

THE REAL STORY BEHIND THE RATE CUTS

Written by Strategic Financing, 8th May 2015

Tuesday's decision from the Reserve Bank of Australia (RBA) to yet again reduce the cash rate came as somewhat of a surprise to many, especially to bullish investors of Sydney residential real estate.

In my 20 years of banking experience, the rationale behind an RBA decision has always been associated to a specific economic event with the aim to influence the economy through interest rate regulation. The last two rate cuts have certainly deviated from the traditional logic that we have grown accustomed to.

In the 6 months preceding these decisions the RBA made note of improvement in the traditional economic indicators used to measure the performance of the economy; household confidence has trended well consistently through the latter half of 2014, there has been growth in the availability of jobs, inflation has been around 2.3% with GDP growth trending slightly above a projection of 3% for 2015. This has been the major impetus for confusion among speculators towards recent cash rate announcements.



During the GFC; Australia was commonly portrayed as a 'two speed economy' referring to the substantial boom in the mining sector running in unison with an otherwise struggling greater economy. The net outcome of this was positive as Australia once again defined itself as the lucky country; riding out the peak of the recession comfortably on the tail of the apparently insatiable demand for resources coming out of China.

Consistent with the theory of market cycles the demand for resources has now retracted significantly and although the loss in mining jobs has not been overly substantial, the effect upon the economy is none-the-less creating an impact on the balance of payments by reducing the funds received by the government that had been budgeted to be re-appropriated to capital expenditure and critical projects required to maintain a desired standard of living. As we are in an election year it is unlikely that there will be an increase in taxes to counteract the shortfall in expected income.

The task at hand for the RBA is certainly not straight forward, as the traditional application of its influence on interest rates is having a divergent effect through an unsustainable rise in particular housing markets in context to the fragile wider national economy. The intended respondents to the declining cash rate within the business sector are not absorbing the benefit which is otherwise fuelling the raging inferno of median dwelling prices in Sydney. The contention is in our stubbornly high Australian Dollar making the business sector less competitive internationally, concurrently to strong overseas demand in Australian investment assets.

With the polarity in the different segments within our economy we can presume that the RBA's move to reduce rates will not be enough on its own to suppress the dormant concerns within the economy.

The reduced cash rate and its flow-on effect to interest rates add a certain stimulus to property prices thus resulting in an increase in household debt levels. There also has been much debate concerning negative gearing and how it exacerbates property investment demand. Its traditional effectiveness has diminished with low interest rates and changes to taxation policy over the past decade. The government's capacity to influence the economy as such is greatly hindered not only by the dramatic reduction in income from unrealised mining revenues but also by the current political environment and contention towards changes in taxation policy. The potential abolishment of negative gearing and superannuation tax benefits would not only detrimentally destabilise the property market, but result in political suicide.

Most purchasing decisions made by every day Australians are independent of the macroeconomic considerations noted above and are more reliant on a simplistic cash flow rationale of "*Can I afford the repayment?*" The RBA is mindful of this and factors this concern towards its long term interest expectations to avoid overwhelming incidents of mortgage stress across the economy. The growing divergence in the economy however has led both the RBA and the Government to take a new tact to assess and control the risk in the housing market by applying controls to lending through other regulators such as the Australian Prudential Regulation Authority (APRA). We believe that over the last 6 months a deal has been made in the background between these authorities which we are about to see implemented in the near future.

So what is the likely impact of new regulation to the mortgage market and continuing reductions to interest rates and how it may possibly impact you?

It is certain that RBA intention is to both curb residential investment lending while supporting the business sector, they will defer the responsibility of the residential market to APRA who will work to cool the market through influence and regulation of the banks.

We predict that discussions between the authorities will result in the following possible changes, especially if the cash rate is to be further reduced:

- An interest premium on lending used for investment purposes rather than for the purchase of primary residence.
- Lending over 80% which would typically be facilitated with the use of Lenders Mortgage Insurance will only be permitted with principle and interest repayments.
- Restriction on 'cash out' applications, using equity against your property to withdraw without a specific approved purpose.
- Reluctance of banks to roll over existing interest only loan facilities without significant consideration.
- Loan products will be created which incentivise principle and interest repayments.
- The internal banks hurdle rate will be increased, which will make demonstrating serviceability much harder.
- Restricted lending to Non-residents applicants.

Most lenders has passed on 0.25% -0.20% from the RBA interest cut, with a number of lenders yet to make their announcement. Thus far ING and ANZ have decreased their variable rate 0.25%; Westpac dropped 0.22% with Macquarie, CBA, St George and NAB reducing rates 0.20%. We believe that the coming changes will make the mortgage market much more competitive and will provide much greater credit to the value of structuring and strategy in attaining loan approvals.

We anticipate that the credit policies across the various lenders will diverge substantially and as such the focus on rate will dilute towards a need to structure a deal with a lender policy most complimentary to cash flow.

In conclusion we still believe there are some exceptional investment property opportunities in the market. Borrowers should be prudent in sticking to fundamentals in acquiring quality assets, ensuring their cash flow is sufficient to cover unforeseen events and bedding down the right strategies for you. I hope you have found the above information interesting and useful. Please feel to contact myself or my staff if you wish to discuss further and for us to conduct a review into your specific situation.