Increasing Affordability of Housing for First Home Buyers

ANZ Submission to the Productivity Commission Inquiry on First Home Ownership

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Chapter 1

The housing market in Australia

1.1 Introduction and summary

ANZ is pleased to make this submission to the Productivity Commission's inquiry into First Home Ownership. ANZ is one of the largest providers of home loans in Australia, with outstanding loans of $68 billion as at 30 September 2003. ANZ made housing loans of $28 billion in the year to the end of September 2003.

The subject of the inquiry is broad ranging, and this submission does not cover all of the questions canvassed in the Commission's Issues Paper.[1] As a provider of finance for housing, ANZ aims to assist the Commission in understanding what has occurred in the housing market, particularly in terms of the relationship between interest rates, borrowing and trends in house prices. We also provide comment on some of the proposals already floated as possible policy solutions, and suggest consideration of a measure to assist first home buyers to save for a deposit, while acknowledging that measures to increase the supply of housing (such as planning policies and the release of land for new developments) will have the most substantial impact in terms of reducing house prices.

High house prices have created, for some people, a 'deposit gap'. There is no shortage of finance for house purchases, but lenders cannot prudently lend to borrowers who cannot save and invest some of their own money in the house.[2] As described in Chapter 2 of this Submission, the Australian Government can help bridge the deposit gap by allowing savings for home ownership to accumulate with favourable tax treatment.

ANZ also submits that while house prices have certainly increased rapidly in recent years, the ability of borrowers to repay their mortgages has not diminished, largely because interest rates have fallen at the same time that house prices have risen. ANZ submits that there is no reason to believe that house prices (in general) have been caused by a price 'bubble'. Rather, house prices have been determined by the fundamental factors of demand and supply.

In short:

- ANZ does not believe that house prices are caused by a 'bubble'. Where there may be certain sub-markets where bubbles have been arguably present — inner city apartments, for example — this is not true for Australia as a whole, where house prices can be explained by an environment of low interest rates and rising incomes as growth in housing supply has remained steady.

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[1] Productivity Commission, First Home Ownership Issues Paper, September 2003.

[2] To some degree, the deposit gap can be filled by mortgage insurance, which provides insurance cover to lenders for borrowers with an insufficient deposit to otherwise access loans (the cost of mortgage insurance is borne by the borrower). However, mortgage insurance, while valuable, is not a complete solution to the issue of the deposit gap.

- For first home buyers attempting to accumulate the 10 per cent of the purchase price required (made up of a minimum deposit of five per cent of the purchase price plus purchase costs - primarily stamp duty), the fact that the required deposit grows at the same rate as house prices could make the task difficult. For them, a policy measure such as a targeted tax incentive for designated savings could be desirable.
- Measures which provide first home buyers with windfall gains — such as cuts to stamp duty levied by State Governments — are likely to be largely capitalised into prices and hence unlikely to help affordability.
- Shared equity schemes, such as recently proposed by the Menzies Centre, while possibly a useful device for some people to diversify their assets, are unlikely to put much downward pressure on house prices, and could in fact have the opposite effect.
- Proposals for a 'housing life line' likewise have some merit, but they are really a specialised form of social security that will not affect house prices in a material way and so not contribute substantially to making first homes any more affordable.
- The only lasting measures that will lead to a fall in house prices are those which increase the supply of housing, especially for first home buyers.

1.2 Trends in house prices

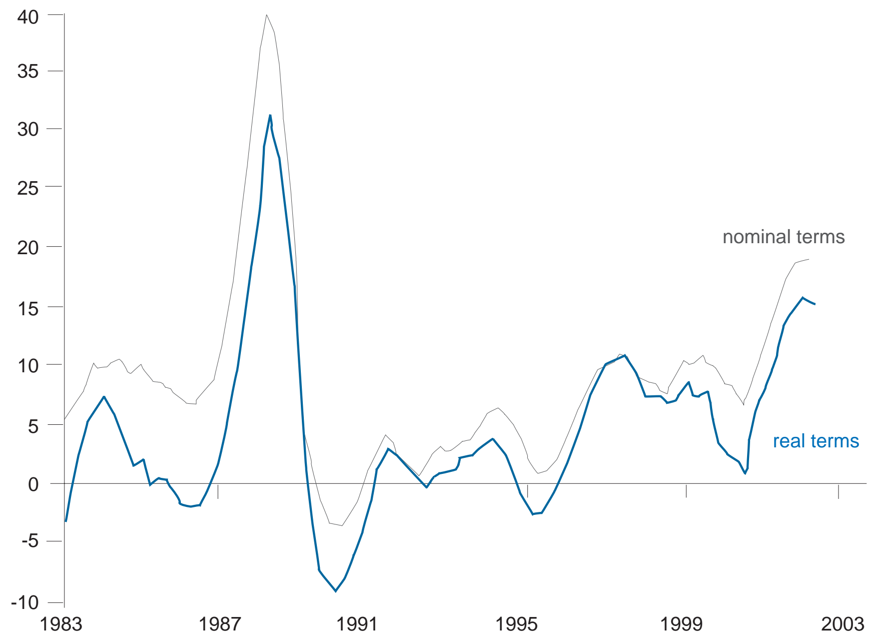
As is well known, house prices have increased rapidly in Australia in recent years. Figure 1.1 shows the annual change in house prices over the past 20 years, in both nominal and real terms. While never approaching the massive boom of the late 1980s (when house prices increased in one year by nearly 40 per cent in nominal terms, or just over 30 per cent in real terms), since the late 1990s nominal house prices have consistently grown at least 10 per cent per year, and more recently at double that rate. Growth in real terms was subdued at the turn of the decade by the effects of the GST on inflation, but most recently it has been very strong too. On any analysis, Australia has experienced a housing boom.

ANZ

Figure 1.1

HOUSE PRICES

Per cent change from year earlier



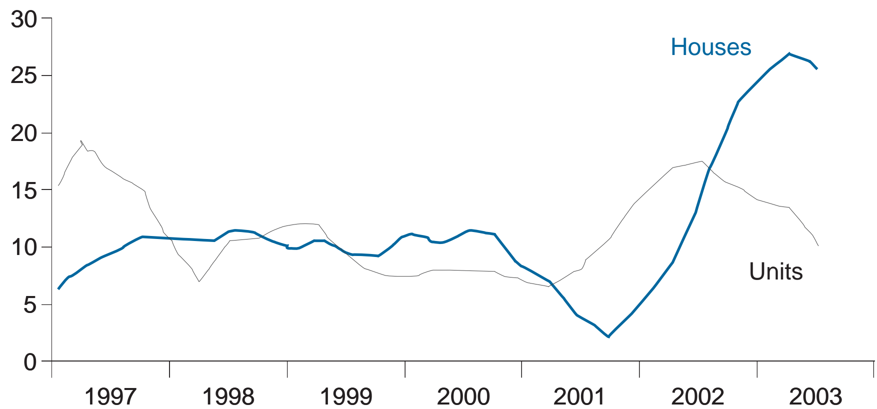
Source: REIA, ANZ

Figures 1.2-1.5 show that the boom has been spread across the country. It started in Melbourne around 1997 and three or four years later spread to Sydney, Brisbane and the other capitals. Even in Hobart, house prices rose by 24 per cent in the two years to June 2003, compared to a cumulative rise of just 3 per cent over the previous 5 years.

Figure 1.2

SYDNEY PRICES

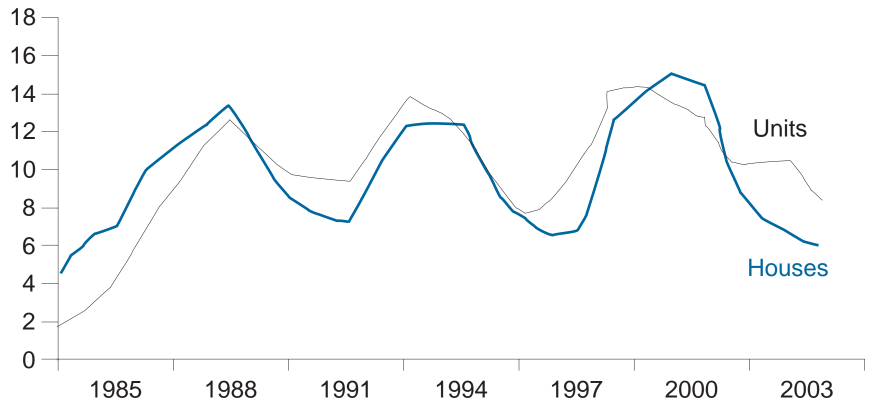
Per cent change from year earlier (moving annual median)



Source: REIA, ANZ

Figure 1.3

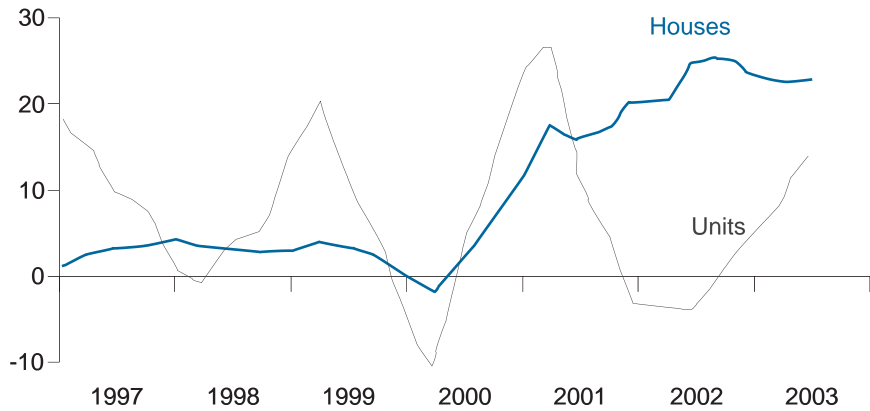
MELBOURNE PRICES



Source: REIA, ANZ

Figure 1.4

BRISBANE PRICES

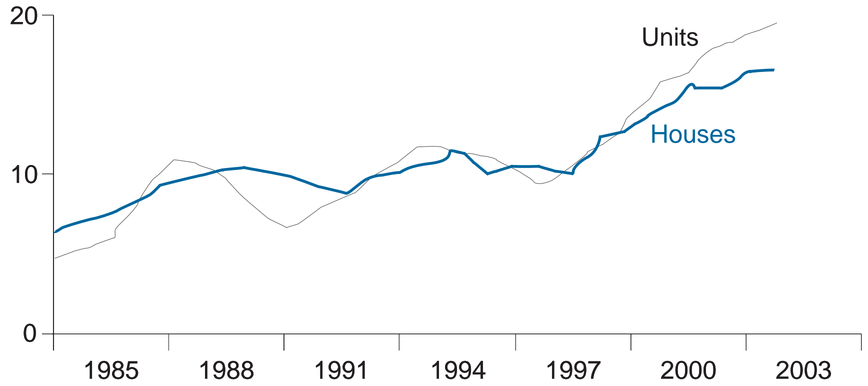


Source: REIA, ANZ

Figure 1.5

OTHER CAPITAL CITIES

Per cent change from year earlier (moving annual median)

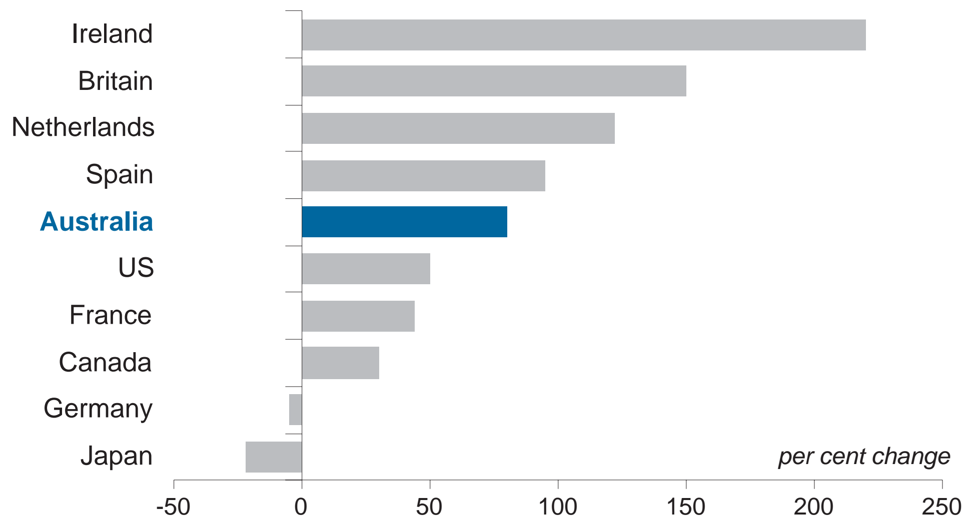


Source: REIA, ANZ

Australia is not the only country to have experienced these trends. Since the mid 1990s house prices have grown in many countries around the world, as shown in Figure 1.6.

Figure 1.6

INCREASE IN HOUSE PRICES 1995 TO 2002



Source: The Economist, 31 May 2003, Statement on Monetary Policy, August 2003

1.3 House Prices and Borrowing Capacity

According to many commentators, house prices are in a 'bubble'. An asset price bubble occurs when the asset's price grows without any fundamental justification i.e. prices are expected to rise for no reason other than they have risen in the recent past, and so they do. This creates expectations of further price rises and so on. Eventually, however, owners of the assets (for whatever reason) realise that this process cannot go on indefinitely, leading to expectations that prices will fall and the bubble 'bursts', with the process going in the reverse direction. The price of the asset then falls, usually very fast, to something approaching a value consistent with its fundamental determinants.

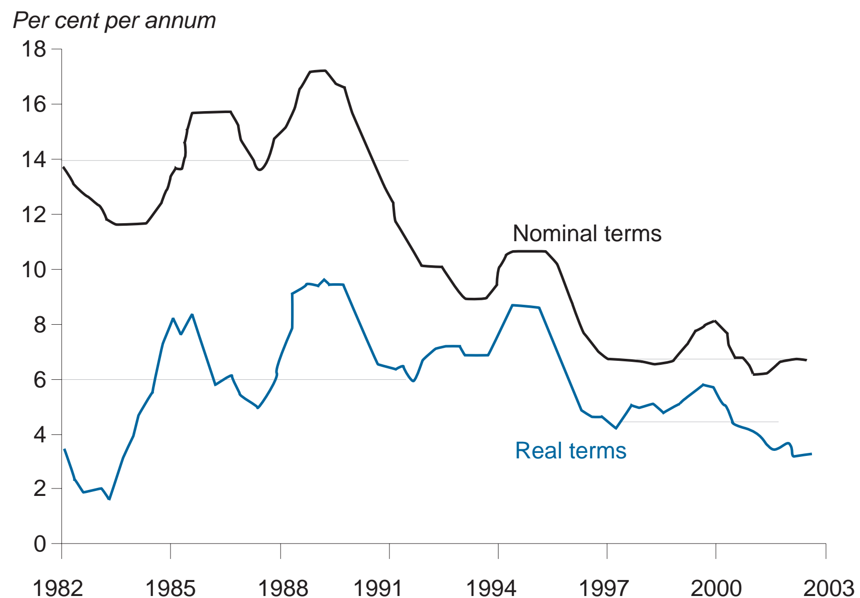
There have been many examples of asset price bubbles in history, the most recent being the 'dot com' boom and bust. Shares in companies with little or zero intrinsic value (that is, they had no hope of making any actual profits) were bid up to stratospheric heights. Many of these companies are now valueless, in every sense. Even companies that had some intrinsic value saw their share price fall by 98 or 99 per cent after the bubble burst in 2000.

ANZ's view is that unlike the 'dot com' example, for the nation as a whole house prices in Australia can be explained by fundamental determinants. (But this does not rule out price bubbles in particular housing sub markets. For example, prices in the inner city apartment markets in Melbourne and Sydney appear to have taken on certain bubble-like characteristics.)

In particular, the rise in house prices can be very well explained by the fall in housing interest rates. Figure 1.7 shows how interest rates have fallen in both real and nominal terms.

Figure 1.7

STANDARD VARIABLE MORTGAGE RATE



Source: RBA; ANZ

Interest rates in nominal terms are at 20 year lows. They are also very low in real terms by historical standards, but the nominal interest rate is probably more relevant, since it determines the cash flows of borrowers.

Figure 1.8 shows that since the mid 1990s, there has been only a slight increase in mortgage interest payments as a share of disposable income, and no increase in the share of total interest payments.

Figure 1.9 shows that households' borrowing capacity — based on earnings and required repayments for a 25 year loan — track very closely with house prices. Households have taken advantage of low interest rates and higher incomes to borrow more and house prices have been bid up as a result. Over the past 12 years, average incomes have risen by 63 per cent while the mortgage rate has fallen by about half. As a result, the borrowing capacity of an average-income household has risen by nearly 175 per cent. This increase in 'purchasing power' has been capitalised into prices.

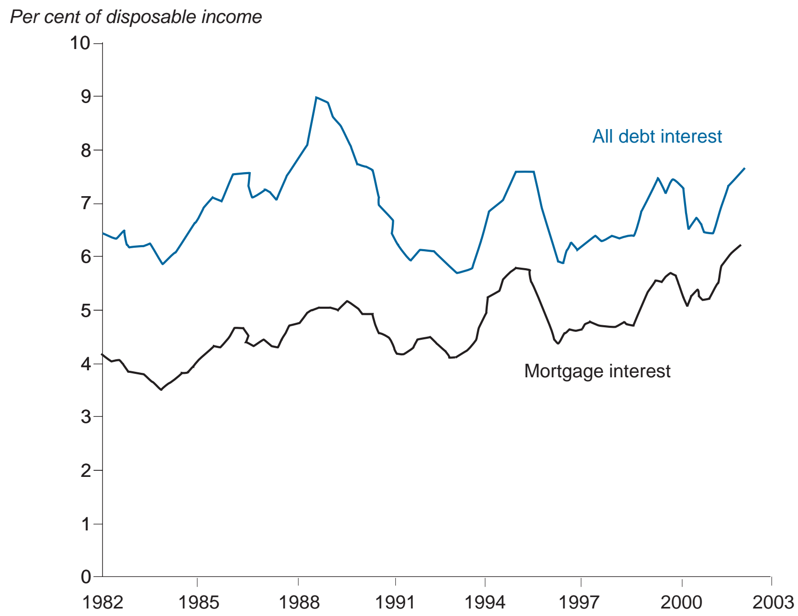
Seen in this light, house prices have not been caused by a bubble. They have been caused by fundamental factors that should determine house prices. The decrease in interest rates should be thought of as a once-off, structural fall in the level of interest rates that has been associated with a once-off, structural increase in the price of houses. Since interest rates have reached their low point, it is to be expected that house prices have reached a high point, and from now on, will be determined by the balance of supply and demand forces, with the latter mainly a function of income and population growth.

Moreover, if affordability is defined as the ratio of house prices to borrowing capacity, then affordability has remained (more or less) unchanged over the period since 1985, as shown in Figure 1.9. That said the price line has crept a bit above the borrowing capacity line, indicating that borrowing capacity has begun to fall somewhat behind prices. Looking forward, if interest rates rise due to cyclical economic factors, borrowing capacity for the average home buyer will fall. But this should lead to a fall in housing prices. Affordability for the average homebuyer should be largely unaffected.

However, the situation for first home buyers is different from the average home buyer because they need to be able to gain initial access to mortgage finance, and to do this they need (in most circumstances) a deposit. The following chapter discusses measures to increase affordability for first home buyers.

Figure 1.8

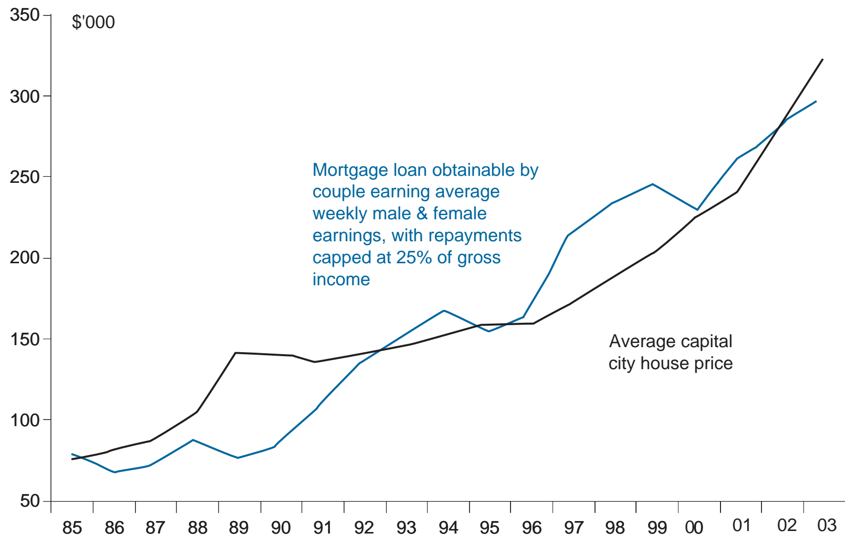
INTEREST PAYMENTS AS A SHARE OF DISPOSABLE INCOME



Source: RBA; ANZ

Figure 1.9

BORROWING CAPACITY AND HOUSE PRICES



Note: data are for the June quarter each year

Source: ABS, ANZ, REIA

Chapter 2

Measures to Increase Affordability for First Home Buyers

2.4 Investment Saving Accounts

Declining interest rates and rising incomes have meant that borrowing capacity and house prices have tracked each other quite closely over time. However, an issue can still arise for home buyers who are trying to enter the market because they need a deposit and the size of the deposit increases proportionately with the price of houses. Even a modestly priced house, say at $250,000, requires a deposit (comprised of a minimum of five per cent of the purchase price plus purchase costs, primarily stamp duty) of about $25,000. For a household with a moderate income, saving $25,000 could be quite challenging. While this issue arises most acutely in those parts of Australia where housing prices are highest (principally Sydney and Melbourne), as shown in Chapter 1 of this submission, house prices have risen all over Australia in recent years.

One way the Government could help home owners would be to allow special purpose savings vehicles to accumulate income with such income taxed at a low rate (preferably zero), provided the money is put toward a deposit on a house when it is withdrawn. Such schemes exist in the United States and United Kingdom and are called "investment savings accounts".[3]

These accounts would provide people with an incentive to save for the particular purpose of first home ownership. While an investment-saving account scheme would be a demand side measure, there are reasons to believe that the benefits would not be capitalised into property prices. This is because the accumulation of deposit funds in these accounts would occur over a period of several years and so would not be of a windfall nature.

Care would need to be taken that only *bona fide* first home buyers benefited from this scheme, but that is true of current measures to help first home buyers.

Box 2.1 describes in more detail how investment savings accounts work overseas.

[3] Though the funds in these accounts can be put towards a broader range of good causes, such as medical and educational expenses. While it is too early to tell whether these accounts have achieved their objectives, they have become popular.

Box 2.1

INVESTMENT SAVINGS ACCOUNTS

United Kingdom

Investment Savings Accounts (ISAs) are available to UK residents aged 18 years and over. Investors can hold different types of investments, which are free from UK Personal Income Tax and Capital Gains Tax. ISAs can include stocks and shares, life insurance and cash.

There are two main types of ISA — the Mini and the Maxi. Investors can put up to £7,000 in a Maxi ISA or up to £3,000 in a Mini ISA. (Both limits are to be reviewed in 2006.) However, they cannot invest in both types in the same tax year. Investors cannot take out a Maxi ISA with more than one provider in each tax year.

Investors can invest in up to three separate Mini ISAs in any tax year, one for each of these investment types: cash (£3,000); shares (£3,000); Life insurance (investment products with a life insurance element, £1,000)

Alternatively, investors can choose to open one Maxi ISA in any tax year: all £7,000 in stocks and shares, or cash up to £3,000 and/or life insurance up to £1,000 with remainder in stocks & shares, taking the balance up to £7,000.

United States

A number of tax-exempt savings vehicles exist in the United States. One particularly effective program is the college savings plan, commonly referred to as a "Section 529" plan. Since Congress added the 529 plan to the law in 1996, most states have established at least one 529 plan.

A Section 529 plan is a tax-advantaged investment savings account for saving for higher education expenses. A person, or the "owner," establishes an account with the state the owner selects, deposits cash in the account and designates a beneficiary of that account. Until the beneficiary reaches college age, the plan invests the money in the account, and its earnings and growth during that time are not subject to federal income tax. When the beneficiary reaches college age, the funds in the beneficiary's account are generally used to pay expenses of the beneficiary's higher education at any college or university, not just one in the state that sponsors the plan. Since January 1, 2002, amounts withdrawn for certain educational expenses have not been subject to income tax. Amounts not used for educational expenses are subject to income tax when the assets from the account are withdrawn or when the account is closed.

2.5 Shared Equity Schemes

Economists Andrew Caplin and Christopher Joye in a report commissioned by the Menzies Research Centre recently floated the notion of shared equity schemes.[4] The principal idea appears to be that typically, households have a very large proportion of their wealth tied up in their home and it would make financial sense for them to diversify their portfolio by holding less housing wealth and more of other assets. The Caplin Joye argument is that a shared equity scheme would not only achieve this objective, it would improve affordability as well.

[4] Their report can be accessed at www.mrcltd.org.au.

ANZ

While there could be many variants, in essence, a shared equity scheme might work as follows. A household and an investor (perhaps a financial institution) each take a 50 per cent share in a house. The household pays no rent to the FI for its share of the house, but the FI takes all the capital gain (or loss as the case may be). For the household, the benefit is that it can live in a house of a given quality, size and location at half the price. However, it can make no capital gain on the house — but it could use the capital that it would have otherwise been invested in the house (absent the Scheme) to invest in other assets. The household has thus diversified its portfolio of assets. The financial institution has taken an equity position in an asset class that previously was not available to it.

For example, instead of paying $400,000 for a $400,000 house, a household pays $200,000 and the investor pays $200,000. Repayments by the household on a 25 year credit foncier loan of $400,000 (at 6.5% interest) would be (about) $32,800 per year. Repayments on a $200,000 loan would be $16,400. Thus taking out a housing of loan of $200,000 rather than a $400,000 would free up $16,400 per year in cash for this household. This freed-up cash could be used to invest in other assets, and in the meantime housing affordability for the household has doubled.

However, there are many reasons why this scenario might not unfold. First, households might use the scheme to buy a 50 per cent share in $800,000 house i.e. borrow $400,000 just as they would in the absence of the scheme. Given the evidence that Australian households will borrow right up to their limit, given house prices, this might well happen, in which case there would be none of the portfolio diversification mooted by Caplin and Joye. Second, households might use the extra purchasing power afforded to them by the Scheme to bid up house prices, so that (in *extremis*) they would get a half share in a $800,000 house which was the same quality as the $400,000 house they would have bought absent the Scheme. Third, even if prices are not bid up and households do purchase a half share in a $400,000 house, as discussed above, there is no guarantee that they would use the freed up cash to purchase other assets. Instead, they might spend it on consumption items. For a household, the repayment of a home loan is a form of forced saving and given Australia's very low household savings rate, it is not obvious that offering households a chance to save even less than they do now is a good idea.

There is a host of other practical issues that would need to be dealt with under such a Scheme, such as the rights of the household to make renovations, what rights a mortgagee (who would not necessarily be the investor) would have over the property, what rights the household would have to sell its share of the property, and so on. These issues need not be insurmountable but they would be difficult.

ANZ's view is that shared equity schemes might occupy a niche market, and they might help households who wish to diversify their wealth. However, they are unlikely to improve affordability for first home owners.

2.6 The Housing Lifeline

Professors Joshua Gans and Stephen King, also in a report for the Menzies Research Centre, have proposed a "housing lifeline". This would be a loan made by the Government that would be provided to households for housing payments, in the event of a short-term loss of income (for example, due to a spell of unemployment). Households would pay back the loan (as and when possible) and draw on it again if they are hit with another short-term financial crisis.

The housing lifeline is a type of social security aimed at a particular purpose, which is to maintain housing payments for households in temporary financial distress. It is based on the assumption that the costs associated with intervening at this early stage would be less than the cost to the community of this temporary financial distress becoming more permanent. It is also a type of insurance that fills a gap in the market. For a variety of reasons, insurance against macroeconomic risks, with very bad consequences — for example, the risk of losing one's job in a recession — cannot be bought privately.

The King Gans proposal has merit. However, it will not do much to make housing more affordable for those who are seeking to enter the market, except, possibly, that potential new home owners would face fewer risks and so at the margin, might enter the market whereas they would otherwise choose not to.

2.7 Stamp Duty

Another proposal that has been put forward as one way to make housing more affordable is for state governments to reduce rates stamp duty on property purchases.

This is not generally correct. As explained in this Submission, the evidence suggests that house buyers spend as much as they can up to their borrowing limit. A fall in stamp duties is likely to lead to a corresponding rise in house prices. House buyers would be little better off, and house sellers would obtain a windfall gain at the expense of state governments.

The above scenario would almost certainly occur in situations where the supply of land is (approximately) fixed such as within metropolitan areas. In situations where the supply of land is potentially more variable, such as on the fringes of metropolitan areas — which tend to attract relatively high numbers of first home buyers — then the costs of stamp duty are likely to be shared between developers of new houses and home buyers. This means that, provided there is competition between developers, cuts in stamp duty might lead to a fall in prices, to the benefit of buyers. However, this benefit is unlikely to be very large.

Conclusion

In ANZ's view, while there may be certain sub-markets where bubbles are arguably present such as inner city apartments, house prices for Australia as a whole can be explained by 'fundamentals' — an environment of low interest rates and rising incomes as growth in housing supply has remained steady.

Under these circumstances, any policies which address the demand for housing in the absence of policies addressing the supply of housing are likely to result in further increases in house prices.

ANZ does acknowledge however, that rising house prices have made it difficult for first home buyers to enter the market. In particular, high house prices have created the problem of a ‘deposit gap’ for some people. There is no shortage of finance for lending but prudent lenders require home buyers to have genuine savings and to invest in the house they are buying. Policies such as Investment Savings Accounts, which allow savings for home ownership to accumulate free of tax, may assist first home buyers to bridge this gap.