

## Safe as Houses?

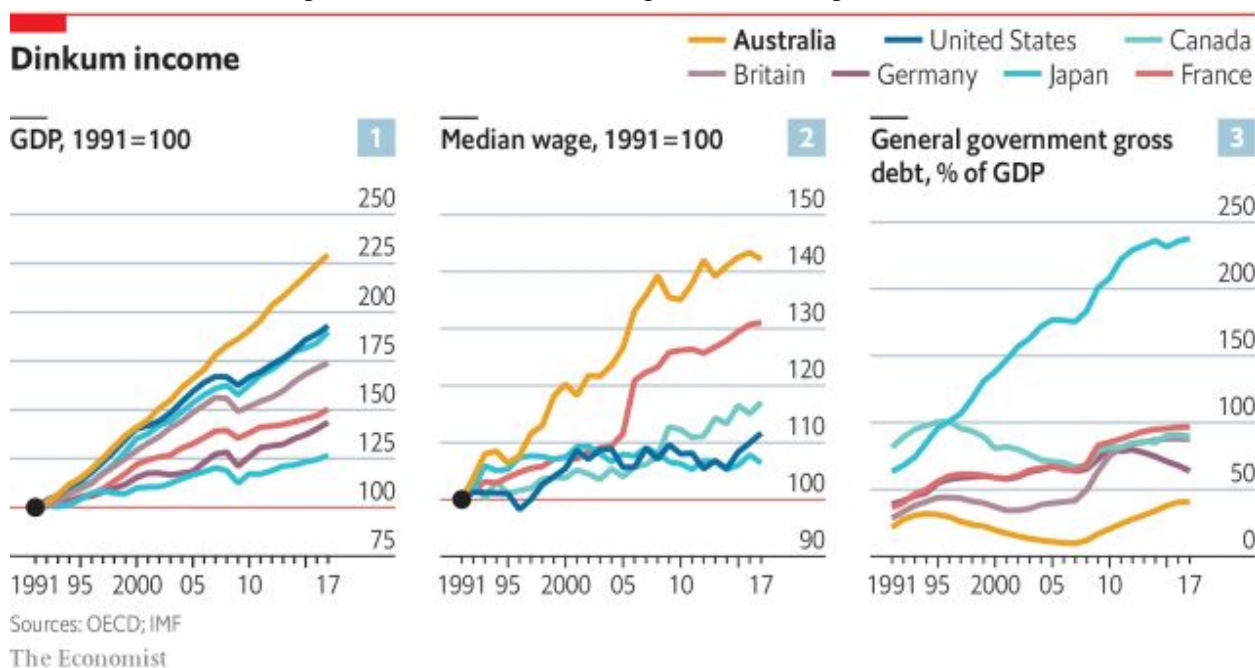
### What's going on with the Australian Property Market?

#### Where we've come from and where are we right now?

Prior to the recent decline, Australia experienced a three-decade-long real estate boom that -- in many ways -- altered the national psyche.

Over that time, [housing prices rose upwards of 7% per year](#), leaving the country with some of the most expensive real estate in the world -- as measured by the [comparison of house prices to household incomes](#) or Price Income Ratio (PIR).

Perhaps the initial driver of the growth was deregulation of the financial markets in the 1980s and 1990s that made credit more widely available, leading Australians to borrow more for housing, which drove up prices. The market continued to surge ever since; even avoiding a crash during the Great Recession.



#### Drivers of Growth

##### Homebuyer Incentives

Having already introduced a scheme (the [First Home Owner Grant](#) - FHOG) in July of 2000 that provided \$7,000 grants to first-time home buyers, the Australian government increased the amount to \$14,000 for existing homes and \$21,000 for new homes.

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## Exports Created Booming Economy

The [Chinese](#) were buying huge amounts of raw materials like iron ore and coal from Australia which boosted the mining sector and strengthened the entire Aussie economy.

## An Abundance of Interest-Only Loans

In 2015, 40% of all Australian mortgages were [interest-only](#) since interest-only loans allowed investors to borrow more money and take advantage of the appreciation wave and maximize gains when their houses appreciate in value.

## Tax Benefits for Real Estate Investors (Negative Gearing)

In Australia, if you bought a home as an investment and the expenses exceeded the income, the loss reduces the taxes you paid on your ordinary income (i.e. there is no separation of 'passive' income as there in the US). As a result of these tax breaks, more people wanted to buy investment property which drove up prices and created a market that incentivized investors both domestic and foreign.

## Valuations and Affordability

After years of historic highs, dwelling values (an aggregated median of units and houses across the country) fell by 3.5 percent in the 12 month period following their peak in October 2017, according to CoreLogic data.

However, there has been very little improvement in housing affordability -- particularly in Australia's two most populous cities, Sydney and Melbourne.

The lack of improvement in housing affordability is largely attributed to the fact that recent price declines are modest compared to the historic booms that helped Sydney home prices soar by 64.4 percent in the five years to January 2018, and Melbourne prices by 56.4 percent.

According to [CoreLogic analyst Cameron Kusher](#), "Any significant reduction in housing costs back to historic premiums would take a long period of declines or flat housing market conditions...however, it seems unlikely, given the economic strength and populations of Sydney and Melbourne, that the value premium of housing in these two cities will revert to historical levels".

## The Impact of Foreign Investors

While the Australian government has restrictions around the number of foreign buyers invested in the marketplace, some reports estimate that over the last several years foreigners were [buying over 18% of new homes and over 8% of resale/existing/established homes](#). If those numbers are accurate, foreign buyers had a big impact on Australian home prices.

Nevertheless, the foreign buying frenzy seems to have faded and is a primary reason home prices in Australia softened over the last several years.

## What's Happened?

In response to prices that have been rising rapidly for several years, authorities have deployed a range of macroprudential policies to slow credit growth and cool the housing market.

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**Examples:**

- In late 2014, APRA required that banks cap the annual growth rate of loans to individual real estate investors to 10% from close to 20%
- In early 2017, it required that banks limit interest-only loans as a share of mortgage underwriting flow to 30%, down from about 40%<sup>1</sup>.

Those policies, coupled with reduced foreign buyer activity, and mortgage underwriting changes, set the stage for the deepest and fastest [Australian housing price decline in more than a decade](#).

And according to some economists, this is only the beginning.

Shane Oliver, chief economist at AMP, estimates that the worst is yet to come for Sydney and Melbourne signaling that the two cities [could fall somewhere around 25%](#).

### **Housing Affordability a Key Political Issue**

While the property market may be cooling and home prices are declining from their peak, at the bottom of the housing ladder, not much has changed for renters -- leaving many feeling doomed to pay someone else's mortgage forever.

Many potential first-time homebuyers have involuntarily put off home purchases, in large part, due to the run-up that saw home prices increase faster than many could save a sufficient deposit required to obtain housing finance.

Further complicating matters, a study conducted in response to the '[Immigration and the Housing Affordability Crisis in Sydney and Melbourne](#)' found that the approaches of the Australian government to curb the housing affordability crisis actually ended up favoring established homeowners over those trying to enter the market.

### **Reduced Foreign Buyer Activity**

As mentioned, weaker overseas investment demand is another important reason for the housing price declines. Foreign demand, primarily from China, grew rapidly between 2013 and 2016 and accounted for an estimated 15%-25% of new home purchases in Sydney and Melbourne over that span.

To curb demand, governments in Victoria and New South Wales, the most populous states, raised their stamp duty rate applicable to foreign investors. Victoria hiked its rate to 7% from 3% in 2016, while New South Wales raised its rate to 8% from 4%.

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<sup>1</sup> [\\*30% interest-only cap was scrapped after 19 months](#) after hitting a low of 15% in December 2018. This shows APRA's responsiveness to conditions. APRA will continue to review lenders' internal risk controls.

Land tax surcharges for foreign and absentee homeowners also increased. Foreign investments in residential property plummeted by 66% during the fiscal year ended 30 June 2017, compared with the year before.

In May of 2017, the Australian Government announced a range of reforms designed to reduce the pressure on housing affordability and, in turn, put “Australians first for Australian housing”.

A measure was proposed that [temporary tax residents would no longer be exempt from capital gains tax \(CGT\) when selling their main residence](#) -- although the rule was made subject to grandfathering for existing properties held on the date of announcement and disposed of on or prior to June 30, 2019.

As of May 2019, there has been no official determination as to whether the proposed bill will proceed as is (or ever) -- as indicated by the response of Assistant Treasurer Stuart Roberts to a question on the subject at the Tax Institute’s National Conference, in which he stated: “*Sometimes things get announced and don’t get progressed and it’s just best to leave it that way*”.

Rules prior to May 8, 2012 provided an exemption from CGT for non-residents where a gain was made on the disposal of a dwelling where it was an individual’s main residence throughout their ownership period.

The main residence exemption rule also provided a partial exemption if the dwelling was the individual’s main residence for only a part of their ownership period or if it was also used partially to produce rental income during their ownership period.

### **Current Status:**

Legislation enabling the [removal of the CGT main residence exemption](#) from foreign residents was originally scheduled for debate on October 16, 2018, in the Senate. However, the legislation was withdrawn from discussion by the Government and it currently seems unlikely that it will be considered prior to the next Federal election in May, 2019.

Among the other measures were additional taxes -- such as the "ghost house" levy -- for foreign owners of Australian property in cases where the property is neither occupied or genuinely available for rent for at least six months of the year.

A [withholding tax on payments made to foreign residents who dispose of taxable Australian property](#) has been increased from 10% to 12.5% of the sale value, and its threshold lowered from only affecting properties valued above \$2 million to a \$750,000 threshold.

### **Mortgage Underwriting Changes**

Australia has always taken a regulatory approach to overseas property investors, however, in December 2015, following growing concern that Chinese buyers were driving values up and pricing first home buyers out of the property market, the Australian Government introduced a raft of new laws to [make it tougher for overseas investors to purchase Australian property](#).

Under the new laws, non-resident non-Australian citizen buyers can only purchase new properties, not established ones. Non-resident non-Australian citizens who purchase property in Australia without first seeking approval from the Foreign Investment Review Board (FIRB) also face fines of up to \$135,000, three years' imprisonment or both. Companies breaching these rules can be fined up to \$675,000, while buyers' agents and real estate agents who help foreign buyers violate these rules also face stiff penalties.

In addition to these strict conditions, foreigners who want to buy an Australian investment property must pay an application fee of \$5,000 for properties valued under \$1 million, and \$10,000 for properties over \$1 million. It then increases by \$10,000 for each additional million dollars in property value<sup>2</sup>.

These legislative changes were closely followed by some of Australia's biggest banks (Commonwealth Bank of Australia, Westpac, NAB and ANZ) [imposing stricter lending conditions on borrowers](#), making it harder for customers to borrow money.

In fact, ANZ and Westpac stopped offering home loans to non-residents altogether, while NAB dropped its maximum loan to valuation ratio (LVR) to 60% – meaning overseas buyers need a deposit of at least 40% in order to get mortgage financing.

Commonwealth Bank also announced that it would no longer accept home loan applications from temporary residents who don't earn an income in Australia.

While the process might sound tricky for Non-Resident Australians to navigate, it is actually very smooth once you have a solid grasp of the rules and regulations that apply to foreign buyers.

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### **\*Dependence on China's Economy**

Australia's dependence on Chinese money has been a blessing for the local economy, but it could unravel if China's economic slowdown worsens.

Given that China is the world's second-largest economy, its slowdown is expected to have a ripple effect across the world. This will be acutely felt in Australia considering that one-third of Australia's exports are shipped to China, given that China is by far Australia's largest trading partner, contributing \$194.6 billion worth of imports and exports. This was more than the combined value of trade with the next closest trade partners (Japan and the United States) which totaled \$147.8 billion.

In addition, Australia remains globally competitive with regards to Foreign Direct Investment from China as it is [the second largest recipient of accumulated Chinese investment](#) -- only behind the U.S. -- with under \$100 Billion USD since 2008.

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<sup>2</sup> Paying this fee also does not guarantee that a buyer will be able to purchase the property they want.

## Estimating the Downside

Since peaking in July 2017, residential property prices in Sydney and Melbourne have fallen the furthest, with some analysts expecting a further decline of [10% on a national basis through 2019](#), with a forecast of a total decline of 15% in Sydney and 10% in Melbourne. That said, experts don't envision a housing market crash in Australia that is severe enough to threaten broad financial stability.

In contrast to the key drivers of the U.S. housing crisis a decade ago, Australia has not seen a surge in subprime loans where money was lent to homeowners who often had "no income, no job, no asset" (NINJA loans). Secondly, these Australian mortgages are full recourse meaning homeowners cannot just turn the home back over to the mortgage lender just because the house value falls below their debt. In the US this phenomena pushed home prices even lower as banks out foreclosed properties back on the market.

So far, the housing price correction appears purposely induced by proactive macroprudential policies, which suggests that regulators maintain decent control over the severity of the decline and have room to soften their stance if necessary.

However, the risk of even greater declines cannot be ignored given the possibility of a global trade war, lending conditions becoming overly restrictive, and a change of government seeing the removal of tax breaks on negative gearing and increases in capital gains tax.

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