence that the increased affordability that results from low interest rates has also affected buyer preferences, and many previous home owners have traded up to better, larger homes in more desirable areas. New homes are also significantly larger on average than houses built a decade ago. In its report *First home ownership*, the Productivity Commission explains this effect succinctly:

16 Derived from RBA data and statistics provided by Parliamentary Library.

17 ABA, *Submission 16*, p. 4.

18 Productivity Commission Inquiry Report, *First Home Ownership,* p. 44.

> For owner-occupiers, a halving of the interest rate almost doubles the mortgage potentially obtainable, as well as nearly doubling the price of a home that a home that can be 'afforded' for a given budget or income.[19]

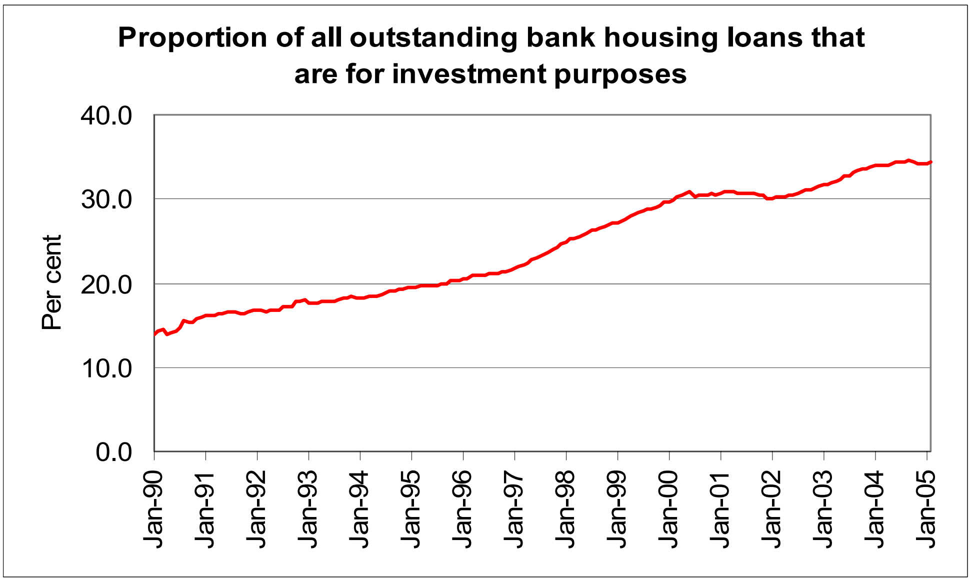
The RBA agrees that debt has risen because households can afford to borrow more, but points out that a low inflation environment also means that households hold their debt for longer. This is because the real value of the debt is not eroded as fast as it is in a high inflation environment. The RBA considers that these two factors (low interest and slower debt erosion) could account for an approximate doubling of the debt-to-income ratio.[20]

Investor activity in the housing market

Significantly higher investment activity in the housing market is an important factor adding to housing demand. Investor activity increases buyer competition and, as a result, prices.

As shown in Figure 4, investment loans as a proportion of total outstanding housing loans have grown from around 15% in 1990 to about 34% in 2005. This growth has slowed in response to the softening of the property market since 2004.

Figure 4: Proportion of bank housing loans for investment property.



Source: Reserve Bank of Australia Bulletins.

19 Productivity Commission Inquiry Report, *First Home Ownership,* p. XVII.

20 RBA, *Do Australian Households borrow too much?*, Speech by the Governor, Mr I.J. Macfarlane, to the Sydney Institute, 3 April 2003.

While Australia (70%) has roughly the same rate of home ownership as the UK (69%), the USA (67%) and Canada (64%) it has a significantly higher rate of ownership of investment property. About 13% of Australian households receive rental income (up from about 9% a decade ago), compared with about 6.5% in both the USA and Canada, and 2% in the UK.[21]

The rise in property investment appears to have been driven by a number of factors, including:

- Perceptions that this is a profitable activity, anticipating capital appreciation;
- Taxation considerations (eg: negative gearing, favourable capital gains tax treatment);
- The availability of a range of diversified banking products particularly suited to investors (eg home equity loans); and
- Money more freely accessible as a result of financial sector deregulation.

The Productivity Commission identified a 'supportive' tax environment and aggressive marketing of property investment 'opportunities' among the factors that further stimulated the investor-driven component of the demand for housing.[22]

The RBA has expressed particular concern about the rise of investor activity in the housing market, warning that many people were more exposed to risk than they perhaps realised.

Income and employment growth

A number of commentators, including the ANZ and the Productivity Commission, have identified rising household incomes and employment rates as contributing to rises in demand for housing and price rises.[23]

In its report *First Home Ownership*, the Productivity Commission pointed out that aggregate household income had increased in real terms by 2.8 per cent a year since 1992-93, while real disposable income increased by an average rate of 1.2 per cent per year.

In the same period, the number of people in full time jobs increased by approximately one million, an average increase of 1.5 per cent per year.[24]

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21 Productivity Commission Inquiry Report, *First Home Ownership*, pp. 22 & 33. According to the Australian Taxation Office's *Taxation Statistics* in 2001-02 there were 10 280 299 taxpayers of whom 1 337 520 (13 per cent) received rental income. The RBA reports that borrowing for property investment grew at an average of 21.6 per cent in the period 1993-2003, compared to 13.4 per cent for owner occupied housing; RBA, *Do Australian households borrow too much?*, p. 4

22 Productivity Commission Inquiry Report, *First Home Ownership*, pp. XVIII.

23 ANZ, *Submission 17*, p. 1.

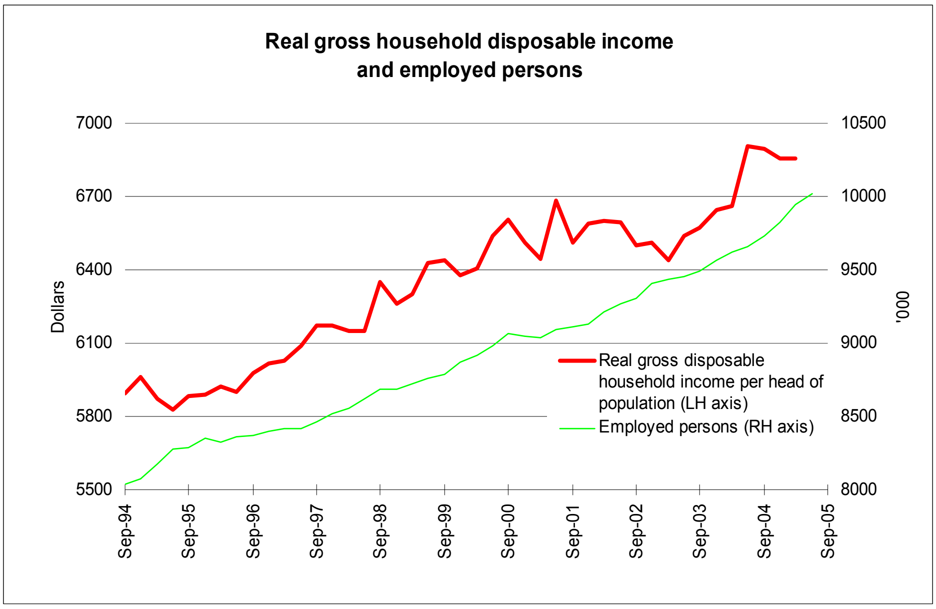
The Commission argued that as income and employment rise, more people have the capacity to purchase housing, and existing owners have increased capacity to trade up to higher quality housing if that is their preference.

The Commission's research indicated that the link between rising incomes and employment and rising house prices was significant, although difficult to disentangle from other demand side factors. However, it concluded that:

> Nevertheless, it seems incontrovertible that income and employment growth have underpinned growth in housing demand in Australia since the 1990s, which has in turn placed upward pressure on prices.[25]

Figure 5 shows the growth in incomes and employment over the last decade. While rising incomes may have added to the demand for housing, they have not kept pace with the rise in debt, which increased substantially relative to income.

Figure 5: Growth in real income and employment 1994 – 2005



Source: ABS

Lending policies and practices of finance providers

There seems little doubt that the lending policies and practices of banks and other financial institutions contributed to increased demand for housing finance and thereby household debt. However, the extent of the impact which this had is debated. Chapter 5 of the report explores this area in more depth.

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24 Productivity Commission Inquiry Report, *First Home Ownership*, p. 60.

25 Productivity Commission Inquiry Report, *First Home Ownership*, p. 61.

Wealth effects

The housing boom of the past few years resulted in substantial wealth gains in many Australian households as existing houses were revalued upwards. The ANZ estimates that net household wealth has increased by 45 per cent over the last three years.[26] This increase in valuations has given rise to what commentators describe as a 'wealth effect', which is considered to have been a factor in increasing household debt.

The Governor of the RBA, Mr Macfarlane, described the wealth effect in the following terms:

> Recent evidence from several countries including Australia shows that during periods when house prices are rising rapidly households tend to react to this by increasing their consumption faster than their income—that is, they reduce their savings. They can do this either by reducing discretionary saving or by borrowing against the equity in their house to finance non-housing expenditure, a process referred to as housing equity withdrawal. This process occurred in Australia particularly in 2002 and 2003. [27]

The ANZ maintains that the wealth effect has both monetary and psychological dimensions. In a monetary sense, households whose property values have increased substantially are able to tap into that wealth through a range of new loan products such as home equity loans. From a psychological perspective, increases in property prices make households feel wealthier and more comfortable about dipping into savings or borrowing more.

The ANZ estimates that the wealth effect increased household consumption growth from 4.2 per cent to 6.2 per cent for the March quarter 2004, and observed that the impact of this effect takes up to 18 months to become fully reflected in household consumption.[28] The ANZ's observations are consistent with research by the RBA.

A research study conducted by the Economic Research Department of the RBA in 2003 confirmed that the wealth effect is significant in driving household expenditure, although the study did not extend to whether overall debt levels increased as a result. That study drew comparisons between stock market wealth and housing wealth:

> For our preferred model, a one dollar permanent increase in stock market wealth is estimated to increase annual consumption by 6 to 9 cents in the long run and a similar increase in housing wealth is estimated to increase consumption by around 3 cents. Since households' housing assets are more

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26 ANZ Economic Research, *Household consumption and the wealth effect*, June 2004. This section draws heavily on the ANZ's paper and also on RBA studies and statements on this effect.

27 Governor of the Reserve Bank, Mr I Macfarlane, House of Representatives Standing Committee on Economics, Finance and Public Administration, *Official Committee Hansard,* 12 August 2005, p. 3-4.

28 ANZ, *Household consumption and the wealth effect,* p. 2.

> than three times as large as stock market assets, our estimates imply that a one per cent increase n housing wealth has an effect on aggregate consumption that is at least as large as that of a one per cent increase in stock market wealth.[29]

A manifestation of wealth effects, the use of home equity loans, has been identified by the RBA as adding to the risks faced by those households who use them. Households are generally acknowledged as being most at risk early in the period of a loan, this risk being diminished as the principle is repaid and incomes rise. The RBA has pointed out that in a low inflation environment, households stay in this risk zone for longer because incomes rise more slowly. The use of equity loans can further prolong the risk period as the principle may be topped up from time to time instead of being paid out.[30]

The RBA considers that the wealth effect may have dissipated somewhat as a result of recent developments in the housing market:

> In a world where dwelling prices have stopped rising and even declined somewhat, perceptions of ongoing rapid increases in wealth are presumably now in the process of dissipating. This will weaken positive wealth effects, and could possibly lead to a partial reversal in time. On the other hand, the earlier increases in dwelling prices were very large, and even with the latest data showing declines, a big cumulative rise in wealth has occurred over the past decade, most of which has not been tapped. So there may yet be some expansionary impetus in the pipeline from those earlier gains.[31]

29 RBA discussion paper, *Housing Wealth, Stock Market Wealth and Consumption: A panel analysis for Australia*, Nikola Dvornak and Marion Kohler, July 2003.

30 See RBA, *Do Australian households borrow too much?*, p. 4.

31 RBA, *Economic Conditions and Prospects*, Speech by Mr Glen Stevens, Deputy Governor, 2 June 2004.