THE REAL STORY BEHIND THE RATE CHANGES PART 2

Written by Strategic Financing, 3rd August 2015

It was not too long ago that we released an article deconstructing the RBA decision in decreasing interest rates and made a few predictions around the role of APRA in influencing the banks investment lending policies. It would seem that these predictions eventuated and recent events have created a need to elaborate on this topic.

The week just passed has brought with it a significant turn of events in the lending arena and bank policy. It would seem that in addition to the measures previously adopted, APRA are pushing for further measures for prudential practices in regards to investment lending.

To recap events:

- CBA, ANZ and Macquarie reacted fairly quickly in implementing a premium to the cost of investment lending.
- NAB announced that they will add a 0.29% premium to all interest only loans, regardless of the purpose being investment or otherwise.
- AMP completely shut down all investment loans and pulled their direct to SMSF product.
- Nearly all other lending institutions have since fallen in line and passed on a form of interest increase between 0.27-0.29% to all investment borrowings.

The rationale behind these measures and the resultant increase in cost of funding; is the tightening of capital adequacy requirements imposed by the governing authority APRA, on the basis that banks balance sheets are too exposed to speculative investment and do not demonstrate sufficient strength to cope with a possible downturn in residential asset values. The regulator aims to restrict the exposure by limiting the annual growth of bank loan books to investors at 10%. As a result we are observing generally collusive behaviour amongst the banks in pricing, however, where they are becoming increasingly divergent is in regards to lending policies, as they have no realistic avenue in growing their investment balance sheets. The significance of this is that a restriction on funds flowing into the housing system will definitely place pressure on the demand and trends in asset values. The real unquantified variable is the true concentration of overseas investment within the residential market.

It will be interesting to see what happens with the Westpac Group in the coming weeks, a few days ago they had announced they would need to hold back on imposing a margin to investor lending for up to 7 months due to a technical glitch in their systems, leaving some to speculate that the bank was acting in defiance of APRA, however the bank announced last Friday that they have managed to somehow resolve the issue. More significantly; it has recently surfaced that Westpac is under scrutiny for its policies towards non-resident investors. As published in the AFR, a leaked communication between Westpac and a small network of brokers dealing predominantly in high volumes of non-resident applications read;

"All future home lending applications that you submit to Westpac must contain a primary application that has an Australian residential address." A Westpac spokesperson said *"the bank was reminding brokers to operate within the FIRB rules."*

Questions may be raised as to why only certain brokers received this communication and the rationale in identifying them from the wider channel, although one thing is certain; Westpac is the most significant financer for Non-resident lending in Australia, therefore changes in their appetite for this business, whether voluntary or in-voluntary, will have a significant impact on Non-residents being able to complete pre-committed purchases of new development stock over the next two years. There will no doubt be a flow-on effect to values of new residential property. Most active developers in the Sydney residential market are not established enough to remember what happens when off-the-plan purchasers are unable to complete on a wide scale due to finance. Anecdotally one of the largest privately-owned developers in Australia reported in the quarter ending March 2005, that over 30% of sales were unable to complete settlement due to a 5-10% retraction of residential values and the resultant requirement for additional capital commitment.

If one thing is clear, it is that the current events appear to be carefully orchestrated. This is further exemplified by the lack of political commentary on the imposed changes, it was only 12 months ago that Joe Hockey was highly vocal on the decision by CBA to retain 0.05% of the RBA rate cuts and now we have all major lenders increasing their margins by 0.27-0.29% and we have complete silence. It would seem that the current state of play has not come as a surprise to any of our policy makers.

Q&A WITH PAUL MIRON

Are we predicting that there is a 'property bubble' about to burst in Sydney?

It is quite popular for property commentators to speculate on boom and bust periods in order to draw attention to themselves through over-sensationalised opinions. My personal view; is that these are typically triggered by an unpredictable precursor such as a share market crash, war or terrorist attack and as such it is inherently difficult to forecast specifically when they will occur.

The term bubble creates a misconception that a market cannot cope or recover from a detrimental provocation. If the market fundamentals are sufficiently strong the event may be succeeded without much economic collateral, resulting in a temporary slowdown or period of stability rather than a bust. Our better judgment is eroded by two emotions; Greed and Fear, which accentuate financial outcomes. These two emotions essentially drive the full effect of boom and bust events.

We predict that there will be at least a significant slowdown, on the back of APRA regulations and the ability of proposed off-the-plan settlements to complete, particularly those of non-resident investors and over leveraged first home buyers dependent on mortgage insurance.

The significance of APRA imposed regulations on the market curtails the influence of consumer sentiment and renders speculation of a property bubble irrelevant. Whether the market is over heated or not, APRA believe the time has come to intervene and they have the power to at least cap further growth by restricting the access to funding.

What changes do we expect to occur with mortgages?

We are very certain with this next prediction. At the present moment certain lenders have 'unrestrictive cash out' policies; essentially as long as you can demonstrate a capacity to afford the repayments of a debt, you can borrow up to 80% of the substantiated value of a residential property. There are also a handful of lenders offering similar facilities against commercial securities.

Given the changes that have been implemented this week, it has become uncommercial for the banks to continue to offer this form of facility on a large scale. In order to continue to support this functionality the banks will need to keep funds in reserve in the event a borrower calls on the ability to draw down on the surplus funds. With growing limitations on the availability of funds, banks are credit rationalising their decisions to maximise profits, the commerciality of a decision to commit funds to an undrawn facility makes little sense if those limited funds could otherwise we lent to a borrower with a fully drawn home loan facility, irrespective of the 0.27% increase in interest rate.

We therefore predict that the banks will no longer offer cash-out equity against property securities without evidence of purpose such as a signed contract of sale for a new purchase.

Opinion on interest rates and variable versus fixed at the current time?

We believe that the economic fundamentals are soft and further decaying; which therefore defies the logic for an interest rate increase. If the AUD falls suddenly there could be pressure for the RBA to increase rates as a reactionary measure. If the AUD does not fall and economic fundamentals continue to weaken creating a necessity for further cuts, we believe that the major banks will not pass on the cut in full.

Overall I am generally not a strong believer in fixing interest rates as the full risk scenario has already been factored in well in advance. Having a fixed loan becomes highly cumbersome; in the event there is a necessity to payout the facility the exposure to break costs may be substantial. Most importantly the benefit of a 100% offset account is not compatible to any fixed component of lending. Thus having a variable component to your loans is important, the commercial benefit far outweighs the perceived benefit of securing your interest position. Fixing a loan is like taking a gamble against the bank and general market.

That being said there are clients of particular banks who may find a short term arbitrage in being able to fix their interest rate in the next two weeks and not feel the full effect of the 0.27% increase, whilst possibly enjoying a cheaper interest rate over the next two years if the RBA announces no changes to the official cash rate.

What is the best course of action in response to the recent changes?

The lending landscape has had a significant change in the past three months. Our regulators are demonstrating that they are prepared to intervene and disrupt the free market mechanics that our banks have enjoyed for over 10 years. We should anticipate more counter logical decisions coming through.

Once you have secured a residential mortgage contract the terms other than interest rate cannot be altered unless either the change is requested by the client, or the client is in default, for the life of the contract. These contracts are deemed to be ‘evergreen’.

Therefore to characterise the current state of the market:

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- Residential property values are high, possibly at their peak
- Lenders are currently allowing cash-out against properties without a specific purpose
- Existing loan facilities allow surplus capital to be held in an offset-account at no cost in perpetuity of the facility

Our suggestion is to take advantage of the above and raise as much capital against your existing securities as possible. In the event of a correction, tomorrow's market environment will likely be characterised by lower asset values and a lack of access to funding. The availability of an evergreen facility, ready to draw at the right opportunity in a difficult market can make the difference in securing a timely and favorable acquisition. If you want to enjoy flexibility in using your equity you should consider acting now as there is a significant risk that this functionality will no longer be available for reasons explained above.

We recommend that prior to making any significant financial commitment, a thorough review of your own household financial fundamentals be taken into consideration, involving a careful assessment of cash flow and the availability of sufficient surplus capital to anchor you through any unforeseen bumps in the road ahead. It is human nature to get carried away in a buoyant market in fear of missing out. There is no such thing as luck; there is only good strategic preparation.

Please feel free to contact our office if you wish to make an appointment to have an intelligent conversation concerning your options and the best structure in regards to your financial affairs.

Kind Regards,

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