THE AUSTRALIAN RESIDENTIAL REAL ESTATE MARKET

Residential real estate is the foundation financial asset of all modern economic systems. Australian housing is valued at $5.9 trillion, dwarfing the value of ASX listed companies of $1.6 trillion and the value of all commercial real estate of $0.7 trillion.

We have written this piece to argue against those predicting an imminent ‘housing crash’ because the Australian housing market is as oversupplied as the US housing market prior to the global financial crisis of 2008. This analysis is very wrong, there is no supply issue in Australia and vacancy rates remains low at ~3%, compared to peak US housing vacancy rates of ~11%. But the more important point is that this analysis is not that relevant to the future value of the Australian housing market.

We argue that the current extreme levels of Australian housing prices relative to household incomes has been driven by a long period of credit growth in excess of household income growth. We will describe the reasons behind this credit growth and then highlight the real factors that will probably precipitate an Australian housing correction.

WHY HAVE AUSTRALIAN HOUSING PRICES RISEN SO MUCH?

Australia has experienced uninterrupted house price growth for a generation, creating the seemingly irrefutable but dangerous mantra ‘as safe as houses’. This unprecedented asset price boom has occurred because of a self-reinforcing feedback loop driven by the interaction of both borrowers and lenders.

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2 Bloomberg
THE UNFAILING WILLINGNESS TO BORROW MONEY

Almost all buyers of housing, whether owner occupiers or investors, majority fund their purchases with bank debt. The willingness to bear this financial risk has been driven by a combination of many factors, but the necessary ingredient has been the validating nature of 30 years of steady house price rises.

The key drivers:

- There has been no recession driven shock to household incomes for 25 years, not even the global financial crisis impacted the Australian economy. The majority of Australian households have not experienced an inability to meet their financial commitments.

AUSTRALIAN GDP GROWTH – SINCE 1959

Australia has not experienced a recession since 1991. This record of growth is the second best in modern history (after Netherlands at 26 years, from 1982 to 2008), but an astonishing effort given this period includes the global financial crisis.

- Interest rates have fallen consistently for 25 years and are at historic lows. Not only has this trend increased debt servicing capability substantially, it has created a consensus view that interest rates do not increase.
• Housing investors receive tax concessions for investment. This framework has driven investor loans from 15% of all housing loans in 1991 to just over 35% today. Investor loan growth has been supported by mortgage brokers, real estate agents and the media.

**INVESTOR LOANS AS A PERCENTAGE OF TOTAL LOANS**

![Graph showing the percentage of investor loans over time.](image)

The banking industry, mortgage brokers, the media and residential real estate agents have all worked together to create a class of ‘residential real estate investors’. Investor loans to housing represent 20% of all banking loans.

Source: APRA, Bank Assets 2015

• Buyer behaviour is supported by commission driven mortgage brokers, who sell loans on behalf of the banking system. An astonishing 53% of all new loans are now written by this type of agent.

Curiously, the major banks fully or part own most of the major mortgage brokers. For example, for reasons unknown, National Australia Bank fully owns three mortgage broking companies employing a total of 3,500 mortgage brokers. To the impartial observer, the incentive structures created from this arrangement are likely to cause falling lending standards.

• Parts of the residential real estate agency industry acts as unregulated ‘investment advisers’. This group unconscionably support the notion of a riskless and infallible housing market. While there is nothing illegal about their behaviour because the Corporations Law does not recognise real estate as a ‘financial product’, it is certainly being sold as such by the real estate industry.

The evolution has been slow but consistent. We are now seeing some real estate agency firms establishing mortgage broking businesses, insurance broking and financial planning firms. It is difficult to think of a more conflicted business model.

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5 Australian housing can be purchased as an investment utilising high leverage (in some cases up to 95% of the purchase price can be debt funded). Investors are permitted to deduct interest expenses from their personal taxable income, while future capital gains are taxed at half this rate.

6 Australian Prudential Regulation Authority

7 RBA Website and Mortgage Choice 2016 half year results presentation

8 Macquarie Bank, Mortgage Choice report, August 2015
THE UNFAILING WILLINGNESS TO LEND

To create credit growth, the willingness to borrow must be supported by the willingness to lend. All housing and banking crises in history have been preceded by large and sustained periods of credit growth⁹.

Since 1991 Australian banks have increased their loan book by 8.2% per annum, compared to economic growth of 6.0% per annum¹⁰. Beneath this headline loan growth is a significant change in loan composition. Over this time, Australian banks have increased loans to the housing market from $85 billion to $1.5 trillion¹¹, representing loan growth of 12.2% per annum. This level housing debt represents approximately 100% of Australian GDP. For context, US housing debt as a % of GDP peaked at 95% just prior to the Global Financial Crisis¹².

Because growth in house lending has been so much greater than any other type of lending, housing loans have moved from 20% of all bank loans in 1991 to 60% today¹³. More concerning is that 20% of all Australian bank loans have been made for real estate investments.

An example of the concerning behaviour of Australian banks was when the banking regulator APRA recently sought to crimp loan growth to investors to 10% per annum. This saw the banks undertake an unexplained reclassification of $35 billion housing loans from ‘investor’ to ‘owner occupier’, representing about 35% of all housing loans made over the past 12 months.

AUSTRALIAN HOUSING CREDIT GROWTH

Credit growth has oscillated wildly over the past 25 years. It has been tepid recently compared to history, but the compounding effect means loans to housing have grown to $1.5 trillion

Source: RBA Housing Credit Growth

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⁹ Manias, Panics and Crashes, A history of financial crises, Kindleberger and Aliber.
¹⁰ Australian Prudential Regulation Authority, Banking Assets, 1991 to 2015
¹¹ Reserve Bank of Australia, D2 Lending and Credit Aggregates
¹² Federal Reserve Bank of St Louis
¹³ Australian Prudential Regulation Authority, Banking Assets, 2015
ARE THE INGREDIENTS IN PLACE FOR AN AUSTRALIAN HOUSING CRASH?

The answer is unfortunately and unequivocally ‘yes’. All of the factors that have existed in every historical housing crisis are currently in place in Australia.

HOUSEHOLD DEBT AS % OF INCOME

A significant and sustained increase in household leverage

This metric hit 128% in the USA by 2007, prior to the GFC

AUSTRALIAN HOUSE PRICE INDEX TO GDP PRICE INDEX

House price growth unprecedented in the recorded history of modern economies

AUSTRALIAN WAGES GROWTH

Slowing economic growth

Source: ABS, APRA, RBA
WHAT DOES A HOUSING ‘CRASH’ LOOK LIKE?

In their famous book on financial history, Reinhart and Rogoff studied 21 major house crises. They found the average fall in house prices was circa 35%, with declines ranging from 10% to 60%.

Clearly, the term ‘safe as houses’ is utterly discredited by the historical evidence that shows house prices can and do fall significantly.

The other important lesson is housing markets do not ‘crash’ in the traditional sense of the word. It is a slow process; it takes on average six years for the price correction to occur.

HOW MUCH?

The final point on the history of housing crises, they normally always coincide with a banking crises:

“Banking crises tend to occur either at the peak of a boom in real housing prices or right after the bust.”

This relationship makes sense. It is a particularly likely relationship in Australia where the entire banking system is supported by housing prices.

14 “This Time is Different, Eight Centuries of Financial Folly”, Reinhart and Rogoff, 2009
15 Bordo and Jeanne (2002)
WHAT WILL CAUSE AN AUSTRALIAN HOUSING CRISIS?
We have shown that the necessary ingredients are in place for a housing and banking crisis:

- High debt levels to household income
- Heavy and sustained house price growth
- A slowing economy

These factors are **necessary but not sufficient**. A housing and banking crisis requires a catalyst to change behaviour. This catalyst must ultimately cause credit growth to move into negative territory.

Below we provide the two variables that are likely to be the catalysts.

**MONITOR WAGES GROWTH (WILLINGNESS TO BORROW)**
Wages growth is slowing significantly in Australia. The most recent data shows it has slowed to 2%, the lowest level since the housing boom started. There is rightly enormous concern over this trend from the Reserve Bank of Australia, but they so far have been ineffective in arresting it by cutting interest rates to historic lows.

If wages growth moves into negative territory it will signal falling household income which may ultimately translate into house loan defaults. This transmission may take time; households will first cut spending in discretionary purchases before defaulting on their home loan payments.

**MONITOR BANK ATTITUDE TO LENDING (WILLINGNESS TO LEND)**
We have already seen banks being told by the regulator to crimp lending to investors. We have also seen banks completely ban lending to ‘offshore investors’. This is potentially the beginning of **tightening credit conditions**. Any further evidence of loan growth contraction by the banks will be very concerning.

**AUSTRALIAN HOUSING CREDIT GROWTH**

This is the key metric to watch. If credit growth falls below 0%, a housing crisis will likely occur. By way of reference US credit growth contracted 5% during the GFC.
CONCLUSION

Australian house prices have risen on the back of credit growing in excess of income growth over a long period of time. The history of housing and banking crises is that they begin due to declining credit growth. As we have discussed, declining credit growth will be generated by a fall in the willingness to borrow and a fall in the willingness to lend.

Investors interested in the future of the Australian housing market should:

• Watch the Australian Bureau of Statistics monthly wage growth figures. If this data series moves into negative territory, this will flag a reduction in the willingness to borrow

• Monitor the anecdotal commentary and statements from participants in the financial system. Any evidence that loan approval processes will be tightened is a negative

Ultimately, the data series to monitor is credit growth to Australian housing, which is updated monthly on the APRA website. If credit growth moves into negative territory, the Australian housing market may begin its slow correction, with prices falling gradually over many years.
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