

BRIEFING ON MACROPRUDENTIAL OPTIONS FOR HOUSING LENDING

RBA's view on key policy risks

1. Growth in new lending to investors

- Investor housing loan approvals currently account for 38% of the value of total housing loan approvals; the previous peak was 38% in December 2003.
 - Growth in housing loan approvals has been strongest in Sydney (up 88% over the past two years) and Melbourne (up 49% over the past two years).
- Two concerns on increase in investor lending:

Macroeconomic:

- Extra speculative demand can amplify the property price cycle and increase the potential for prices to fall later. Such a fall would affect household spending and wealth. This effect is likely to be spread across a broader range of households than the investors that contributed to the heightened activity.

Concentration risk:

- Lending has been concentrated in Sydney and Melbourne, creating a concentrated exposure in these cities. The risk could come from a state-based economic shock, or if the speculative upswing in demand brings forth an increase in construction on a scale that leads to a future overhang of supply.
- In Sydney, the risk of oversupply appears limited because of the pick-up in construction follows a period of limited new supply and it has been spread geographically and by dwelling type. While the unemployment rate has picked up a little over the past 18 months, the overall economic environment in NSW is in a fairly good state.
- In Melbourne, there has been a greater geographic concentration of higher-density construction in inner-city areas. Some developments have a concentration of smaller-sized apartments that may only appeal to some renters, or purchasers in the secondary market. Economic conditions are not as favourable in Victoria and the unemployment rate is 6.8%.

2. Low interest rate environment

- While a pick-up in risk appetite of households is to some extent an expected outcome given the low interest rate environment, their revealed preference is to direct investment into the housing market.
- Historically low interest rates (combined with rising housing prices and strong price competition in the mortgage market) means that some households may attempt to take out loans that they would not be able to comfortably service in a higher interest rate environment.
- APRA's draft Prudential Practice Guide (PPG) emphasises that ADIs should apply an interest rate add-on to the mortgage rate, in conjunction with an interest rate floor in assessing a borrower's capacity to service the loan. In order to maintain the risk profile of borrowers when interest rates are declining, the size of the add-on needs to increase (or the floor needs to be sufficiently high).

3. Lending standards

- In aggregate, banks' lending standards have been holding fairly steady overall; lending in some loan segments has eased a little, while lending in some other segments has tightened up a bit.
- The main lending standard of concern is the share of **interest-only lending**, both to owner-occupiers and investors. For investors, 64% of banks' new lending is interest-only loans and for owner-occupiers the share is 31%.

- The typical interest-only period is 5 years, but some banks allow the interest-only period to extend to 15 years. During this period, the loan is **amortising** more slowly than a loan that requires principal and interest (P&I) payments. If housing prices should fall, this increases the risk that the loan balance may exceed the property value (negative equity). There is some risk that the borrower could face difficulty servicing the higher P&I payments when the interest-only period ends, although this is typically mitigated by banks assessing interest-only borrowers on their ability to make P&I payments.

Policy Options

From: [CAPUTO, Mark](#)
To: [HUTCHINSON, Paul](#)
Subject: FW: Housing loan approvals and credit growth [SEC=UNCLASSIFIED]
Date: Tuesday, 14 October 2014 5:59:15 PM
Attachments: [image003.png](#)
[image006.png](#)

Hi Malcolm,

It is difficult to estimate the impact on loan approvals from a target on housing and investor credit growth, because there is uncertainty about net repayments, including the extent of prepayments and the age distribution of housing loans, and by how much loan approvals and credit might evolve over the months of September to December of this calendar year. Nonetheless, we can make some back-of-the-envelope estimates (see Table 1).

In doing so, we assume that the target growth rate is binding. We assume that in the second half of 2014 net repayments as a share of credit outstanding remains constant, as does loan approvals as a share of credit outstanding. Over the first half of 2015 net repayments as a share of credit outstanding continues to remain constant. Owner-occupier loan approvals exclude refinancing. Investor loan approvals include refinancing.

Table1. Estimated impact on loan approvals in the first six months of 2015 compared with approvals in the second half of 2014*

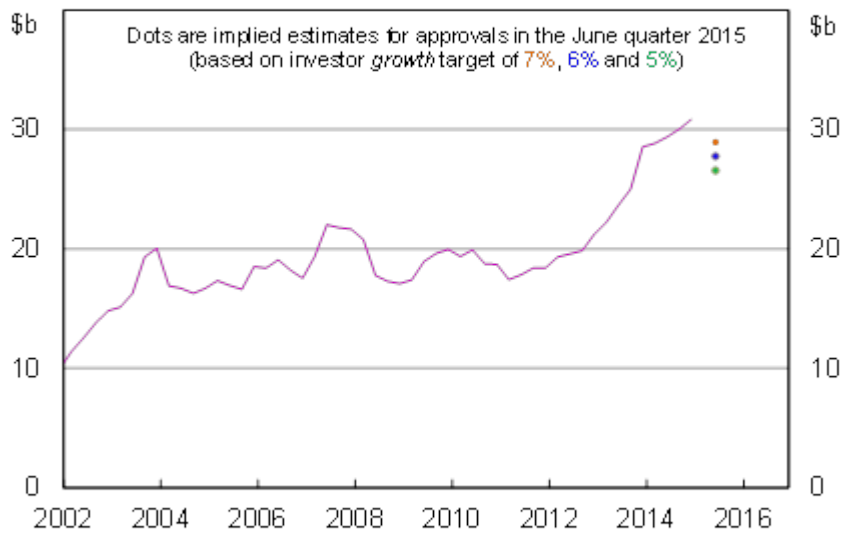
Credit Growth Target** Six-month ended, annualised	Investors		Owner-occupiers		Total Housing	
	Per cent change	Change (\$b)	Per cent change	Change (\$b)	Per cent change	Change (\$b)
5	-12.7	-7.8	-0.2	0.2	-5.8	-7.9
6	-8.8	-5.4	5.9	4.4	-0.7	-1.0
7	-4.9	-3.0	11.9	9.0	4.4	5.9

*Totals may not sum due to rounding; investor refinancing is included; owner-occupier refinancing is not included

**Target refers to both total housing and investor

National Investor Housing Loan Approvals*

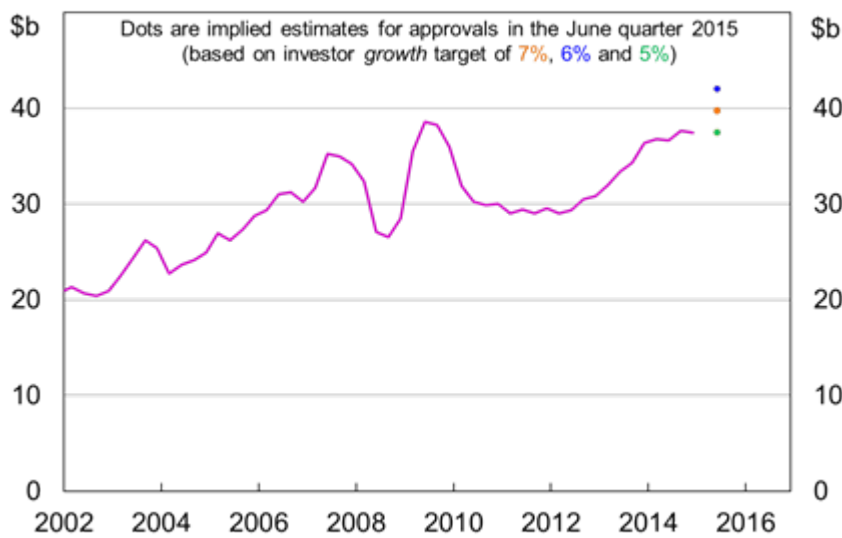
Quarterly



*Includes refinancing and construction
Sources: ABS, RBA

National Owner-occupier Loan Approvals*

Quarterly



*Includes refinancing and construction
Sources: ABS, RBA

ESTABLISHING A BENCHMARK RATE FOR INVESTOR PROPERTY LENDING**Background****How to calibrate the benchmark growth rate?**

Household debt has been broadly stable as a share of income for about a decade. National aggregate ratios are not robust indicators of a sector's resilience because the distribution of debt and income can change over time. But as a first pass, it is reasonable to expect that the current level of the indebtedness ratio is sustainable in a range of macroeconomic circumstances. Therefore there does not seem to be a case to set the benchmark growth rate significantly below the rate of growth of household income, in order to achieve a material decline in the indebtedness ratio. With growth in nominal household disposable income running at a little above 3 per cent, this sets a lower bound for possible benchmarks at around 3 per cent. Current

growth in investor credit, at nearly 10 per cent, suggests an upper bound around 8 per cent to achieve some comfort about the leverage in this market.

Within this range, there are several options for the preferred benchmark rate for investor housing credit growth (including securitised credit).

- a) **Around 4½ per cent**, based on projected household disposable income growth over calendar 2015. This could be justified as being consistent with stabilising the indebtedness ratio. However, it would be procyclical, in that it would be responding to a period of slow income growth by insisting that credit growth also slow. It would also be materially slower than the current rate of owner-occupier credit growth, which so far has not raised systemic concerns.
- b) **Around 6 per cent**, based on a reasonable expectation of trend growth in disposable income, once the effects of the decline in the terms of trade have washed through. It is also broadly consistent with current growth in owner-occupier housing credit, which as noted above has not been seen as adding materially to systemic risk.
- c) **7 per cent**, consistent with the system profile for residential mortgage lending already agreed as part of the LCR/CLF process. Unless owner-occupier lending actually picks up from its current rate, however, the growth in investor housing credit implied by the CLF projections would be stronger than this. It is therefore not clear that these projections should be the basis for the preferred benchmark.

Staff projections suggest that only a moderate decline in system investor loan approvals would be required to meet a benchmark growth rate for investor housing credit in the 5–7 per cent range for calendar 2015. The exact size of the decline depends partly on assumptions about repayments through churn, refinancing and amortisation in the investor housing book. For a reasonable range of values for this implied repayment rate, and assuming that investor housing credit growth remains at its current rate for the remainder of 2014, the required decline in investor approvals is of the order of 10–20 per cent. This would take the level of investor housing loan approvals back to that seen a year ago. It is worth noting that investor loan approvals would have to increase noticeably from here to sustain the current growth rate of investor housing credit, even though the implied repayment rate is a little below its historical average.

Since credit is not available at a state level, the benchmark can only be expressed as a national growth rate. The flow of loan approvals at a state level can be used as a cross-check to ensure that the benchmark incentive has had its greatest effects in the markets that have been strongest recently.

Financial Stability Department
15 October 2014



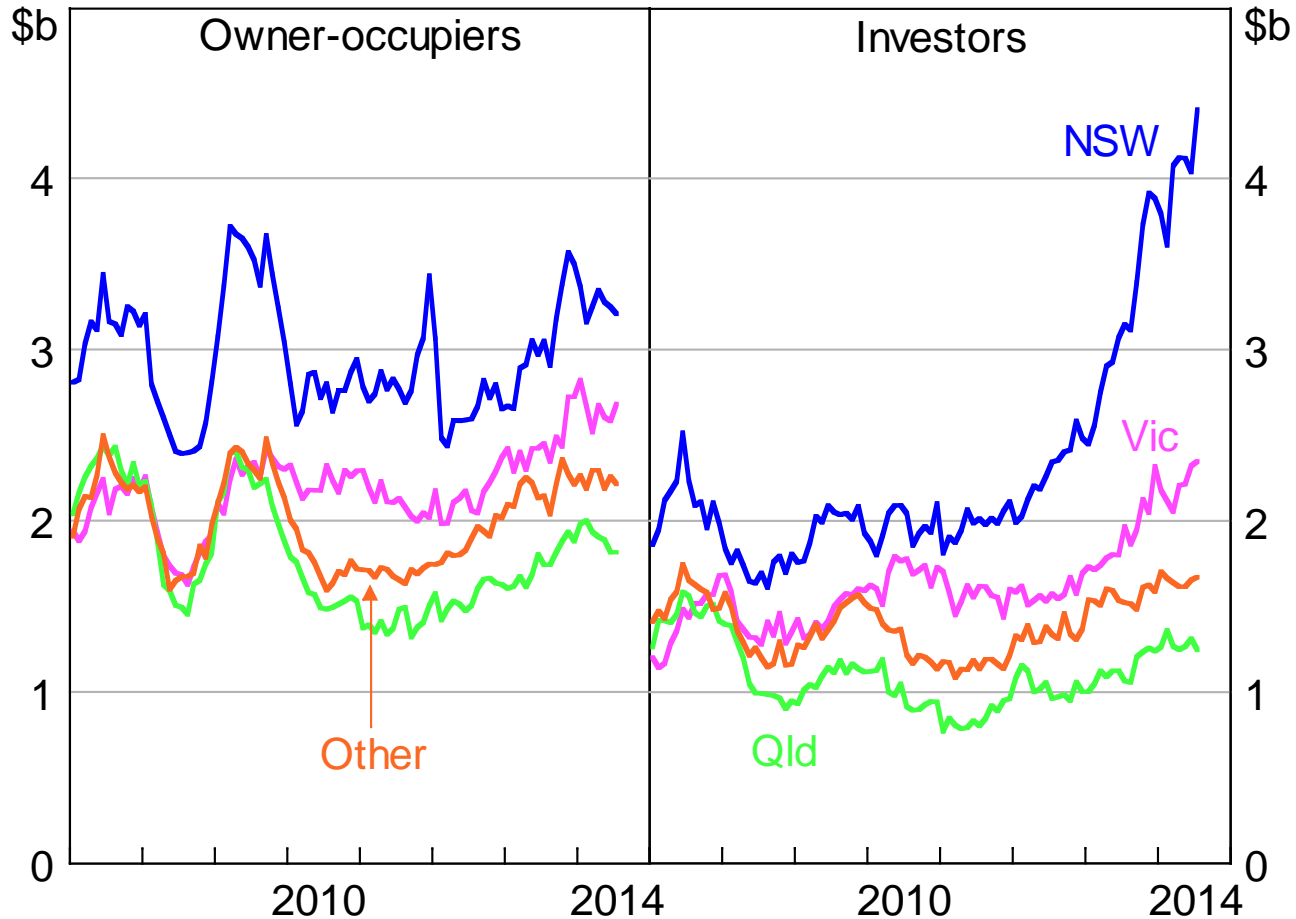
15 October 2014
FS Weekly Meeting

Combating Housing Market Risk

Michael Robson

Motivation

Housing Loan Approvals by State*



* Excludes construction; investor approvals include refinancing

Sources: ABS; RBA

Outline

1. Policy options and target variables
2. Defining success
3. Implementation and other issues

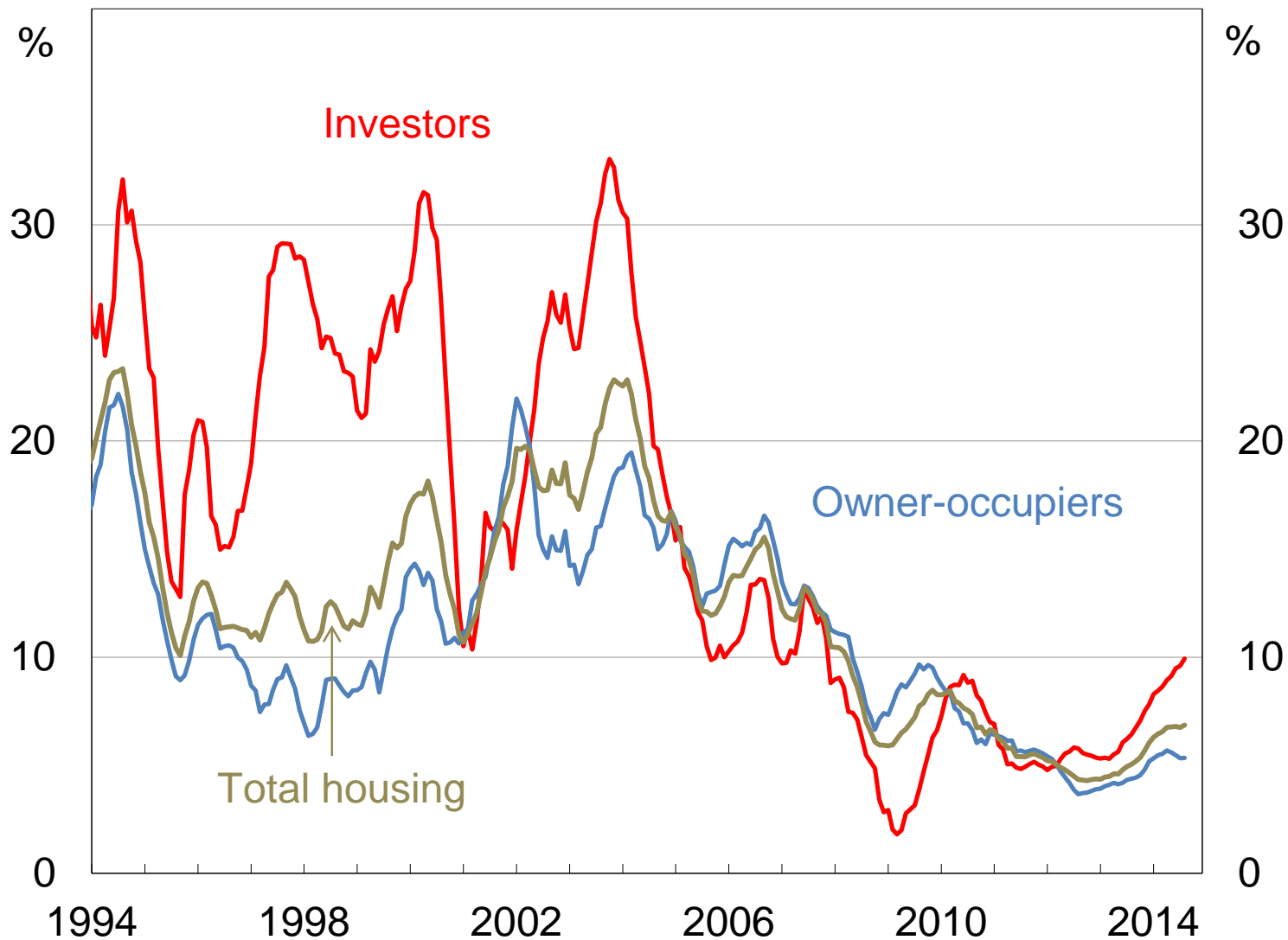
What Constitutes a Good Policy?

The ideal policy would be:

- Effective
- Targeted
- Easy to communicate
- Easy to implement
- Easy to monitor
- Hard to manipulate

Housing Credit Growth

Six-month-ended, annualised



Sources: APRA; RBA

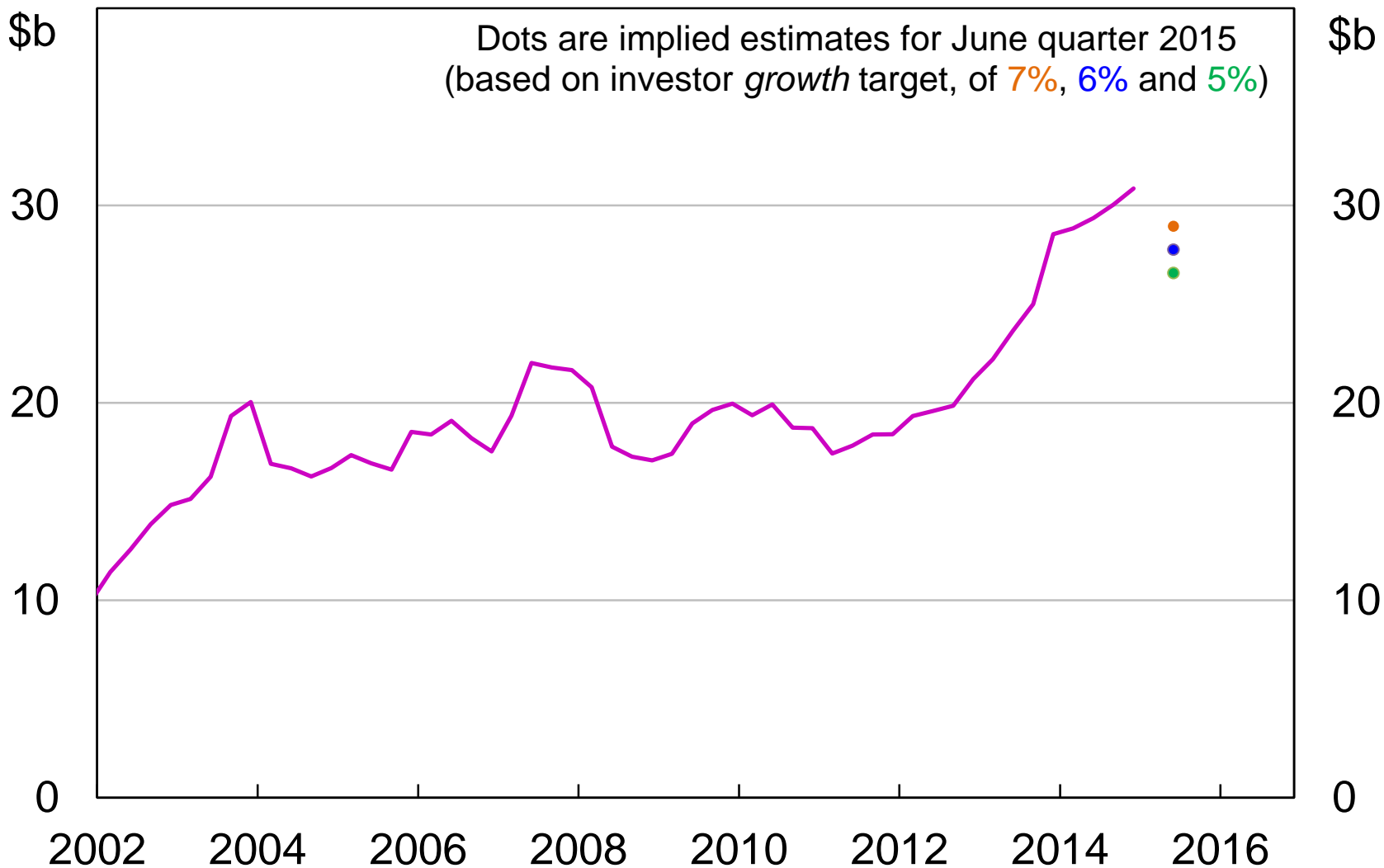
Policy implementation

Specific considerations:

- Range or hard target?
- Limits or incentives?
- Institutions need time to adjust
- Trade-off between industry consultation and timely policy implementation
- Consultation period can be used to increase public awareness – maximise the indirect effect of the policy
- How are institutions currently placed?

National Investor Housing Loan Approvals*

Quarterly



*Includes refinancing and construction
Sources: ABS; RBA

Policy implementation

Other considerations:

- Targeting and the potential to work around the regulations by shifting loans between:
 - » Sectors
 - » Products
 - » Regions
- Trade-off between policy complexity and effective implementation/communication
 - » Capital surcharges allow flexible implementation for institutions but how would they be applied?
 - » Hard limits on lending are simple and likely to be effective but may trigger the damaging sudden correction we're seeking to avoid

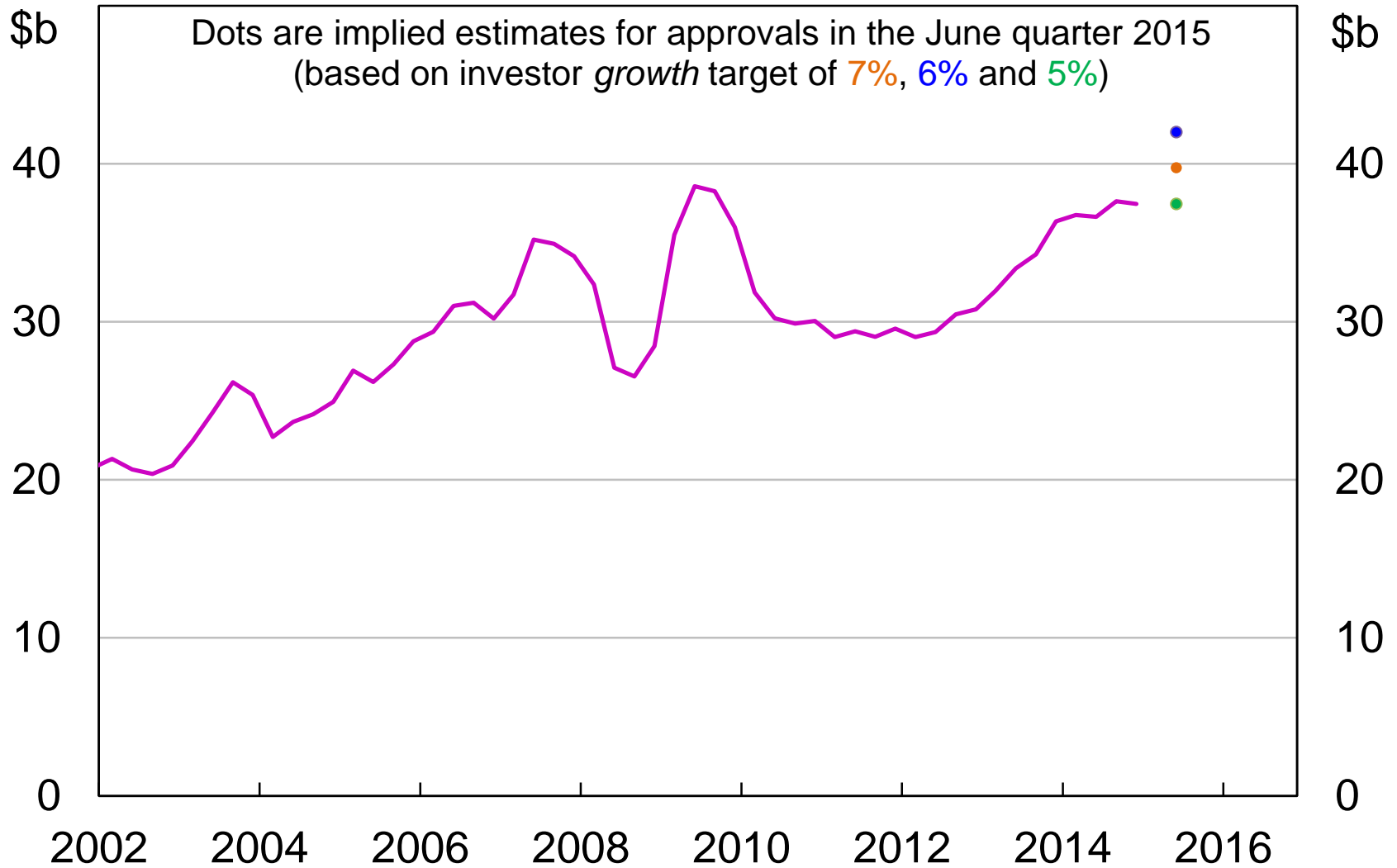
Conclusions

- More work and discussion is needed in this space
- The lack of precedent for implementing this type of prudential policy increases uncertainty but the costs of inaction may be very high
- Communicating the policy will be key to maximising efficacy – argues for simplicity

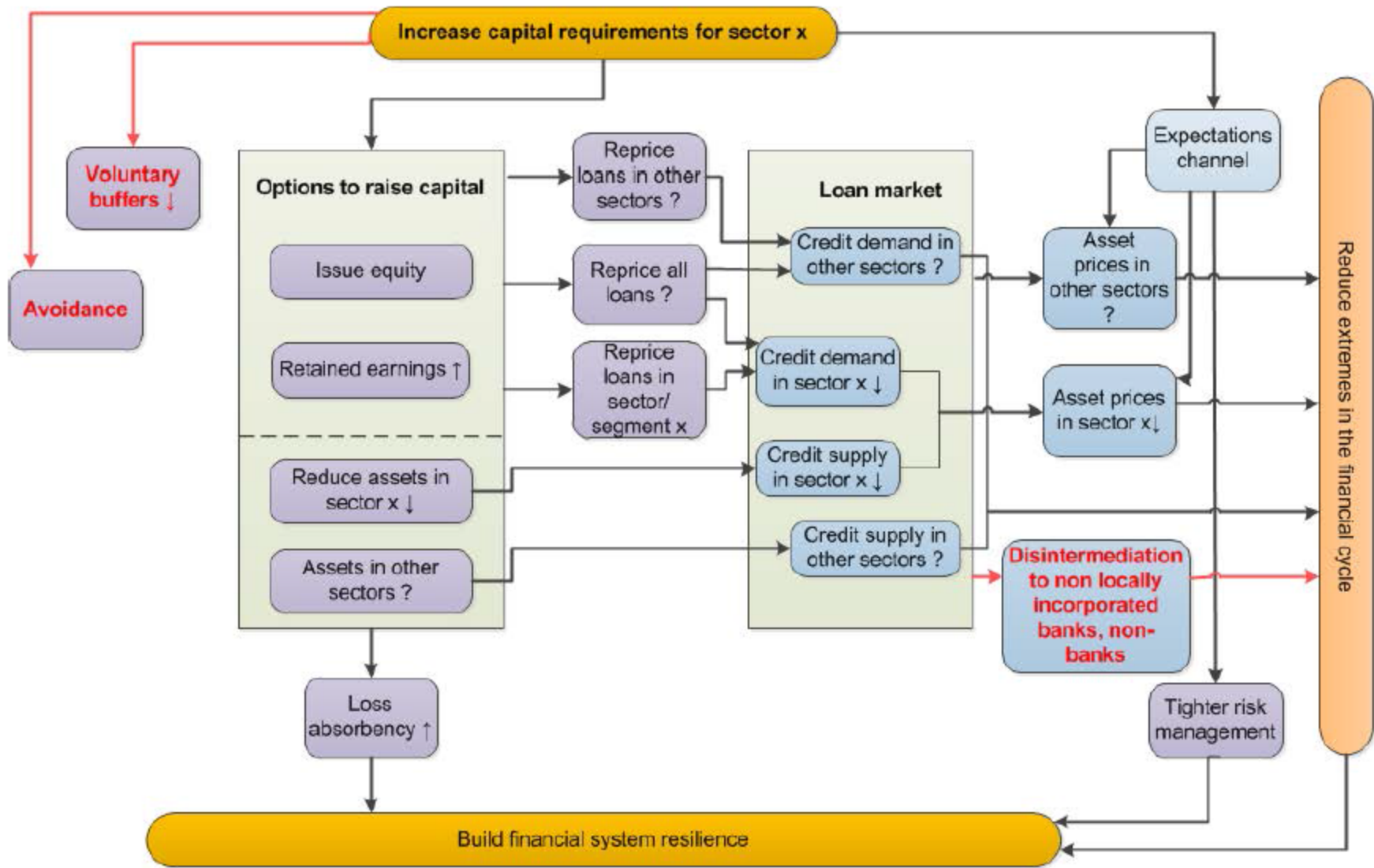
Spares

National Owner-occupier Loan Approvals*

Quarterly



*Includes refinancing and construction
Sources: ABS; RBA



Key: purple background – bank reactions; blue background – market reactions; red text – policy leakages.

Motivation

	Year-ended					
	June 2014	Dec 2014	June 2015	Dec 2015	June 2016	Dec 2016
GDP growth	3	2½	2–3	2½–3½	2¾–3¾	2¾–4¼
Non-farm GDP growth	3¼	2¾	2–3	2½–3½	2¾–3¾	2¾–4¼
CPI inflation ^(b)	3	2	1¾–2¾	2½–3½	2½–3½	2¼–3¼
Underlying inflation ^(b)	2¾	2¼	1¾–2¾	2¼–3¼	2–3	2–3
	Year-average					
	2013/14	2014	2014/15	2015	2015/16	2016
GDP growth	3	3	2–3	2–3	2½–3½	2¾–3¾

(a) Technical assumptions include A\$ at US\$0.93, TWI at 72 and Brent crude oil price at US\$106 per barrel

(b) Based on current legislation for the price of carbon

Sources: ABS; RBA

From: [ROBSON, Michael](#)
To: [HUTCHINSON, Paul](#); [CAPUTO, Mark](#)
Subject: FW: Implied reduction in loan approvals [SEC=UNCLASSIFIED]
Date: Monday, 20 October 2014 3:29:46 PM
Attachments: [image001.png](#)
[image002.png](#)

From: ROBSON, Michael
Sent: Monday, 20 October 2014 2:39 PM
To: ELLIS, Luci
Subject: RE: Implied reduction in loan approvals [SEC=UNCLASSIFIED]

The fall in investor approvals from the September quarter this year to the end of 2015 is 4.9% in the constant repayment ratio scenario and 15.6% in the 7% repayment share scenario. That includes a projection for the month of September. If you'd like an estimate totally free from projections the falls are 5.7% and 16.4% for the 8.4% and 7% repayment scenarios respectively.

From: ELLIS, Luci
Sent: Monday, 20 October 2014 2:10 PM
To: ROBSON, Michael
Subject: RE: Implied reduction in loan approvals [SEC=UNCLASSIFIED]

Thanks Michael – for the purposes of the note, could I please also have the percentage declines between now and end-2015 implied by the two scenarios in the second graph.

Best regards
Luci

From: ROBSON, Michael
Sent: Monday, 20 October 2014 12:53 PM
To: ELLIS, Luci
Subject: RE: Implied reduction in loan approvals [SEC=UNCLASSIFIED]

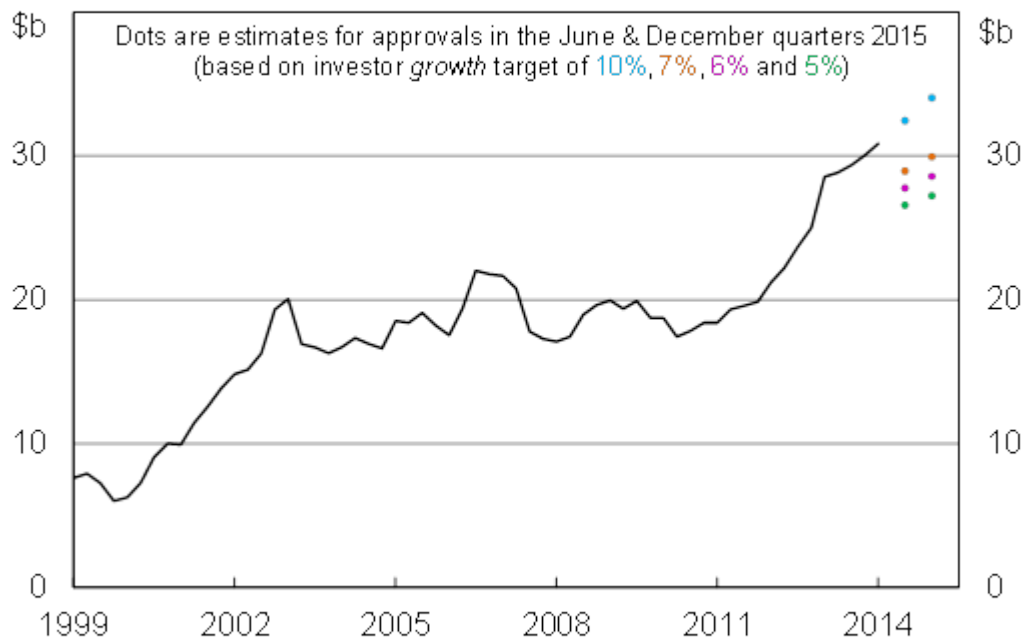
Hi Luci,

The charts we talked about are below (I'm getting the graphit versions done up now). As you can see the approvals profile is relatively sensitive to the repayment share assumption.

For info, the repayment share for investors averaged 7.6per cent over the past five years but hovers around 8.2 if you take it back ten or fifteen years.

National Investor Loan Approvals

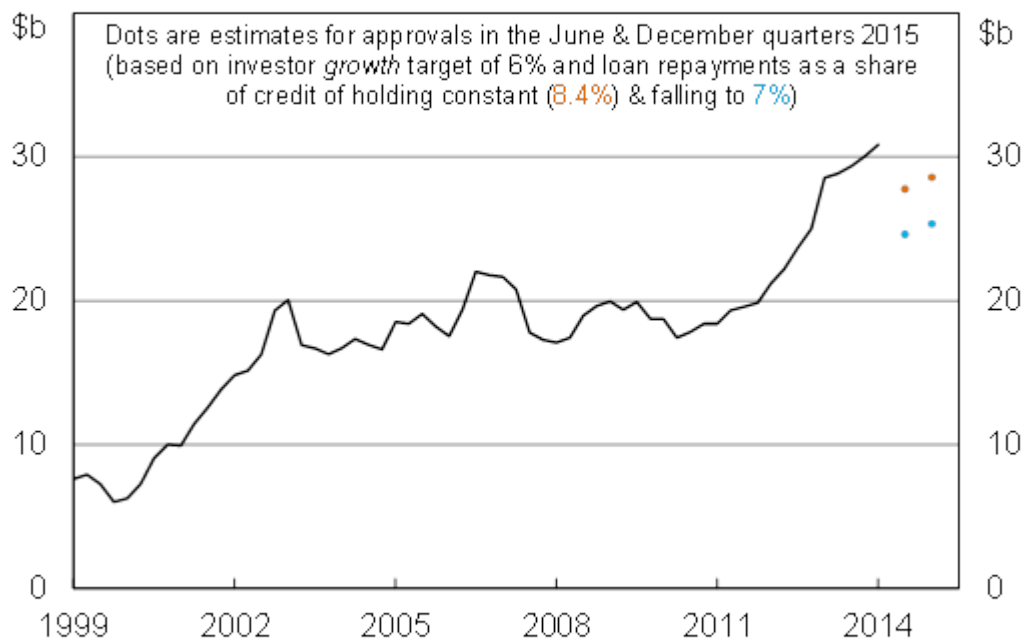
Quarterly



*Including refinancing and construction
Sources: ABS; RBA

National Investor Loan Approvals

Quarterly



*Including refinancing and construction
Sources: ABS; RBA

I'll send through the tidy versions when they're done.

Michael.



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6 - 14-11-06 0000

Panel Discussion: Managing Risks in Residential Mortgage Portfolios

APRA ADI Supervisors Conference 2014

Grant Turner

Senior Manager, Financial Stability Department

Reserve Bank of Australia

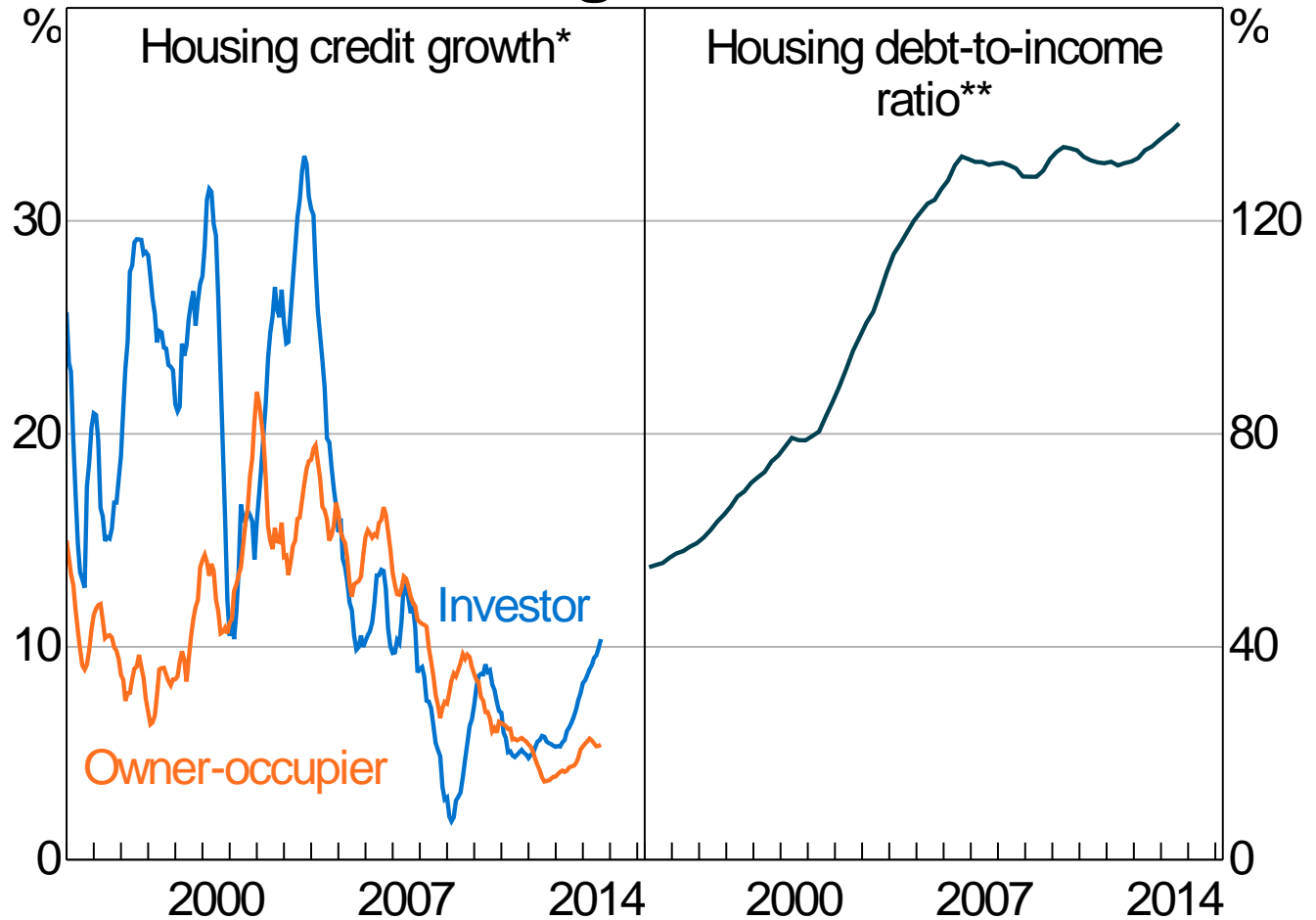


Residential mortgage market – current conditions

- Loan portfolios are performing well (and historically have)
- Many borrowers are well ahead of their scheduled repayments
- Aggregate household indebtedness high
- Interest rates historically low
- Price competition has intensified recently, aided by lower funding costs



Housing Indicators



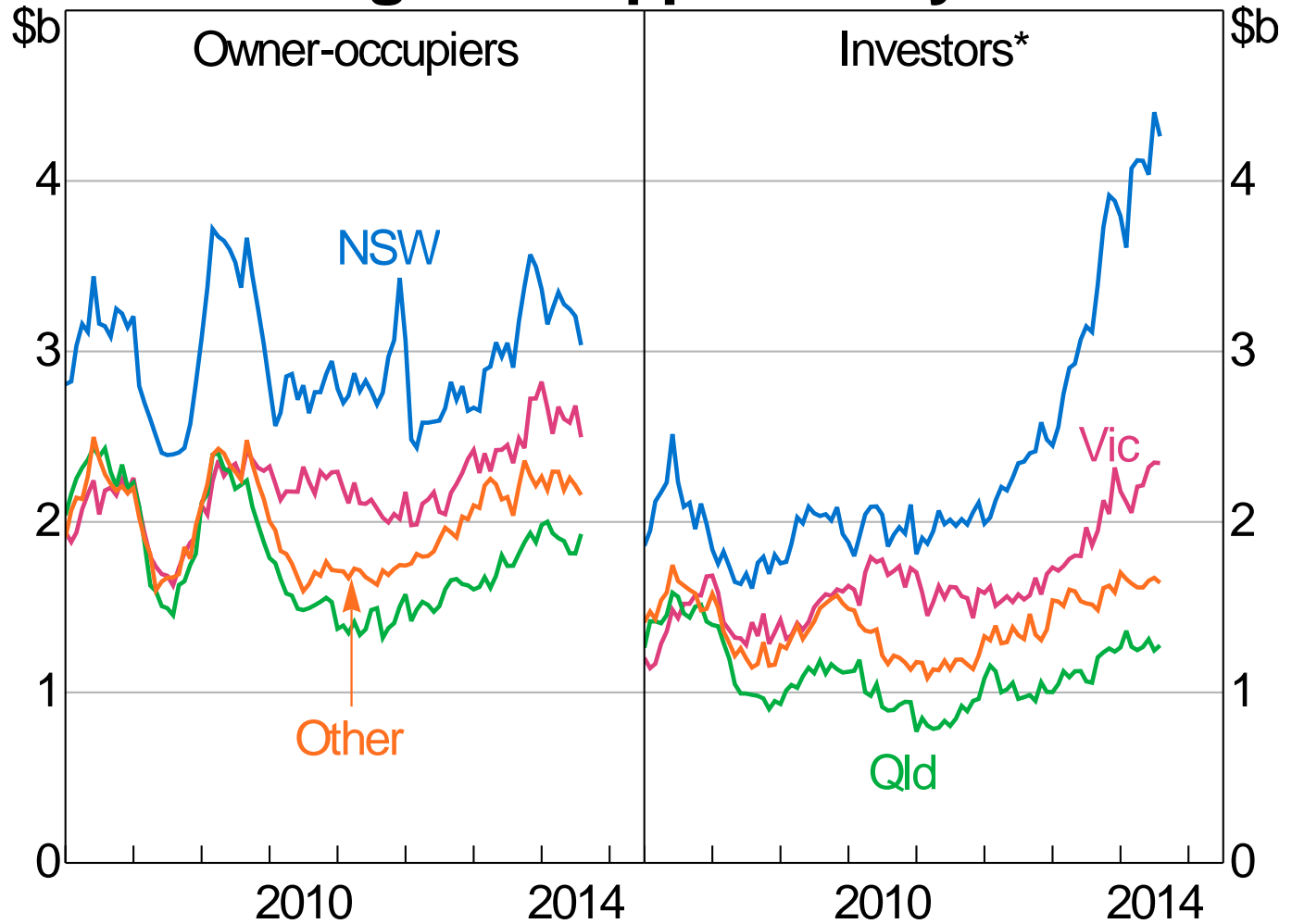
* Six-month-ended, annualised

** RBA estimate for September quarter 2014

Sources: ABS; APRA; RBA



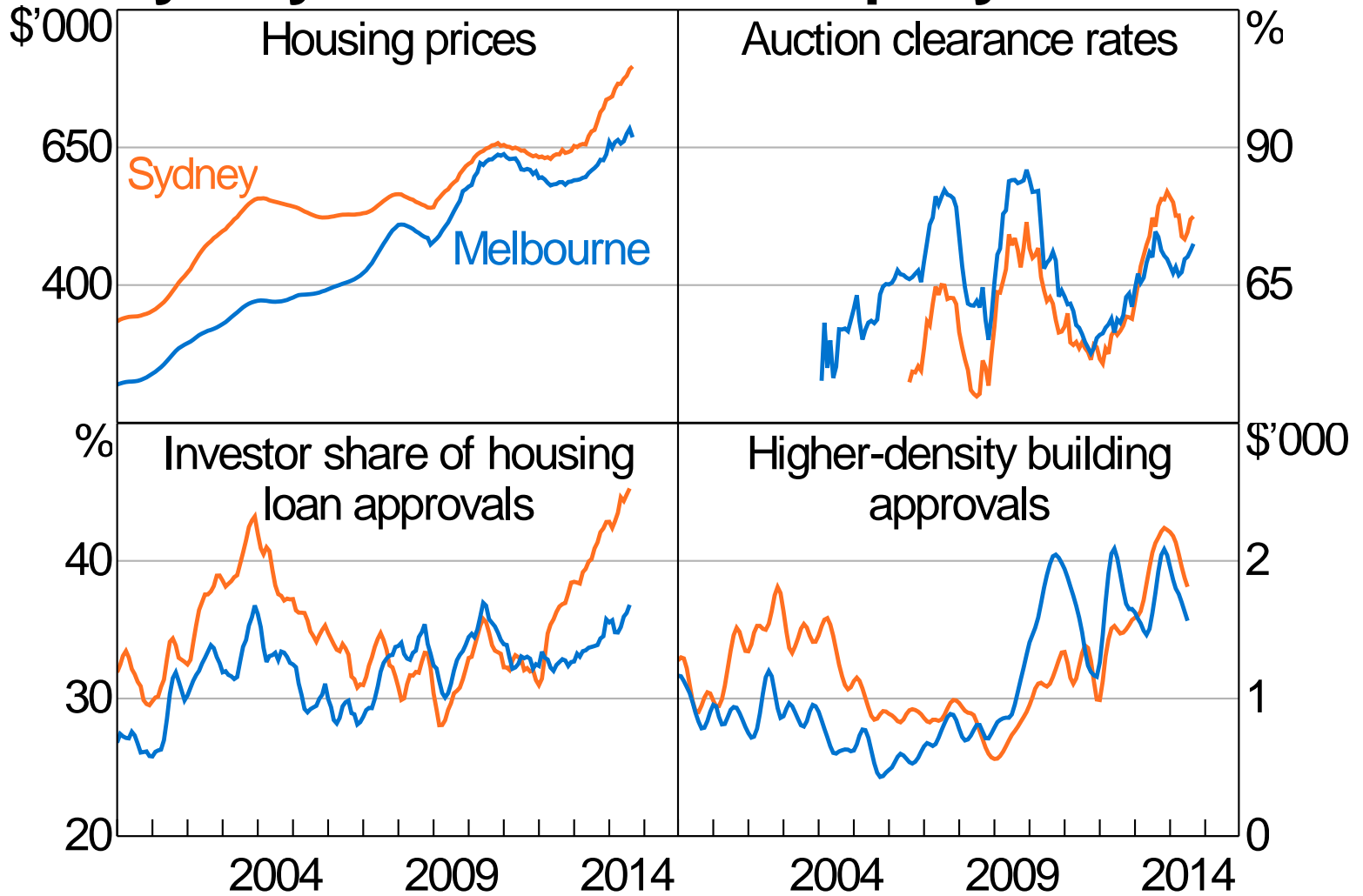
Housing Loan Approvals by State



* Includes refinancing



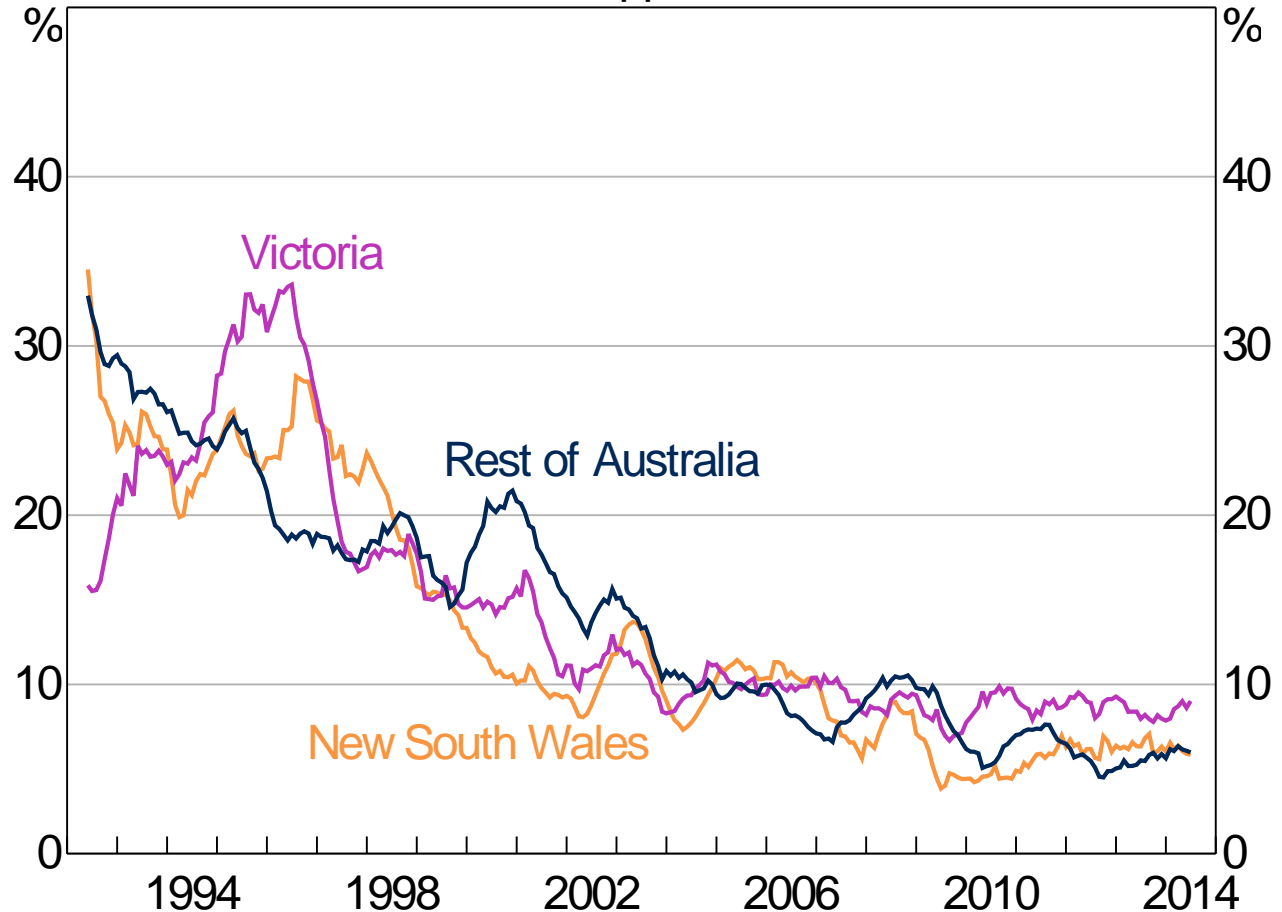
Sydney and Melbourne Property Markets





Lending to Investors for New Construction*

Share of all loan approvals to investors



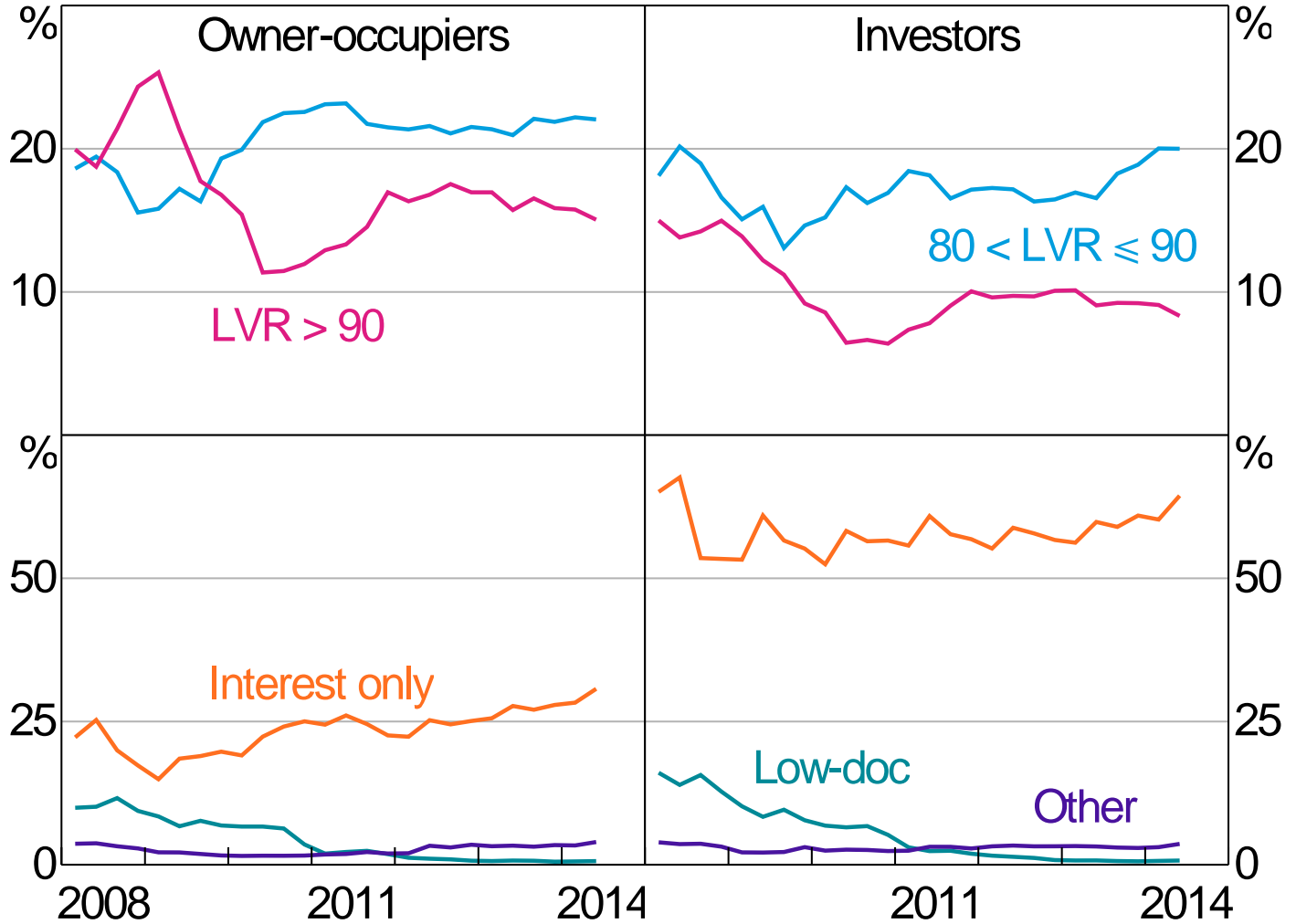
* Twelve-month moving average

Sources: ABS; RBA



Banks' Housing Loan Characteristics

Share of new loan approvals





Potential risks in residential mortgage portfolios

- Households exposed to higher interest rates
- Procyclicality in housing prices increased due to speculative demand
 - Disproportionately strong investor activity
 - Entrenched expectations of further price gains
 - Possibly also evident in some interest-only borrowing
- Overbuilding risks seem localised
- Risks to household balance sheets at this point more of a concern than risk of losses for lenders



Regulatory response

- APRA has already stepped up its supervisory efforts in relation to housing lending
 - New supervisory survey of risk indicators; PPG; letters to bank boards; stress tests.
- Highlighting of housing risks to lenders and borrowers in RBA FSR and speeches
- CFR agencies discussing further steps to lean against the current housing cycle somewhat, particularly with relation to investor activity



General thoughts on systemic risk and prudential intervention

- Prudential intervention can be justified when the financial system is causing, or likely to cause, material damage to the economy
- Several aspects can be identified that might contribute to a market or entity posing systemic risk:
 - Sizeable
 - Interconnected
 - Correlated
 - Procyclical

Source: RBA Submission to FSI, Chapter 4



Principles for good (macro)prudential policy

- Targeted at specific system-wide risk
- Effective at reducing that risk
- Incentive-based?
- Easy to communicate
- Consistent with regulator mandates/powers
- Easy to implement
- Easy to monitor and hard to manipulate
- Minimise unintended consequences
- If risk is cyclical, exit strategy needed



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Thank you

Q&A FOR INTERVIEW, 10 DECEMBER 2014

Main messages on housing announcements

- ❖ We are not particularly concerned about risks to domestic banks. They have become more resilient over time. (However, the longer the current period of strong investor lending goes on, the more the risks to lenders will increase.)
- ❖ We are concerned that the housing and mortgage markets have become unbalanced. We are particularly concerned about lending to property investors and interest-only lending, especially in the Sydney and Melbourne markets.
- ❖ In the first instance, the risks are macroeconomic. Extra speculative demand can amplify the property price cycle and increase the potential for prices to fall later. Such a fall would affect household spending and wealth. And the households that are most affected might not be the ones borrowing now.
- ❖ The Bank has been publicly commenting on housing market activity – particularly NSW investors –and associated risks for more than a year. APRA has already been progressively increasing the response to these risks. The recent announcements should be seen as another the dial being turned up another notch. There is room to do more if needed, but we are not trying to stop the market dead. It is an incremental response to an incremental increase in risk.
- ❖ We are not signalling a change in our philosophy. The Australian authorities remain sceptical about quantitative limits on lending (which is what people usually mean by macroprudential tools), so they have not been the first thing APRA has reached for in developing its response. The policy responses are taking shape within our existing framework for financial stability policy. This is the Council's cooperative processes at work.
- ❖ We also welcome ASIC's announcement on Tuesday that they will be investigating interest-only mortgage lending. Interest-only borrowing – not paying your loan down – means that households aren't building up equity in their property and so they are more vulnerable to ending up underwater on the loan, if housing prices fall. It is also a bit of a signal that people are increasingly motivated by speculative expectations.
- ❖ There are similarities between our current responses and APRA's and ASIC's actions in 2003–2005.
- ❖ In the current environment, it is even more important for lenders to maintain prudent lending standards. Where these standards sit now is probably fine overall, but lenders need to be especially careful when interest rates are low and property values are rising.
- ❖ It needs to be remembered that mortgage lending is pretty low risk compared with almost every other part of a bank's business.

Q&A

If much of the demand is from foreigners, will these measures have much effect anyway?

The FIRB data are imperfect but they do suggest that foreigners' purchases are a relatively small part of total housing turnover. Investor loan approvals have almost doubled in NSW in the past two years and in Victoria they are about 50 per cent higher. New lending to owner-occupiers in those states has increased much more moderately in recent times.

Don't these policy measures risk creating a downturn in housing construction, which you have previously said Australia needed?

According to the available data, the vast bulk of new lending to individuals for property investment is for established housing, not new-build or future construction. This has been the case for some years. If a particular lender's investor lending is disproportionately funding new developments, APRA could allow for that in determining the supervisory response. In reality most of the financing of high-density construction shows up as lending to property developers long before the household buying the apartment takes out a loan to fund the purchase.

The policy measures aren't geographically targeted, so how do they reconcile with the Bank's stated concerns being mainly confined to Sydney and Melbourne?

The benchmark on investor lending is specified at the national level partly because the available information on loan exposures is available at the national level. But we would expect that a constraint on growth will have its greatest effect in the parts of the aggregate that are growing fastest, that is, in Sydney and Melbourne.

Isn't this 'benchmark' a bit vague?

It is important to be flexible so that the supervisory response can be targeted to the real sources of systemic risk. For example it would not make sense to hit very small lenders with much higher capital charge because they made an investor loan this month and doubled their one-loan portfolio.

Isn't 10 per cent a bit soft?

We are not trying to kill the market stone dead. Investor housing credit is currently running at a bit under 10 per cent. Some lenders will have investor credit growth well below this benchmark anyway, so if all lenders do end up at least a little under this benchmark, which we hope they will, then aggregate growth in investor credit will be noticeably below 10 per cent. Setting a benchmark for individual institutions is not the same thing as setting it for an aggregate, and APRA has allowed for that.

Where did the 10 per cent benchmark come from?

This was a collective assessment by the Council agencies. We took the view that we did not want to clamp down on the market excessively. We also took the view that in the long run, household credit can expand sustainably at a rate something like the rate of trend nominal household income growth, maybe a bit more or less in shorter periods. Trend income growth is below 10 per cent, more like 6 per cent or thereabouts. But it was important to make an allowance for the fact that some lenders will undershoot the benchmark, so the aggregate result will likely be slower than that.

But isn't household income growth likely to be below average in the next few years, because of the end of the mining boom?

Maybe, but we don't want to be procyclical and clamp down on credit supply more when the economy is growing below trend.

Why hasn't APRA introduced a NZ-style LVR cap?

The RBNZ has instituted the best policy they felt they had available. A cap on the share of new high-LVR loans does seem better than an outright ban. But excessive high-LVR lending is not the issue that Australia faces right now. Putting on a quantitative limit on high-LVR lending in Australia would be like bandaging your arm when you have a headache [quotable: Q&A from Citibank talk in May]. APRA is watching this and other aspects of lending standards very closely.

What about a countercyclical capital buffer?

This tool is in APRA's armoury; it's part of Basel III. But consider that it will have greatest effects on types of lending that require more capital to be held against them, because they are risky. Housing is not that risky, compared with all the other people banks can lend to. So a countercyclical capital buffer will probably constrain the lending that has the highest risk weights (e.g. SME lending) more than it would constrain mortgage lending.

Resource: Document 5 in the March 2014 FOI document release.

Isn't this a reversal about what you have been saying all along about macroprudential?

On the contrary, there is nothing in what APRA announced on Tuesday that is inconsistent with what we have been saying for the past several years. (Quote from Adelaide speech: "We view macroprudential policy as something to be subsumed into the broader financial stability framework. We recognise that quantitative restrictions were already tried in the 1960s and 1970s – and didn't always work so well. And we think that it is prudential measures, macro or otherwise, ought to be wielded by the prudential supervisor, where they have the appropriately formulated mandate.")

What about monetary policy?

The risks around housing (and financial stability more generally) are a good argument for avoiding an over-easing of monetary policy. Our concerns are quite focused on the investor market in the largest cities. So it would not make sense to attempt to address those concerns by raising interest rates for the whole economy.

Do we have a bubble?

Not really, and it's not a helpful distinction. There will always be some speculative demand in the housing market (or any other asset market). At the moment there is more than normal and more than we are comfortable with. It isn't just on-off, bubble-no bubble. As Luci discussed in her June speech in Adelaide, prices can appear completely in line with fundamentals such as rents, and you can still have a major downturn in prices and financial stability problem. This is essentially what happened in commercial property prices in Australia in the early 1990s. (Anyone who thinks the early 1990s was a 'housing' problem was not paying attention.)

Are you saying the banks are at risk?

No, not especially. We believe the risks are mainly to the macroeconomy. The higher prices rise, the further they might fall later. Because housing is purchased partly with debt, the effects on wealth and payment distress aren't symmetric between price rises and price falls. However, the longer the current period of strong investor lending goes on, the more the risks to lenders will increase.

Doesn't this mean that Australia has a subprime housing problem? Are we going to end up like the US?

No, and no. In the US boom, the upswing in lending was concentrated on borrowers who were likely to have difficulty repaying: their credit histories were 'subprime'. In Australia, subprime ('non-conforming') and low-doc lending are very low shares of housing lending, and they are not growing strongly. The strength here is in investor lending; those borrowers are usually older and wealthier than the average household. There are also a lot of other differences between the US boom and the Australian situation. One important one is that in the United States, there was a building boom. Another is that lending standards in Australia are still pretty sound. In the US boom, they completely broke down.

Resource: Ellis (2008) '[The Housing Meltdown: Why Did It Happen in the United States?](#)', BIS Working Paper 251. See also <http://www.rba.gov.au/speeches/2012/sp-so-110412.html>

What should Australian households do in the face of these risks?

First, don't overextend. Be realistic about what you can afford, and make sure that you can afford your mortgage repayment even if interest rates rise. If you can make extra repayments now, it would be a good idea to do so.

If you are considering buying a property as an investment, consider that you are now in the business of renting housing services to other people. You are a landlord. Consider also that housing prices don't always rise. In fact in Sydney, they have experienced three periods of decline of more than a year, in the past decade. And consider that interest rates can rise from here. Make sure that you can manage that if and when it comes to pass.

If the risk is mainly macroeconomic, why can't the RBA just respond to a downturn with monetary policy?

The problem with just using interest rates to respond is that we expect the bad outcomes will be unevenly distributed. Housing prices won't fall evenly (they never do), and the people who end up owing more than their home is worth (i.e. in negative equity). It is much harder to use monetary policy to respond to a fall in wealth that only affects a small fraction of households, but very severely, than if the fall in wealth is more evenly spread. This is why the effects of sharemarket crashes are not a good guide to the effects of a housing market crash. Because share ownership is usually not that leveraged, the effects of a fall in share prices is more even across owners of shares.

Resource: FS Note: 'Why are we worried about investor housing?' [D14/406193](#)