RESERVE BANK OF AUSTRALIA

Speech

Australian Property – Financial Stability and Foreign Involvement

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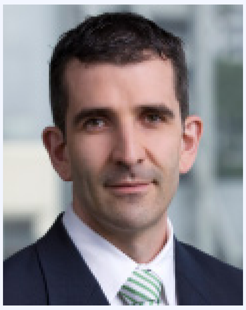


Thank you for the opportunity to speak at this event. The property industry has come to have an international element to it, as witnessed by today's event. Property markets are also something we monitor closely at the Reserve Bank and not only for their important impact on economic activity.

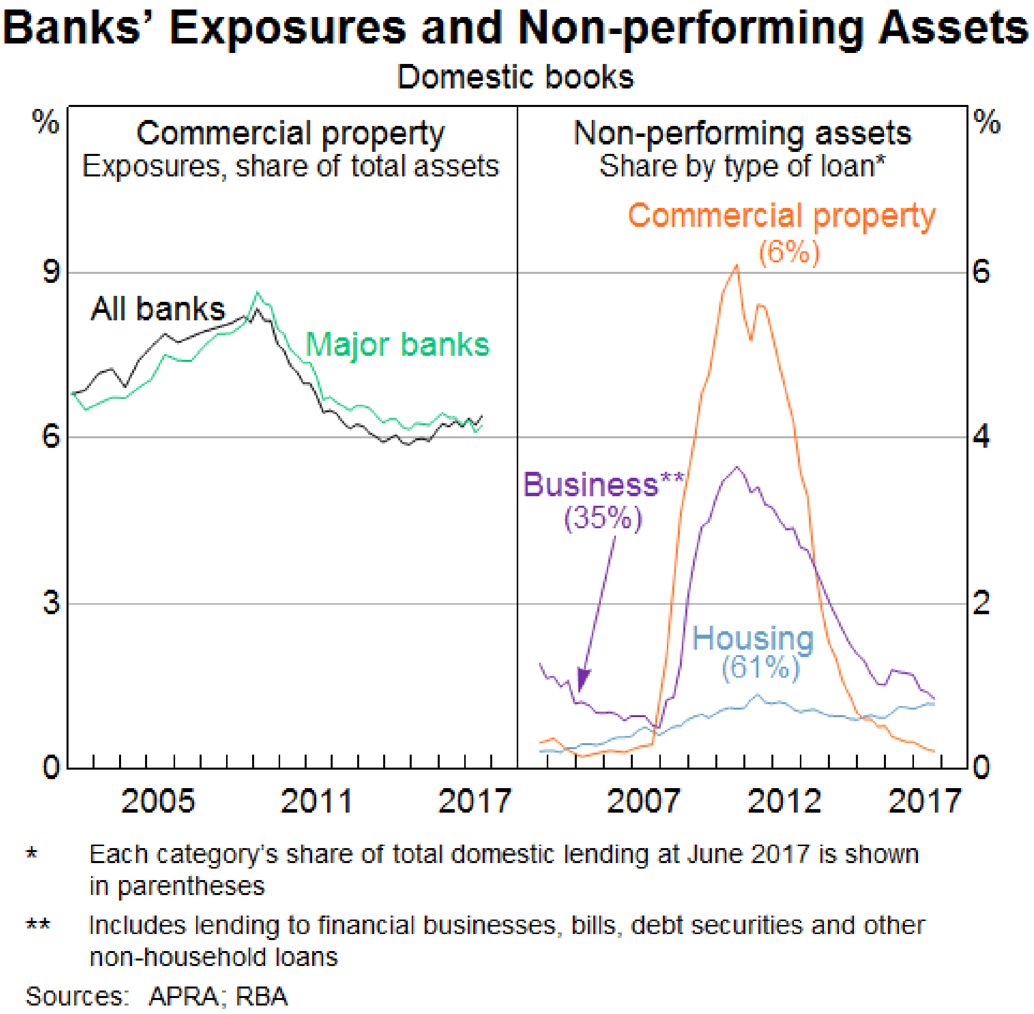
Property can also have a substantial impact on the stability of the financial system. The Reserve Bank does not supervise or regulate lending institutions; in Australia that is the responsibility of the Australian Prudential Regulation Authority (APRA). But the Bank does have responsibility to promote the stability of the financial system as a whole. In a stable financial system all the various parts, including banks, other institutions and financial markets, work together to enable the smooth flow of funds between savers and borrowers, so supporting economic growth.

Property and Financial Stability

The property market is important for financial stability for a number of reasons. In the past, banks have experienced substantial losses on their commercial property lending because of its large cycles. Residential property is also important for financial stability because residential mortgages account for a very large share of banks' lending in Australia. Because of the high value of households' mortgage debt and housing assets, the property market also has implications for the resilience of households' balance sheets. Today, I will outline the connection of financial stability with commercial property, and then with residential property.

Internationally, banks experienced substantial losses on their commercial property lending in the financial crisis. In Australia the performance of commercial property lending also deteriorated, but losses were relatively moderate.

Graph 1



However, Australia does have its own history in the early 1990s of large losses on commercial property lending, resulting in individual lenders needing to be rescued and threatening the stability of the financial system. [1] In five years, Australian banks experienced losses of around 10 per cent of their loans, concentrated in their commercial property lending.

This was a classic boom-bust or 'hog cycle' story. The second half of the 1980s saw buoyant economic conditions, strong growth in commercial property prices and a large increase in commercial property construction.

A ready supply of credit fuelled the boom. Following bank deregulation and the entry of foreign banks into the domestic market in the mid 1980s, the domestic banks competed to hold on to their market share. Lending standards were lowered and business credit grew by around 25 per cent each year in the second half of the 1980s. With the economy overheating, monetary policy was tightened. Increased interest payments and the economy falling into recession resulted in rising losses on business lending. Office prices halved from their peak as construction initiated in the late 1980s added to supply in an already falling market. Losses mounted at banks with two having to be rescued, and one major bank needing to raise capital. [2]

As notable as this episode seems, it follows a script that had played out before domestically and has since internationally. There are several aspects to commercial property lending that make it inherently risky, and typically more risky than residential mortgage lending.[3] A large share of banks' commercial property lending is for construction and development, including for large apartment buildings. Construction and development loans tend to be riskier because the property isn't yet earning rent, things can go wrong in the often complex construction phase, and market conditions can change in the several years or more it takes to complete large projects. Losses can also be greater on lending for commercial property than for residential property because borrowers with a limited liability company structure have less incentive to repay than individual residential mortgage borrowers who face full recourse.

Adding to the risk is that the availability of finance for commercial property has tended to be pro-cyclical. A booming property market has often led to an easing of both lending standards and borrowers' collateral constraints just as demand for funding is rising. Relative to residential property, the greater ability for funding to come from outside established lenders adds to this cyclicality. Commercial property lending can be syndicated and large individual projects make it easier for new banks to enter the market at a relatively low cost. This cyclicality of lending can accentuate the cycles in commercial property construction and prices.

Foreign investors may add to the cyclicality of the commercial property market if they tend to enter the market when prices have been rising and there are more properties for sale.[4] Alternatively, if foreign investors' decisions are largely influenced by conditions in their home country rather than the domestic market they may actually moderate the domestic property cycle.[5] Foreign banks direct links to domestic banks tend to be small, so their impact on the domestic financial system is likely to be indirect through an amplification of the credit cycle and property market.

Historically, residential property lending has been less risky for banks than commercial property lending. Indeed, the stress test conducted by APRA indicated that Australian banks have sufficient capital to survive a deep recession and a collapse in the housing market.[6] [7] However, the sheer size of mortgage lending on Australian banks' books means that residential loan performance is critical to banks' health and so the stability of the broader financial system. Housing debt is also important for the resilience of the household sector in Australia. The ratio of household debt to income is high in Australia relative to other advanced economies, and has edged higher since the financial crisis. [8]

In Australia, unlike many other countries, individual households also borrow to directly purchase investment properties, which may add to risk. More than one-in-ten tax payers owns an investment property. Most of these are geared, so much so that the majority do not earn positive income for their owners. While these borrowers generally start with smaller loans, and most of the debt is held by high-income households, they have less incentive to pay down their mortgage ahead of schedule because of the tax benefits of debt and so tend to retain higher mortgage balances over the lifetime of the loan.

Despite the high level of mortgage borrowing, various factors mitigate the risks to the financial system. Housing debt is mostly well secured. Limits on the maximum loan-to-valuation for mortgage lending and house price appreciation over time mean that existing borrowers generally have a large amount of equity in their homes. In addition, the ability of Australian borrowers to make excess payments on their mortgage, and that this is a tax effective way for owner occupiers to save, means that borrowers tend to accumulate large pre-payments ('mortgage buffers'). Close to two-thirds of loans have such pre-payments, which collectively amount to two and half years of scheduled mortgage repayments at current interest rates.

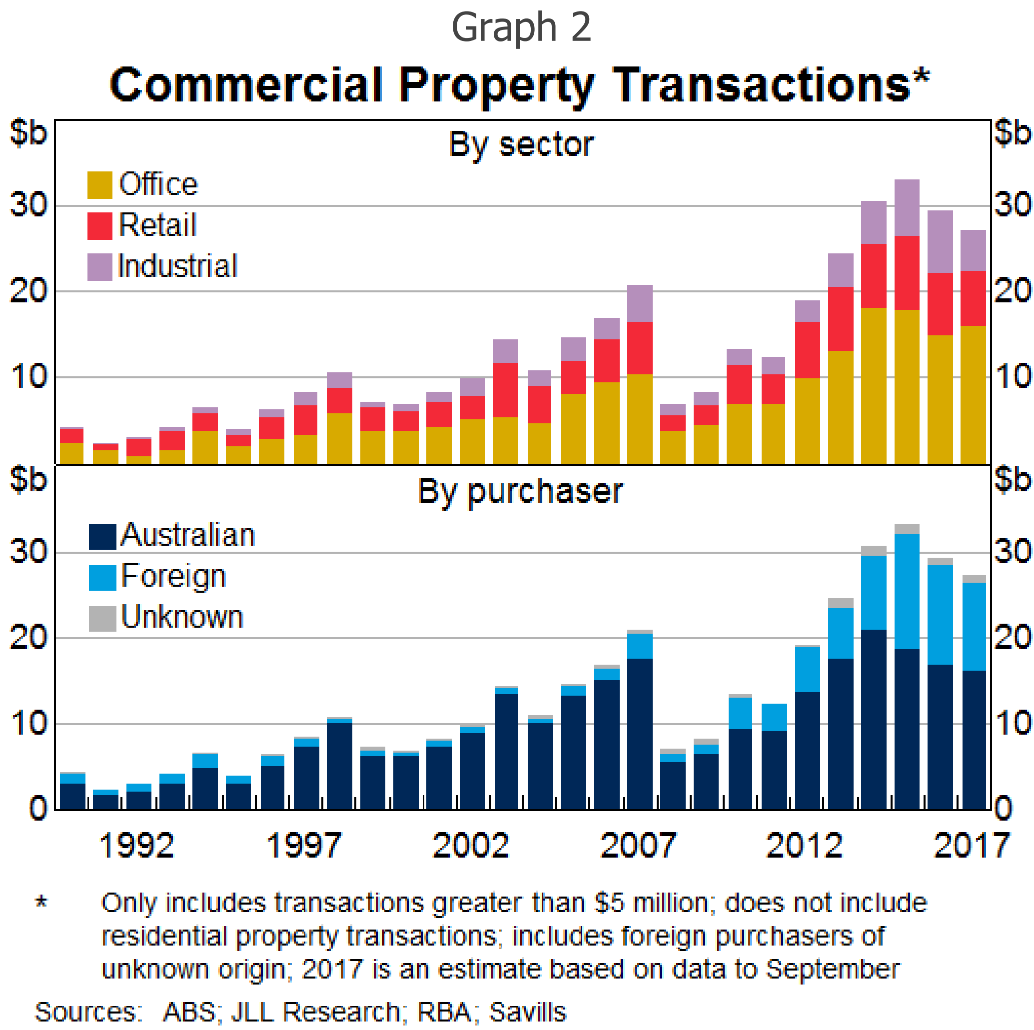
As with commercial property, foreign buyers of residential property could amplify cycles or transmit foreign shocks. Non-residents purchasing Australian real estate as an investment may choose between different countries based on expected returns, which can increase the correlation of the Australian market with other countries. Changes in economic and regulatory conditions in foreign buyers' home countries can also be transmitted to their demand for Australian property. But if purchases of residential property by foreign buyers mainly depend on conditions in their home country, their participation could actually have a moderating impact on the Australian housing cycle.

Having explained why we take a significant interest in the property market from a financial stability perspective, I would now like to provide an update on recent developments in the commercial and residential property markets and the role that international investors, finance and developers have played.

Commercial Property

One part of the commercial property sector that the Reserve Bank has been watching closely is loans for the development of residential property. The surge in apartments recently completed and under construction in the major cities raises the risk of price falls. The construction of new apartments has been largest relative to the existing stock in Brisbane and inner-city Melbourne, though it is largest in absolute numbers in Sydney.

Prices for other types of commercial property have risen sharply with a strong increase in demand from international investors seeking the relatively high yields available on Australian commercial property. Exceptionally low long-term interest rates globally have pushed up valuations for property and other assets, all the more so because relatively strong and stable global economic growth in the past few years has reduced investors' perception of the current risks. While there has not been a surge in construction, the run up in commercial property prices raises the risk of a sharp correction, for example if there is a change in sentiment or a pick-up in long term interest rates.[9]



Commercial office markets have been strongest in Sydney and Melbourne with low vacancy rates and rising prices. In contrast, conditions have been weaker in Perth where vacancy rates increased sharply with the downturn in the state economy from the decline in mining investment.

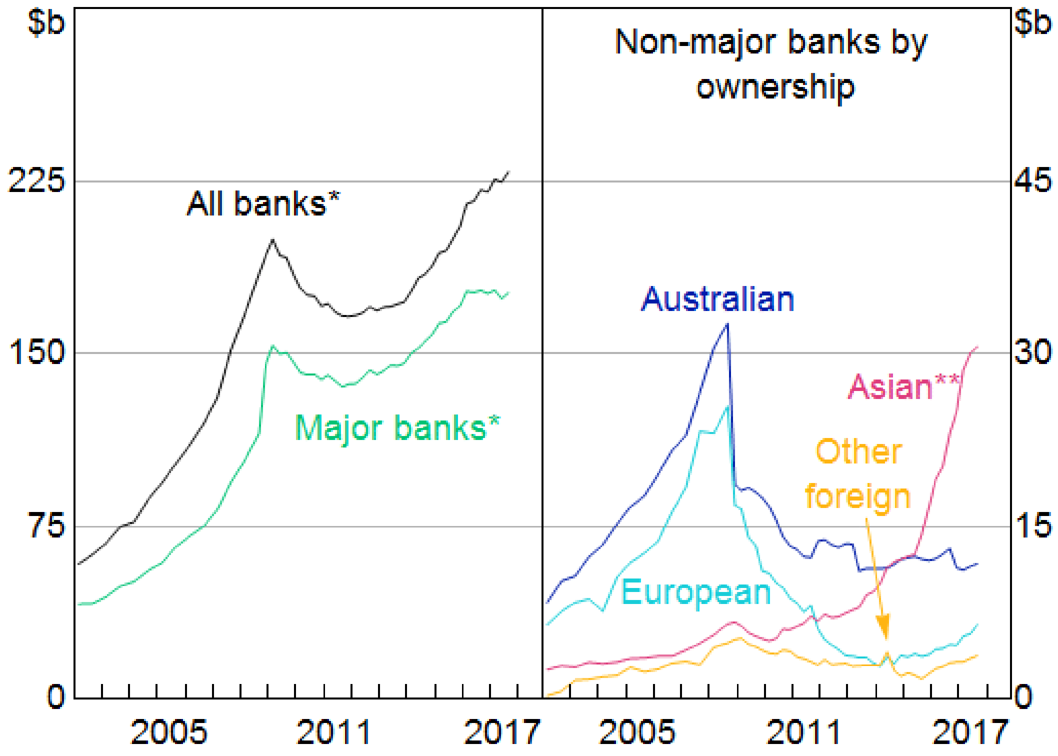
Conditions in retail property markets have also been relatively subdued across Australia. In part, this reflects strong competition in the retail sector from new entrants and online retailers. However, banks have continued to grow their lending for new retail developments and refurbishments with an increased focus on entertainment, hospitality, services and mixed residential.

Overall, Australian banks have tightened their lending conditions for commercial property in recent years.[10] Restrained lending by Australian banks has provided an opportunity for new entrants into the market. Asian banks have grown their commercial property lending sharply, more than doubling their market share in just two years, although it remains relatively small. This strong growth in commercial property lending by Asian banks is reminiscent of European banks' growth in the lead up to the financial crisis. However, whereas Australian banks eased their lending standards in that pre-crisis period in order to compete, this time Australian banks do not appear to have eased lending standards.

Graph 3

Commercial Property Exposures

Banks' consolidated operations



* Excludes overseas exposures

** Includes HSBC

Sources: APRA; RBA

Residential Property

The Australian residential property market has been strong in the post-financial crisis period as interest rates have been kept low to support economic activity and to boost low inflation. Since 2009, national housing prices have risen by around two thirds and growth of housing credit has outpaced that of incomes. By 2014, concerns grew about the risks from an increase in riskier types of lending, including interest-only loans and investor lending at high loan-to-valuation ratios as well as rising household indebtedness. In response to these concerns, the Australian Securities and Investments Commission (ASIC) increased its scrutiny of lending practices and APRA implemented several macro prudential measures in late 2014 and then again in early 2017, on both occasions after consultation with the Council of Financial Regulators, which the Governor of the Reserve Bank chairs. There are several aspects to these regulatory measures. For each authorised deposit-taking institution (ADI), the growth of investor housing lending has been capped at 10 per cent. Interest-only loans can be no more than 30 per cent of new mortgage lending. In addition, APRA has been monitoring high loan-to-valuation mortgage lending and instructed lenders to pay closer attention to loan serviceability criteria, such as the interest rate buffer applied to the current low mortgage rates and borrowers' expenses. [11]

These measures have played a role in reducing the build up in risks from household borrowing. Lenders responded to the restrictions by increasing their interest rates for interest-only loans and investor lending. In response, the share of new loans that are interest-only has been falling, and overall investor credit growth has remained below the 10 per cent threshold. Many existing borrowers have also switched their interest-only loans to principal-and-interest loans and there has been a decline in the share of new loans at high loan-to-valuation ratios.

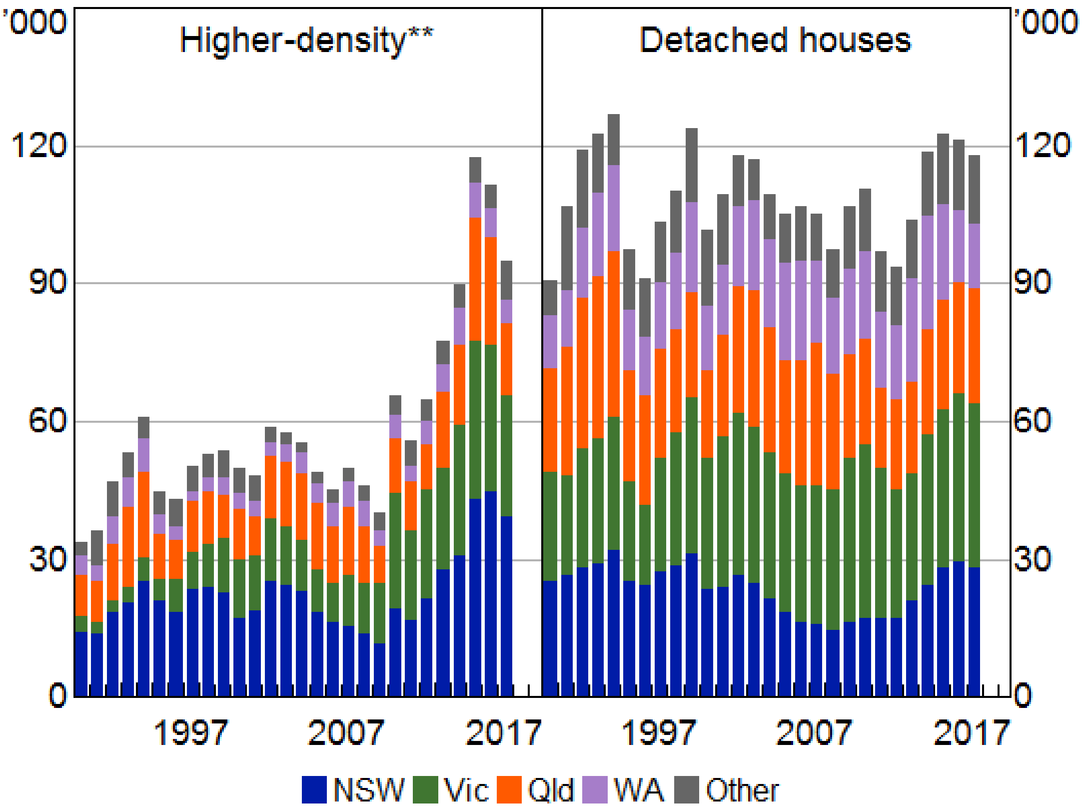
While riskier types of lending have moderated, and investor credit growth has slowed, the pace of overall housing credit growth has been fairly stable this year as borrowing by owner-occupiers has picked up. Conditions in the housing market have eased, particularly in Sydney where prices had experienced strong growth and are particularly high, possibly giving lending restrictions greater impact in Sydney. In Melbourne, conditions remain stronger than in other capital cities. On the other side of the country, and at the other end of the spectrum in terms of housing market conditions, the Perth housing market remains weak. Prices have fallen gradually over the past two to three years, with rents also falling as the rental vacancy rate has increased to its highest level since 1990.

The strong demand driving housing price growth reflected not only low interest rates but also strong population growth. With rising demand and prices, dwelling investment increased strongly. A notable feature of the recent dwelling construction cycle has been the marked increase in the share of higher density construction, a helpful response to the shortage of well-located land in Australia's large cities. Approvals for new higher density dwellings went from being less than half those of detached dwellings less than a decade ago to being almost on par in recent years. But the longer time to build higher-density dwellings than detached houses increases the risk that a large number of new dwellings could be completed just as the housing market turns down, so amplifying the housing cycle.

Graph 4

Dwelling Approvals*

Number



* 2017 is an estimate based on data to September

** Flats, units, apartments, semi-detatched dwellings, terrace houses and townhouses

Sources: ABS; RBA

This surge in apartment construction has been largest in Sydney, but has also been notable in Melbourne. While the number of apartments being built in Brisbane has been smaller compared to its population, it has been greater relative to the existing stock of apartments. Peak apartment completion in Brisbane is expected to occur this year, capping a three-year period in which the number of apartments has increased by over one-third from the stock in 2015. Perth has also seen strong growth in a relatively small stock of apartments.

This change in the composition of the housing stock is resulting in a rebalancing of relative prices, with prices for detached dwellings growing faster than those for apartments in the major cities over the past five years. [12] In the weaker housing markets of Brisbane and Perth, this has seen apartments experience small price falls in recent years. To date, despite valuations for some apartments at settlement being lower than the purchase price off the plan there have not been widespread reports of higher rates of settlement failure or any notable increase in arrears or losses for banks.

Purchases by foreign buyers have received considerable focus in recent years. Non-residents are able to purchase newly constructed dwellings in Australia, while temporary residents, such as those in Australia for work or study, are able to purchase an existing dwelling for their primary residence. It has been hard to get a firm estimate of how large these purchases are, but drawing on a range of sources, it seems that, nationally, purchases by foreign buyers are equivalent to around 10-15 per cent of new construction, or about 5 per cent of total housing sales. The share of new construction purchases is highest in Melbourne and Sydney. It is also higher for apartments, but it is still only perhaps around one-quarter of newly built apartments. Many foreign buyers come from China, seemingly around three-quarters. [13] Purchases of new properties by foreign buyers have eased over the past year, reportedly because of stricter enforcement of Chinese capital controls and tighter access to finance for foreign buyers.

Purchases by foreign buyers do not, on the whole, reduce the supply of dwellings available to local residents and in fact may actually contribute to expansion of the housing stock. Foreign buyers in Australia for work or study would have been renting if they did not purchase. Other foreign buyers rent the property as an investment and so contribute to the rental stock. Also, there are some new developments that only proceed because they get high pre-sales from foreign buyers.

The strength of the Australian property market, and the participation by foreign buyers, has also enticed some foreign developers to Australia for specific projects, but overall they remain a small part of the market. Foreign banks also have a very small role in residential property lending in Australia.

Conclusion

Given their significance for financial stability, the Reserve Bank carefully monitors property markets. History has taught us that commercial property lending can result in substantial losses for banks. And the large stock of residential property debt means that it too is important for financial stability and household resilience.

The high valuation of commercial property, which is common to many other assets, increases the potential for a sharp correction and so the risks from commercial property lending. The high level of household mortgage borrowing also brings risks, both for lenders and households.

Purchases and financing by foreigner investors and banks have been prominent in the current commercial property cycle. We have seen this before and are well aware of the impact this can have on the cycle. The increased purchases of dwellings by foreign buyers, particularly for investment purposes, are a more recent phenomenon and so their impact on the housing cycle is less clear.

APRA has investigated commercial property lending standards to ensure these are not eroded, while measures by APRA and ASIC aim to reduce the riskiness of new residential lending. And the Reserve Bank, with its mandate for overall financial stability, will continue to closely monitor risks from property markets and lending.

Thank you for your time, and I am now happy to take your questions.

Endnotes

[*] Thanks to Grace Taylor and Timoth De Atholia for assistance and many colleagues for helpful comments and suggestions.

[1] For a thorough review, see Rogers D (2014) "Credit losses at Australian banks: 1980 – 2013", Reserve Bank of Australia Research Discussion Paper 2015-06. The role of losses on property lending in banking crisis stretches back to the 1890s in Australia as outlined in Fisher C and C Kent (1999) "Two depressions, one banking collapse", Reserve Bank of Australia Research Discussion Paper 1999-06.

[2] State Bank of South Australia had to receive support exceeding three times its 1989 capital levels, State Bank of Victoria was sold to Commonwealth Bank of Australia while Westpac had to raise equity to ensure losses did not erode capital below the regulatory minimum.

[3] For a summary of these risks see L Ellis and C Naughtin (2010) "Commercial Property and Financial Stability – An international perspective", Reserve Bank of Australia Bulletin, June Quarter.

[4] See for example M Papaioannou, J Park, J Pihlman and H van der Hoorn (2013) "Procyclical Behavior of Institutional Investors During the Recent Financial Crisis: Causes, Impacts, and Challenges", IMF Working Paper 13/193.

[5] Foreign investment and finance can of course bring benefits to the domestic economy by increasing the amount of construction undertaken and reducing the cost of property to tenants.

[6] See Byres W (2014), 'Seeking Strength in Adversity: Lessons from APRA's 2014 Stress Test on Australia's Largest Banks', AB+F Randstad Leaders Lecture Series, 7 November.

[7] In 2005 then chairman of the Federal Reserve Ben Bernanke was asked what was his worst case scenario if house prices fell substantially in the United States. He replied that "It's a pretty unlikely possibility. We've never had a decline in house prices on a nationwide basis." National house prices subsequently fell 30 per cent. It is a reminder that we should never discount the seemingly unlikely when it comes to housing.

[8] Specifically, total household debt is 1.9 times household disposable income, including such components as HECS debts. Housing debt is almost 1.4 times household disposable income.

[9] An increase in long term rates could be more problematic if it is not associated with stronger economic growth, for example if there was a surprise increase in inflation increased inflation risk premia and so the expected path of monetary policy, or term premia increased with a rise in financial market volatility.

[10] See APRA's thematic review of commercial property lending <http://www.apra.gov.au/adi/Documents/CRE-feedback-letter-all-ADIs.pdf>.

[11] For further details on APRA's approach to lending standards see H Richards (2016) "A prudential approach to mortgage lending" <http://apra.gov.au/Speeches/Pages/A-prudential-approach-to-mortgage-lending.aspx>

[12] An equivalent description is that detached house prices have recorded stronger growth because their prices incorporate a larger land component.

[13] See also Reserve Bank of Australia *Financial Stability Review* "Box B: Chinese Demand for Australian Property", April 2016.