NARROW ROAD
CAPITAL

RBA to APRA – we've set house prices on fire, you fix it

Two recent presentations by senior RBA staff have acknowledged that cutting interest rates has put a rocket under house prices. This is a refreshing change, as for years Philip Lowe had claimed that previous interest cuts played no part in subsequent house price surges. The presentations also acknowledged that rising house prices can create financial stability concerns. Unfortunately, the RBA is unwilling to take action to deal with this and has thrown responsibility over to APRA for the problem it has created. This article looks at the building financial stability issues and the actions that APRA could take to clean up the RBA's mess.

The two recent presentations were by RBA Governor Philip Lowe and the RBA's Head of Financial Stability Jonathan Kearns. Lowe's departure from his former insistence that rate cuts played no part in previous house price spikes was a welcome development. This position had become untenable after the 2019 research paper by RBA economists Saunders and Tulip. That paper found that based on historical experience and current interest rates, a 1% cut in long term interest rates should lead to a 28% increase in house prices. An interesting side note is that both authors have since left the RBA with Peter Tulip joining the growing group of economists who are calling out the RBA's mistakes. A key section from Lowe's speech is copied below.

I would like to reiterate that the RBA does not target housing prices, nor would it make sense to do so. I recognise that low interest rates are one of the factors contributing to higher housing prices and that high and rising housing prices raise concerns for many people. There are various tools, other than higher interest rates, to address these concerns, leaving monetary policy to maintain its strong focus on the recovery in the economy, jobs and wages.

Lowe's speech followed a week after a lower profile Q&A session with Jonathan Kearns. His comments went several steps further than Lowe's, noting interest rates are a key part of the valuation process for most asset classes. This is obvious to financial market participants, but it is something that the RBA had previously sought to downplay. He also acknowledged that whilst the positive wealth effect from rising assets prices stimulates the economy now, it comes with the likelihood that asset prices will fall in the future and that will have a negative wealth effect. Christopher Joye highlighted this same point last week; that the future could deliver a period when equities and bond prices both fall at the same time. Key comments from Kearns are copied below.

"Low interest rates tend to stimulate asset prices, that's one of the channels that monetary policy works through. It's not surprising to see some turnaround in the housing market…"

"Because risk free sovereign rates effectively underpin the pricing of all sorts of assets, if you have a rise in yields because of risk premia then that can affect the pricing of a broad range of assets simultaneously. Investors who though they perhaps had a hedge through owing bonds and equities can find that all of their assets fall simultaneously and then that can have negative feedback for the economy through wealth effects."

The three major legs of the RBA's easy money policies; a low overnight rate, the term funding facility (TFF) and quantitative easing, work together to push house prices higher. Low interest rates flow through to variable rate mortgages, but that alone has less immediate impact than commonly thought as borrowers with principal and interest repayments are unlikely to see their repayments fall. The TFF has had a substantial impact as banks have used this ridiculously cheap medium term funding to offer cheap fixed rate loans to borrowers. Quantitative easing has more of an indirect impact, with lower long term rates pulling down the risk free rate assumption that underpins risk assets. A ten year bond yield of 4% would make gross rental yields of 2-3% look stingy and prices would adjust accordingly.

Combined, the three easy money tools have become a powerful force pushing housing and most other asset prices higher as they allow for greater leverage, reduce the supply of assets available for purchase and browbeat formerly low risk investors into taking more risk. I've yet to hear a central bank put forward a credible timeline for unwinding these impacts without substantial negative consequences.

Another aspect typically ignored by central banks is that easy money policies are redistributing wealth from savers to borrowers. The valid complaints of retirees that their savings deliver far less income than they previously did has resulted in this group cutting back on their spending, offsetting much of the wealth effect from risk asset owners. There's also redistribution from the retirement funds of those yet to retire, as we've pulled forward returns and thus consign these savings to lower returns in coming decades. It's impossible for bonds and difficult for equities to deliver historical real return levels without interest rates being manipulated to well below zero.

Actions that APRA could take

Noting the house price and borrowing surges of the last few months, as well as the hangover of the shutdown of several industries due to Covid concerns, systemic risks are growing. It seems it is now a matter of when and how APRA acts to address these financial stability concerns. There are precedents in Australia and overseas for various measures, each with their own benefits and costs.

High LVR lending

New Zealand is implementing restrictions on owner occupier loans with less than a 20% deposit and investor loans with less than a 40% deposit. High LVR loans are far more likely to default and far more likely to cause lenders to suffer a loss. Lenders mortgage insurance (LMI) is only a partial protection. The experience in the UK and the US has shown that if a house price downturn is severe, insurers may not have sufficient wherewithal to meet claims in full.

Debt to income ratios

The UK has implemented restrictions that limit the amount of loans lenders can make where the proposed debt to income ratio exceeds 4.5 times. Like limiting high LVR lending, this will reduce the ability of borrowers to gear up, thus reducing their firepower to purchase.

Affordability rates

When assessing whether a borrower can afford a loan, lenders use a buffer over the current interest rate to test that the borrower can meet repayments if interest rates rise. Lenders often use a 2.50% buffer, but APRA could require that this buffer be increased, which would also reduce the amount of debt potential borrowers could take on.

Loan growth rates

In 2014, APRA instructed lenders to cap the growth of their loans to investors at 10%. This turned out to be a gold mine for lenders as they were able to increase the interest rates charged on investor loans to reduce their demand. The current surge in house prices appears to be driven more by owner occupiers, so this measure is less relevant this time around. However, the previous experience is a guide to what could happen if APRA placed caps on higher risk loans, with banks likely to use higher interest rates to ration their capacity.

Capital weights for higher risk loans

On its own, or in conjunction with restrictions on higher risk loans, APRA could increase the capital weights on these mortgages. If banks were facing a greater difference in capital costs for higher risk loans, they would likely respond by creating tiered pricing that rewards lower risk borrowers.

NARROW ROAD CAPITAL

TLAC/Tier 2

APRA has been unduly slow in implementing the total loss absorbing capital (TLAC) requirements. Given the extremely low cost of issuing tier 2 debt (subordinated debt) currently, APRA could significantly reduce the risk of a disorderly bank failure by shortening the implementation period. The protestations by banks several years ago that the global market could not stomach a substantial increase in Australian tier 2 debt have been shown to be completely bogus with recent large deals heavily oversubscribed. Any banks complaining about such a change can be reminded that they have benefited enormously from the TFF and this is a minor cost imposition in comparison.

Countercyclical capital buffer

In APRA's own words, "the primary purpose of the countercyclical capital buffer is to increase the resilience of the ADI sector during periods of heightened systemic risk." If now isn't such a time, this is a phantom prudential instrument.

Comments on implementation

These seven measures aren't exhaustive, but it is likely that a combination will be used in the medium term. The limits on higher risk loans (high LVRs and high debt to income ratios) are the most practical measures to stop borrowers from taking excessive risk given speculative investment activity is booming. These measures may be argued to be locking some first homebuyers out of the market. However, those potential buyers need to hear the hard message that without sufficient savings and income, they run the risk of being forced sellers at a time when house prices are falling.

The recommended adjustments on TLAC and the countercyclical capital buffer are likely to be seen as a prudent response from a regulator that has a history of being appropriately conservative. Whilst banks might quibble at these changes, it is clear that systemic risks are building and that action should be taken. These changes would have minimal cost impacts on banks and borrowers relative to the excessively generous benefits they have already received from the RBA's easy money policies.

Written by Jonathan Rochford for Narrow Road Capital on 13 March 2021. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

Disclosure

This article has been prepared for educational purposes and is in no way meant to be a substitute for professional and tailored financial advice. It contains information derived and sourced from a broad list of third parties and has been prepared on the basis that this third party information is accurate. This article expresses the views of the author at a point in time, and such views may change in the future with no obligation on Narrow Road Capital or the author to publicly update these views. Narrow Road Capital advises on and invests in a wide range of securities, including securities linked to the performance of various companies and financial institutions.