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Productivity Commission
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Dears Sirs/Madams

Re: Draft Report on First Home Ownership

The Draft Report on First Home Ownership highlights a number of issues where the Productivity Commission (PC) needs to do more work. The PC may be aware of these areas and may already have an intention to address such issues.

It is imperative that the Final Report addresses the Inquiry's Terms of Reference and is acceptable to stakeholders, most importantly the Australian public.

The Terms of Reference require the PC to, among other things:

- “Identify any impediments to first home ownership, and assess the feasibility and implications of reducing or removing such impediments”.
- Pay particular attention “to the operation of the total housing market, with specific reference to the availability of a range of public and private housing types, the demand for housing, and the efficiency and use of the existing housing stock”.
- “Identify and examine mechanisms available to improve the ability of households, particularly low-income households, to benefit from owner-occupied housing. This will include an assessment of rent and direct ownership subsidies...”

1. Resources

The PC has referred to the “tight timeframe for the Inquiry”. This raises the question of the appropriateness of the timeframe imposed on it by the federal Treasurer. It also raises the question of the adequacy of resources devoted to the Inquiry, particularly in view of the timeframe.

Indeed, the PC has highlighted that a lack of resources is inhibiting its ability “to address in detail all of the many influences on house prices and affordability”. Many of these influences have a material effect on prices and affordability. An inability to address these

influences would seriously compromise the Inquiry and may reflect badly on the PC. It would also represent a lost chance to address adequately the pressing issue of housing affordability. At this stage, it is apparent that the PC does not propose to address in any detail the following influences (and the PC has recommended divesting itself of many of these issues to other forums):

- Urban planning.
- Land release arrangements.
- Regional policy (refer below).
- Taxation arrangements (the PC states that it “has little doubt that these taxation arrangements have lent impetus to the recent upsurge in investment in rental housing”).
- Public housing (despite public housing having a direct effect on the supply of housing and despite a finding in the Draft Paper that “policies that assist home buyers must have regard to any costs imposed on those in ...public or other forms of community housing”).
- Rental assistance.

It would be a great disappointment to the writer if the above issues were to be divested by the PC in its current Inquiry.

There are many other issues that will need to be covered in the Final Report (which are not covered in the Draft Report) to comply with and meet the Terms of Reference. Some of these issues are outlined below.

The Draft Report was produced 4 ½ months after the issue of Terms of Reference. An Associate Commissioner was appointed to the Inquiry.

The PC should make a concerted effort to obtain the resources needed to meet its obligations under the Terms of Reference. If these efforts are unsuccessful, the PC should give detailed reasons (e.g. timeframe, inability to obtain government funding, and/or prohibition from outsourcing work).

2. Confusion about Affordability

The PC states a view in the Draft Report that “affordability in many parts of Australia is now likely to be approaching, if not passing, the lowest levels in the last cycle”. It should be highlighted that this has occurred despite interest rates being currently much lower compared to the last housing cycle.

The fact is any spike in inflation and interest rates in the next five to ten years is impossible to discount. Moreover, the enormous increase in liquidity around the world in recent years may, in itself, sow the seeds of either inflation or deflation – which, either way, could materially adversely affect affordability.

The PC points out that since 1992-93 “the number of people in full time jobs has risen by 900,000 (growing at an average rate of 1.5% per cent per year)”. This growth was off a low point. Some of these new jobs are casual. Moreover, the housing boom has contributed significantly to growth in full time jobs (more particularly in the property, finance and construction sectors, but also in other sectors of the economy), and the PC points out that “housing booms have often been followed by busts in other countries as well as in Australia”.

The PC concedes in the Draft Report that there has been an apparent decline in home ownership rates in recent years (due to the large increase in rental housing investment). So the PC’s conclusion “that the pursuit of ever increasing levels of home ownership is unlikely to be a sound objective” is difficult to fathom in the current context.

The PC states that “in seeking to improve affordability, it will be equally if not more important to focus on measures that take pressure off house prices over the long term, and that can provide enduring affordability benefits across the price or interest rate cycle”.

In view of the aforementioned, it is interesting to note the PC’s view that “affordability issues are largely cyclical”.

Affordability is not only relevant to those buying a house in the future, but is also a concern for those who have bought in recent years. Moreover, any significant and unsustainable rise housing prices can ultimately result in a fall in prices, which could have a significant adverse effect on the economy – affecting many people, including renters.

3. Terms of Reference

In view of the Terms of Reference, the following areas must be covered more fully by the Inquiry:

a) The level of, and changes in, the distribution of income and wealth in Australia, and the resulting affects on housing affordability. An increasing proportion of the workforce is in casual employment. There have been changes in, and new, household spending commitments. Household disposable income has grown at a much slower rate than the overall economy. The Inquiry’s Terms of Reference have a specific concern with low income households. Indeed, the PC’s Draft Report states that “the basic requirement that all members of the community have access to affordable housing means that distributional issues loom large in policy formulation”. ***Therefore, the PC’s Final Report must cover this area comprehensively.***

b) Taxation arrangements. The PC sees merit in a broad review of the taxation system, including taxation arrangements affecting rental housing investment. The Draft Report suggests the PC has formed a view that there has been an overshooting in housing prices (page ix), but also expresses some doubts (page xx). Nevertheless, the PC is concerned that “any ‘announcement effect’ (in respect of any new taxation arrangements) could exacerbate any downturn” (this could, according to the PC, have a short term effect on affordability). This would tend to indicate that the damage has been done, and that inertia in taxation policy in Australia has contributed to the current problems of housing affordability and household debt. But further delays in acting on taxation policy may have additional downside effects.

The PC does not recommend any housing specific taxation changes in view of its preference for a “broader review” of taxation arrangements. Nevertheless, the PC points out that “too long a delay before commencement of a broader review “would also have its drawbacks”. If time is of the essence, perhaps the PC could focus on a few anomalies in the present taxation arrangements and also make specific recommendations with provisos (such as a specific change on the taxation of housing investment is made on the proviso that a specific change is also made to the taxation of share investment).

The PC needs to establish what effect the growth in rental housing investment in recent years will have on taxation revenues in the future (i.e. with possible distributional implications and possibly affecting the Australian community over time).

The PC states that “there is scope for governments to increase efficiency of housing markets and thereby improve price and affordability outcomes over time”. It is, however, evident that governments have, in themselves, created distortions in the market which have had the opposite effect.

c) Regional policy, including the city size issue as well as possible decentralisation initiatives. This area offers an opportunity to reduce the cost of housing in the short term - while also addressing many other economic and social issues. A new decentralisation initiative could have an ‘announcement effect’ and reduce prices in existing large cities. There are currently physical constraints in expanding existing cities and this has contributed to an increase in prices. If the release of land in large cities is considered to be a way to reduce pressure on supply, so can an increase in development away from these large cities.

d) The structure of mortgage interest rates in Australia. Benefits could accrue to existing and future borrowers from the establishment of long-term interest rate market (say 25 year fixed rates) in Australia. A rise in the use of variable and short-term fixed interest rates in the UK is currently getting a lot of attention in that country (where, ironically, fixed rate lending is more prevalent compared to Australia). The US Government considers its long-term fixed interest market is a major underlying strength.

e) The objectives of housing policy, and addressing more fully or recommending potential institutional mechanisms to monitor, and plan for, the housing market and regions on a long-term basis.

f) The PC considers that “Easy Money” has been a significant factor in driving up housing prices. “Easy money” is affected by i) inflation, ii) monetary policy and iii) competitive factors and innovation in financial markets. The PC’s draft report covers i) and iii), but not monetary policy. The reality is that the RBA has pursued an expansionary monetary policy over a long period of time and now looks to be moving toward a neutral policy (or toward normal interest rates). Therefore, Monetary policy should be discussed.

The PC states that “For owner occupiers, a halving of the interest rate almost doubles the mortgage potential obtainable, as well as roughly doubling the price of a home that can be ‘afforded’ for a given budget or income”. The PC should recognise that principal repayments also affect affordability.

The PC states that “the proportion of households with an investment property has grown from 8 to 12 per cent over the past decade”. But what also needs to be recognised is that some households have purchased very large numbers of properties – and this also has public policy implications.

g) The impact of over-investment in housing and the resulting effect on future economic growth and welfare (including long-term and future housing affordability). Indeed, the PC states that it “has framed its assessments of housing market outcomes and related policy settings in terms of what will deliver the best results for the Australian community over time”.

h) Public housing and rental assistance. The Inquiry’s Terms of Reference require coverage of these issues, at least in respect of “availability” and the “demand for housing”.

i) Credit laws.

4. Specific Issues Where the PC Seeks Comment

The PC “seeks comment on whether current prudential requirements for deposit and non-deposit taking lenders are appropriate and, if not, what changes are required”.

There is a 50% weighting for most loans secured by residential housing, so that a lender only needs half the capital to lend against this security compared to a loan secured by most other types of security (e.g. commercial property or plant and equipment).

Moreover, it is proposed that the capital weighting for loans secured by residential real estate will fall further under BASLE II. The RBA has stated that loans for housing investment are riskier than loans for housing occupation, yet this does not appear to be reflected in capital weightings.

The present capital weighting for loan secured against housing does not appear to be restrictive, or provide any competitive disadvantages, to deposit lending institutions. Indeed, deposit taking institutions in Australia have not securitised mortgage portfolios to any great extent, despite such a practice being common among deposit taking institutions (such as banks) in other countries. ***This suggests that a reduction to weightings is not required from a competitive neutrality point of view.*** It also suggests that the market considers the risk of mortgage assets to be no less than that suggested by institutional weightings. Public authorities should also be cognizant of the effects of risk weightings on various types of lending (e.g. housing versus business lending) and on economic activity.

APRA should require deposit-taking institutions to obtain independent valuations of security properties. In the event of a major fall in housing prices, APRA should then require revaluations. If required loan-to-valuation ratios are exceeded, adjustments to risk weightings should be made. This would also provide a “carrot and stick” approach to “imprudent lending practices”.

APRA’s stress testing should incorporate various economic variables and assumptions, such as a recession, a rise in inflation and a rise in unemployment.

APRA should be aware of the mortgage lending risks posed by redraw facilities and set-off accounts. Such products can allow access to finance in the event of unemployment or sickness (and hide a borrower’s inability to service debt from income), or allow borrowers to leverage up further with additional borrowing facilities. The writer believes that set-off are fully offset against the loan balance in calculating deposit-takers capital requirements – a situation that may not reflect all the risks.

APRA should define large mortgage exposures to individual borrowers (such as from the acquisition of large numbers of properties) and have deposit-taking lenders report these exposures.

APRA should do more work to determine appropriate debt service ratios and debt gearing for borrowers in the various stages of their life. The reality is that there is a trend for people to enter into large mortgage commitments at a later stage in life, with fewer working years available to pay-off loans.

Deposit-taking institutions are placing less emphasis on assessing individual applications. APRA should require these institutions to collect specific information, such as:

- age;
- wages slips and taxation returns, income and expense statements, and to calculate debt service ratios;
- insurances; and
- value properties, obtain asset and liability statements and calculate leverage and loan-to-valuation ratios.

This information should be collated and be reported on an appropriate segmented basis to APRA on a monthly basis.

5. PC's Initiatives to Improve Affordability

A performance criteria of this Inquiry could include recommendations that would directly improve affordability. The reality is that, so far, there are few such recommendations (with most either having a neutral or, by the PC's admission, a very modest effect).

6. Acknowledgements

The PC's Draft Report does acknowledge some submitters. These acknowledgements focus on governments or government departments or agencies and, to a limited extent, some private organizations (principally lobby groups – mainly being industry groups with little representation from welfare and consumer groups). Most of these parties have vested or special interests. Most of these parties also made their submissions after a large number of submissions were already made by other parties. It would be expected that most submitters would glean information from previous submissions to generate ideas. Indeed, some submitters may be attracted to make a submission after reading comments in another submission.

The point is, an acknowledgement should ideally be made to the first submitter who provided a particular unique observation or analysis. The Final Report should also reflect that a wide range of views were obtained, including from those people who are experiencing affordability problems.

I look forward to receiving a copy of the Final Report, which I hope will reflect the professionalism for which the Productivity Commission (and former Industry Commission) is renowned.

Yours faithfully

Nigel Fitzpatrick