The Australian Prudential Regulatory Authority (APRA) and the Reserve Bank (RBA) are locked into a strange game of tweaking with economic levers to try and reduce the risk of a rapidly growing property market. But past cycles of rate rises and rules to try and curb lending to investors show the effectiveness of these measures is running out.

It also underscores the problems arising from a government unwilling to tackle the problem at source – the perverse incentives in the tax system.

Looking back to December 2014, the RBA voiced its mounting concerns about the rapid growth in lending to property investors and the steep increases in property prices it was fuelling. But rather than address these concerns by raising interest rates, as the RBA had done in somewhat similar circumstances in the early 2000s, it was instead left to the banking system regulator APRA to tackle this by writing a letter to banks and other mortgage lenders about the need for more cautious mortgage lending practices.

This letter laid down new rules capping the annual growth in lending to investors at a benchmark of 10%. APRA also set stricter criteria for determining whether borrowers could repay their loans if interest rates were to change.

This warning from the regulator had its desired effect. The share of new housing loans made to investors fell from over 40% during the 2014-15 financial year to less than 30% by the December quarter of 2015.

And this in turn saw the annual growth rate of loans to property investors slow from a peak of 10.8% in the June quarter of 2015 to less than 8% by the end of 2015. It fell again to less than 5% by the September quarter of last year.

The banks also fell into line with the new rules, cutting back on other more risky types of lending, such as interest-only loans, and loans with initial loan-to-valuation ratios in excess of 90%.

The RBA was especially pleased with these developments, thinking that the risk was easing. So when it met again in May last year, the RBA Board was persuaded to cut the cash rate to a new record low of 1.75%,in response to a much-lower-than-expected inflation result for the March quarter.

The RBA still seemed content at its August 2016 meeting, seeing the easing conditions in the housing market as being consistent with APRA tightening the lending standard screws. It decided on another cut in the cash rate, to 1.5%.

But now investors have come back into the property market with a vengeance. These two reductions in interest rates have in effect overwhelmed the tightening in lending standards enforced by APRA during the first half of 2015.

This resurgence in lending to property investors has pushed up property prices once again, especially in Sydney and Melbourne. Dwelling values rose by 18.4% in Sydney and 13.1% Melbourne respectively, over the year to February .

The share of new loans going to investors has picked up from less than 30% in the December quarter 2015, to over 35% in the December quarter 2016, according to APRA statistics. This is from less than 44% of new housing finance commitments (excluding refinancings) in November 2015 to more than 50% in January 2017 according to ABS housing finance statistics.

The annual growth rate of loans outstanding to housing investors, as published by the RBA, has accelerated from 4.6% last August to 6.7% in February this year: over the last four months, lending to property investors has risen at an annualised rate of 8.0%.

Now the RBA is back to being concerned about a build up of risks associated with the housing market.

The RBA's Assistant Governor (Financial System), Michele Bullock, acknowledges that although APRA's 2015 actions "did address some of the risks" that had been mounting during

2014, “the initial effects on credit…may fade over time”. She added that APRA and the RBA “are prepared to do more if needed”. But since the RBA clearly has no appetite to reverse last year’s rate cuts any time soon, the only feasible option in the short term option is for APRA to do something about the Sydney and Melbourne markets.

So APRA has today take another another bite at the cherry , requiring banks to restrict new interest-only lending to 30% of all new loans (a lower proportion than at any time since early 2009) and to ensure that growth in lending to investors is “comfortably below” the 10% cap.

What all of this highlights is the limited effectiveness of so-called “macro-prudential” measures in countering the very strong incentives to invest in residential property. These incentives are created by the combination of record low interest rates and the unusually generous treatment which the Australian taxation system gives to the costs of and returns from debt-funded property investment.

While some commentators have urged the Reserve Bank to lift interest rates in order to dampen the latest surge in borrowing to invest in residential property, this seems unlikely. The RBA continues to expect inflation to remain below its 2-3% target range until at least the middle of next year , and unemployment to remain closer to 6% than to 5%.

It would be far better if the federal government were to tackle the problem at source. He could do this either by limiting the scope for negative gearing or reducing the capital gains tax discount, as Malcolm Turnbull once advocated (in a 2005 paper co-authored with the ANU’s Jeromey Temple). Even the Property Council of Australia has conceded should be lowered to 40%, and denied altogether on investments held for less than two years.

However, given the government’s unwillingness to consider such measures, it seems more likely that APRA may have to become even more prescriptive with its lending criteria. And, as we have seen, in the current interest rate environment that is merely a bandaid solution – and bandaids eventually wear off.

Read more http://theconversation.com/the-apra-bandaid-for-the-housing-market-is-wearing-off

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