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MarketWatch
**Housing fears ease but RBA cautious**

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The risks of a damaging housing crunch had eased, with clear signs of a cooling property market following a crackdown on loose mortgage lending, the Reserve Bank said yesterday.

But in its latest report card on the stability of the financial system, the RBA warned that the accumulated risks to financial stability in the nation's biggest trading partner — China — remain high.

It also cautioned that global markets were underpricing the risk of an economic shock.

While strong economic conditions had improved the health of the global banking system, "very low" yields on long-term government bonds were still causing "elevated asset valuations" and "search for yield activity", so that compensation for risk was "low" for many assets, the RBA said.

"Current asset pricing suggests that investors see little chance of adverse outcomes, and consequently a detrimental shock could lead to a disruptive and lasting correction in a broad range of markets," the RBA said.

An asset price correction could be triggered by a sharp rise in interest rates — if it occurred without stronger economic growth — with a "jump in realised or expected inflation or a change in investors' risk appetite" seen as potential triggers for a jump in rates.

The sobering comments from Australia's central bank came after the biggest falls in global sharemarkets since early 2016. Volatility in shares has surged amid expectations of higher US interest rate and has been sustained by US protectionism and brewing geopolitical risks. A 5 per cent fall in the S&P/ASX 200 share index in the past three months was its worst March quarter since the global financial crisis.

The warnings echoed remarks by RBA governor Philip Lowe in Perth earlier this week that Australia had "a lot riding" on China not fumbling the challenge of lowering risk in its financial sector.

Locally, a slowdown in house price growth, an easing in the amount of lending to property investors and a shift away from interest-only loans have cooled conditions in the Australian housing sector.

The RBA had become alarmed as house prices soared in recent years, fuelled by record low interest rates, population growth, and a scramble by investors for capital growth.

Double-digit house price growth over a number of years had led to Australian households being among the most indebted in the world, at a time of recession-like wage growth.

High household debt to income — up about 30 percentage points to almost 190 per cent in the past five years — "increases the risk of a rise in household financial stress amplifying a shock to the economy", the bank said. The RBA has held its official cash rate at a record low of 1.5 per cent since 2016.

The financial stability review said some banks had reported that mortgage payment arrears had increased for some interest-only borrowers as they switched to principal-and-interest repayments.

One area of potential concern is how borrowers will cope with the end of their interest-only period. Most were due to convert between 2018 and 2021 and the total value of interest-only loans was about $120 billion per year, or 30 per cent of the stock of outstanding mortgage credit, the RBA said.

“The step-up in mortgage payments when the interest-only period ends can be in the range of 30 to 40 per cent, even after factoring in the typically lower interest rates charged on principal-and-interest loans,” the RBA warned.

A number of factors — including borrowers having accumulated substantial pre-payments — suggested that any resulting increase in financial stress should not be widespread, but about a third of mortgages had less than a month’s prepayments, the RBA added.

On a positive note, the Reserve Bank said potential risks posed by the large pipeline of apartment construction in Sydney and pockets of inner-city Melbourne and Brisbane had not materialised.

“In Melbourne and Brisbane, the flow of new additions has peaked and, so far, been absorbed with little disruption to apartment markets, with vacancy rates steady or declining, rents steady or rising, and apartment prices generally only falling modestly.” However, risks remain, with a substantial number of new apartments yet to be completed and some pockets of inner-city Brisbane already experiencing more pronounced price declines.

“The increased share of new housing that is high density, and has a longer planning and development phase, raises the risk of amplified housing cycles as increased supply may not be well timed to match changes in demand,” the RBA cautioned.

The central bank found that settlement valuations in some locations have been below the purchase price, in particular for lower-quality apartments in Brisbane, with reports of increased settlement failure rates and longer settlement times, due mainly to tighter financing conditions for foreign buyers.

“Stricter lending standards for borrowers relying on foreign income have led to some buyers experiencing difficulties raising funds domestically, while tightened Chinese capital controls have made it harder for the many buyers from that country to expatriate funds,” it said.

“Liaison suggests that developers have generally been able to find other buyers at broadly similar prices to those previously contracted, although it is possible that some developers are holding excess stock on their books and so have increased their exposure to losses if prices fall materially.

“In contrast, for higher-quality apartments, which tend to mostly be marketed to owner-occupiers and have better locations and amenities, buyer demand has remained strong and settlement valuations are generally around the purchase price.” Overall, the prudential measures implemented over recent years had led to a general strengthening in lending standards, and the regulatory limits on investor loans and interest-only lending had reduced the build-up of macro-financial concerns, the RBA said.

According to property research firm Corelogic, Australian capital city home prices fell 0.2 per cent in March — their fifth monthly fall in a row. This has brought annual growth down to 0.8 per cent from 11.4 per cent in May last year. Most of the recent house price weakness relates to the bigger markets of Sydney, and to a lesser extent Melbourne.

That cooling in house prices has come in the absence of interest rate increases, making it unusual, according to economists. And while risk isn’t building at the pace it was, concerns about housing remain elevated.Capital city house prices were 27 per cent above their long-term trend and at the high end of developed countries in terms of the ratio of prices to income, but a crash in Australian housing remained unlikely in the absence of a rapid rise in interest rates, AMP Capital Markets warned.

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