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House prices plummet in Sydney: the financialisation of housing comes unstuck

By Alan Morris

1. Introduction

In the decade to June 2017, Sydney (Australia's largest city, population about 5 million) was caught up in a massive escalation of residential property prices; house prices grew by 76.5% in real terms and nominal growth was 111% (Kusher, 2017). The median price of houses in Sydney in June 2017 was $1,178,417, and of apartments, $757,991 (Domain, 2017), making Sydney the second most expensive city globally after Hong Kong. In 2012, there were 159 Sydney suburbs with a median price under $500,000, by October 2017, there were none (Duke, 2017). Almost all of Sydney's suburbs had a median house price of more than a million dollars and in August 2015, the number of Sydney suburbs with a median house price of more than $2 million had doubled in the space of a year. At this time, 40 of the 48 suburbs in Australia with a median price above $2 million were in Sydney (Schlesinger, 2015). There existed what was described as 'a frenzied property market' (Bouris, 2017) characterised by a great fear of not being in the market. An acronym to capture this sentiment emerged, FOMO, 'fear of missing out'.

In mid-2017, the seemingly never-ending surge in the residential property market in Sydney (and Melbourne) came to an abrupt end. By March 2019, Sydney house prices had fallen by 16% in real terms from their peak in mid-2017 (in Janda, 2019) and in April 2019, a report by the rating agency, Moody's, concluded that in the next 12 months prices in parts of Sydney could fall another 15% (in Wright, 2019a). The median house price in Sydney in March 2019 was $1,027,962, a drop of $170,000 from the peak in mid-2017 (Burke, 2019), and the decline has been greater than the decline experienced in the aftermath of the global financial crisis in 2008. Purchases of investment properties have fallen sharply – loans to investors have dropped by about 50% over the last three years (Scutt, 2019). The number of new listing (residential properties for sale) in April 2019 was down 29% on April 2018, probably reflecting a lack of confidence by potential sellers - households are not selling unless they have to. The number of house sales has collapsed to their lowest level since the early 1990s (Wright and Yeates, 2019). In February 2019, the Australian Bureau of Statistics estimated that the total value of new lending to Australian households had declined by 19.8% (Collet, 2019). The slump is affecting all sections of Sydney's housing market and appears to be deepening. In Mosman, one of Sydney's wealthiest suburbs, by May 2019 there had not been one sale in the $10 million plus bracket, whereas in the first five months of 2018, there had been eight $10 million plus sales (Burke and Macken, 2019).

The article sets out to explain the dramatic turnaround in the residential property market in Sydney. The primary argument is that the decline is linked to a serious disruption of the intense financialisation of housing that characterised Sydney's housing market over the last decade. The disruption was mainly due to an increasing fear by the Reserve Bank of Australia [RBA] and the regulators of the financial services industry, the Australian Prudential Regulation Authority [APRA][1] and the Australian Securities and Investment Commission [ASIC],[2] that the price increases were creating an environment fraught with risk.

The article first briefly outlines the features of the financialisation of housing in Sydney. It then examines the reasons for the financialisation of housing creating the 'seeds of its own destruction'.

2. The financialisation of housing in Sydney

A key feature of the financialisation of housing, is that housing is increasingly viewed as a means of accumulation (Aalbers, 2016; Madden & Marcuse, 2016). The massive increase in house prices in Sydney in the 2012 to 2017 period, was premised on the pervasive expectation that house prices in Sydney could only increase and that if a household had the capacity to invest in Sydney's property market, not to do so would be foolhardy. Residential property, in line with the financialisation of housing thesis, was viewed as an obvious and safe site for investment. The intense desire to invest in residential property was given much impetus by an extremely generous tax regime for local property investors. 'Negative gearing' allows investors to deduct losses related to their investment property from their taxable income. Thus, if an investor's mortgage is $30,000 a year and the rent is $1,500 a month ($18,000 a year) and the landlord's expenses are $3,000, they can deduct $15,000 from their overall income for tax purposes ($30,000 - $18,000 plus $3,000). Also, the generous capital gains tax means that when the property is sold, it must be owned for at least 12 months, only 50% of the capital gain is taxed. By 2016, 27% of residential properties in Australia were owned by investors and investors accounted for 47% of the value of 'new mortgage originations' (Corelogic, 2016: 4). Sydney and Melbourne, Australia's two biggest cities, dominated the residential property investment market.

Besides local investors, foreign investors also saw Sydney's residential property as a safe haven. The period 2009 to 2017 was witness to a dramatic increase in foreign investment in

[1] APRA's role is to develop and enforce 'a robust prudential framework of legislation, prudential standards and prudential guidance' so as to ensure that deposit-taking institutions, insurance companies, superannuation funds behave in a prudent fashion and thereby protect the interests of their depositors or clients.

[2] ASIC's role is to ensure that the financial system operates in a fair and transparent and efficient manner by the regulating conduct of companies in the financial sector and financial advisers. APRA and ASIC are in regular contact and often collaborate.

residential property – increasing from $8.77 billion in 2009-10 (Australian Government, 2011) to $34,7 billion in 2013-2014, to $60.8 billion in 2014-2015 and reaching a high point of $72.4 billion in 2015-2016 (Australian Government, 2018). This was despite legislation that confines foreign investment in residential property to new properties only. The increase was driven mainly by Chinese investors entering the Australian residential market as individual investors and as developers. Over the last few years, Chinese, Hong Kong and Singaporean investors have accounted for about a third of all foreign investment in Australian real estate (Fickling, 2019a)

Financial institutions also played a central role in facilitating the housing boom in Sydney. Investors in residential property could obtain loans with relative ease. In April 2017, Australia-wide, interest-only loans accounted for 64% of investor and 23% of owner-occupier loans (RBA, 2017). The ability of borrowers to service the loan was often assessed using a calculation method that overstated the capacity of the borrower. Around 40% of all loans were assessed 'on lower hypothetical P&I [payment and interest] repayments calculated from the entire term of IO [interest only] loans (including the IO period; known as the full-term method)' (RBA, 2017). The Reserve Bank concluded that this method of calculating repayments 'is potentially in breach of the National Consumer Credit Protection Act 2009, which requires that lenders make loans that consumers will be able to repay without undue hardship' (RBA, 2017).

3. Explaining the fall in house prices

The crucial factor contributing to the decline has been the tightening of credit and a shift in the perception that house prices in Sydney can only increase. These changes have resulted in a substantial drop in the number of investors and ultimately a drop in demand and prices. The local dynamics have been compounded by a dramatic drop in foreign investors. In sum, the financialisation of housing created a situation which was viewed as increasingly dangerous for the economy and had to be reined in.

3.1. The tightening up of credit

The housing bubble in Sydney and Melbourne precipitated by the financialisation of housing, was viewed with increasing concern by the Reserve Bank of Australia [RBA]. By 2017, there was a strong view that the astronomical increase in house prices in Sydney and Melbourne had to be reined in. The minutes of the monthly monetary policy meeting of the RBA board at the height of the housing bubble in Sydney in April 2017 (house prices in Sydney had increased 18% in the previous year) are illuminating. They capture the RBA's growing unease with the runaway housing market. There was concern that a proportion of households could find themselves struggling to retain their homes, especially if there was a drop in a household's income for whatever reason, and or an interest rate hike:

Members noted … that some households with home loans appeared to have little or no buffer of excess mortgage repayments and could be vulnerable if household income were lower than expected. This observation emphasised the importance of realistic assessments of household expenses and prudent lending standards for mitigating risks to both financial stability and macroeconomic outcomes (RBA, 2017).

The minutes expressed concern that high-risk interest-only loans were continuing to increase. The increase had taken place despite regulations put in place by the financial regulators, APRA and ASIC in 2014 to slow down the granting of interest-only loans (RBA, 2017).

APRA's guidance had included limits on the share of interest-only loans in new housing loans and a requirement that banks impose strict limits on new interest-only lending at high loan-to-valuation ratios. Members recognised that the calibration of this guidance was not precise or straightforward. Developments needed to be kept under review and, depending on how the system responds to the various measures, members noted that the Council of Financial Regulators would consider further measures if needed (RBA, 2017).

In March 2017, APRA announced that financial institutions needed to restrict interest-only loans to a maximum of 30% of all new residential property loans (APRA, 2017). In a letter addressed to all 'deposit taking institutions', it justified its decision by highlighting 'the heightened risk that has prevailed for the past few years'. The letter went on to state,

the environment remains one of high housing prices, high and rising household indebtedness, subdued household income growth, historically low interest rates and strong competitive pressures … Against this background, APRA views a higher proportion of interest-only lending in the current environment to be indicative of a higher risk profile (APRA, 2017).

APRA's decision was made in a context of increasing concern about financial institutions making risky loans and operating in a high-handed fashion. The behaviour of the financial sector led to an increasingly strong call for a Royal Commission into the behaviour of these institutions. The calls were dismissed by the conservative Coalition government (elected in 2013) on the basis that it would weaken Australia's super profitable and highly monopolised financial sector. In an opinion piece in 2016, Kelly O'Dwyer, the then Minister for Revenue and Financial Services, wrote,

For the Labor Party to propose a Royal Commission into banks is reckless and ill-conceived. Critically, a Royal Commission would go over old ground and would delay well-developed and important reforms, such as lifting the professional standards for advisers. A Royal Commission would send the signal internationally that the government believes there are structural problems with our banking and financial system and could lead to significant repercussions for confidence, international investment, and our AAA credit rating (O'Dwyer, 2016).

Despite intense resistance from the conservative side of politics, further scandals meant that the government was forced to establish a Royal Commission into Misconduct into the Banking, Superannuation and Financial Services Industry in December 2017.

Besides the directive from APRA, the devastating evidence of victims of poor banking practices at the Royal Commission, was a key reason for the tightening of credit by the banks. The Commission received 10,323 submissions from the public. A prime focus of the Commission was irresponsible lending and the final report was highly critical of the financial sector concluding '… conduct by many entities that has taken place over many years … [has caused] substantial loss to many customers but yielding substantial profit to the entities concerned' (Hayne, 2019: 1). The final report went on to state,

Rewarding misconduct is wrong. Yet incentive, bonus and commission schemes throughout the financial services industry have measured sales and profit, but not compliance with the law and proper standards. Incentives have been offered, and rewards have been paid, regardless of whether the sale was made, or profit derived, in accordance with law. Rewards have been paid regardless of whether the person rewarded should have done what they did (Hayne, 2019: 2, italics in original).

Another area of major concern to the Royal Commission was the role of 'mortgage brokers'. Mortgage brokers recruit borrowers for home loans and receive a commission from the

financial institution they link the borrower to. The Commission found that because mortgage brokers were dependent on obtaining a commission from the financial institution concerned, there was a strong incentive to give misleading information to the financial institution in respect of the borrower's borrowing capacity.

If, in practice, brokers were to act in the best interests of borrowers, there would be fewer cases where brokers act in ways that see lenders given wrong or incomplete information about the financial situation of loan applicants (Hayne, 2019: 72).

Although the financial institutions and mortgage brokers bore most of the criticism, APRA, the financial services regulator, was also heavily criticised by the Commission for its weak regulation and failure to deal with serious breaches. Following the Royal Commission, APRA instructed the banks to tighten up on lending. ASIC, whose role is to ensure that corporations behave ethically, announced that it will embed supervisors within the big four banks. The deputy chairperson of ASIC commented that the Royal Commission signified a 'societal shift" in public expectations of corporations and had granted ASIC the capacity to apply tougher penalties if rules around responsible lending laws are breached. He warned that 'We will … need to apply them because otherwise they are an abstract concept'. Another deputy chairperson of ASIC referred to the need to cut out what she described as 'toxic revenue' (in Yeates, 2019).

The mauling the banks received at the Royal Commission meant that they were willing to comply with the stricter regulations around lending. In 2018, the number of loans taken out to buy a new home or apartment dropped nationally by 18.7% and total loans in New South Wales dropped by 11.3% (Wright, 2019b). The director of a leading mortgage broker claimed in July 2018 that, 'Up to 20% of people who took a loan out two or three years ago would not qualify for that loan today. In the last six months lenders have had this lightbulb moment of what 'responsible lending means' (in Pedersen-McKinnon, 2018).

Loan approval times lengthened as lenders spent a lot more time ascertaining whether the borrower had the requisite household income to pay back the loan. The principal economist of the Housing Industry Association [HIA], the peak body representing developers, complained that the tightening up of loan requirements was having an adverse impact on the housing market: In [the context] of the more restrictive lending environment homebuyers now face, it is clear that the soft lending numbers are as much to do with would-be home buyers having greater difficulty accessing finance as it is about sentiment. At this juncture it will be important for the regulators to monitor the impact of their earlier interventions to ensure that policy settings remain appropriate in the new phase of the cycle (HIA, 2018).

Noteworthy is that in December 2018, the APRA announced that from the beginning of 2019, the restrictions on interest-only loans will be lifted. The announcement was justified by the claim that APRA's actions have resulted in financial institutions significantly improving their lending standards and reducing higher risk lending (APRA, 2018). It would appear that the main motivation for the decision was to stem the substantial drop in residential property prices in Sydney and Melbourne (Hutchens, 2019).

3.2. The drop off of local and foreign investors

The tightening up of bank lending and the increased scrutiny of credit worthiness of potential borrowers has had an impact on demand despite record low interest rates. Since peaking in 2017, investor loans have fallen by 45% in value (Scutt, 2019). Besides the tightening of credit, investors are now wary of entering the Sydney property market amidst much talk that it could fall further.

Local investors had also been discouraged by the proposed policy of the opposition Labor Party to restrict negative gearing to new properties only and revamping the capital gains tax by reducing the 50% discount to 25% if it had won government in May 2019. These policies would have been 'grandfathered' so they would have only applied to properties acquired after the 1 January 2020. The shadow treasurer justified the policy, by referring to the role negative gearing and the generous capital gains tax have played in the financialistion of housing:

Labor wants to create the conditions that promote home ownership, not a system which promotes a nation of property oligarchs and renters. The stronger growth for investors accumulating multiple investment properties is just another indication of the 'excesses' in negative gearing … (in Wright, 2019c).

There is a possibility that the failure of the Labor Party to win back government, could result in investors returning to the market in large numbers. Potential investors will be aware that the possibility of negative gearing being restricted or a less generous capital gains tax ever being put in place, is now remote.

As illustrated, in the last decade there was a phenomenal increase in foreign investment in residential property. However, the reversal of foreign investment has been as dramatic as the rise. Foreign investment in residential property in Australia fell from a high of $72.4 billion in 2015-2016, to $30 billion in 2016-17 to $12.5 billion in 2017-2018 (Australian Government, 2019). The number of residential real estate approvals dropped from 40,169 in 2015-2016 to 13,198 in 2016-2017 (Australian Government, 2018).

A key contributor to the decline has been the crackdown by the Chinese government on capital outflows. Chinese citizens can send out a maximum of $US50,000 a year, and the monitoring of endeavours to circumvent this limit has increased significantly (Smith, 2018). A senior researcher with the Bank of China commented, 'The overseas property investment will be more rational in the future. There could be an impact on the Australian property market due to shrinking demand from China' (in Smith, 2018). Overall Chinese investment in Australia declined from a high of $47.3 billion in 2015-16, to $23.7 billion in 2017-18 (Australian Government, 2019).

Noteworthy is that Ausin, a real estate company based in Shanghai and used by Chinese investors to purchase properties in Australia, went into liquidation in August 2018, resulting in around 130 failed residential property settlements in Australia, mainly in Sydney (Tan, 2018). Chinese investors paid Ausin in yuan for Australian properties and the company would then circumvent China's foreign exchange restrictions and purchase residential property in Australia. In a further blow to the Australian residential property market, at the beginning of 2019 it was reported that there had been a major assault on 'underground banks' that have been used to take money out of China for property purchases. Operators of underground banks face jail terms of up to five years and massive fines (Smith and Tan, 2019). Historically, underground banks have played a central role in channelling billions of dollars out of China for investment. Despite the substantial reduction in Chinese investment in residential property, China remained the largest source of foreign investment for residential real estate (Australian Government, 2018).

In Australia, legislation was put in place that also appeared to have had an impact on foreign investment in residential property. In December 2015, an application fee was introduced for foreign investors. In May 2017, an annual vacancy charge was introduced for properties bought by foreign investors and left vacant for more than six months in a 12 month period. Also, a 50% cap on pre-approvals of foreign ownership in new developments was put in

place in 2017 (Australian Government, 2018). Finally, there has also been a tightening up of compliance in relation to the foreign investment regulatory framework. In 2015, the management of the compliance regime was taken over by the Australian Tax Office [ATO]. The ATO employed 57 people whose sole activity is to scrutinise residential property investments by foreign investors (Australian Government, 2018). In 2015-2016, the ATO identified 260 breaches of the framework and in 2016-2017, 549 (Australian Government, 2018).

3.3. Weak demand

In March 2019, it was reported that 8,000 homes in Sydney had been on the market for at least a year (Wright & Bagshaw, 2019). A combination of factors has contributed to the substantial fall-off in local and foreign demand for residential property in Sydney. The realisation that capital growth was definitely no longer a given was clearly the key factor weakening demand. Now that capital growth is no longer certain, the low rent yield has come into play. Prior to the downturn, investors in Sydney were not overly concerned with the state of the rental market, the focus was on capital gains. Now that prices are falling, rental yield has become far more pertinent. In February 2018, rental yields were 3.57%, the lowest in 12 years, and there is little inducement for investors to purchase on the basis that the property will yield a good rental income (Burke, 2018).

This has all come about in a context of a large increase in supply. In 2018, 28,000 new apartments came onto the market and another 26,300 will be completed in 2019. (Fickling, 2019b). Developers are finding it difficult to sell newly completed apartments. Symbolic of the difficulty, at the beginning of 2019 receivers were instructed by a bank based in China to sell 61 apartments in one line in a newly completed, multi-storey apartment block. The developer managed to sell 69 of the 130 apartments, but could not dispose of the remaining 61 (Johanson and Cummins, 2019). The acronym FONGO, fear of not getting out, has emerged to capture a growing anxiety amongst investors, especially those who bought at the height of the boom (Yeates, 2018).

Although, Sydney house prices have dropped substantially, prices are still extremely high relative to household income. For a large proportion of first time home-buyers, it is still exceptionally difficult if not impossible to raise the deposit for a home in Sydney without financial assistance from family. A major factor is low wage growth. For the last seven years, wage growth has barely outstripped inflation. Thus, whereas wage growth in the 2007 to 2012 period was about 3.6%, in the period 2012 to 2017 it was about 2.2%. Real wage growth has averaged about 0.4% in the 2012 to 2017 period, whereas it was about 1% in the decade previously (Australian Government, 2017). In the five-year period, 2012 to 2017, house prices in Sydney almost doubled, effectively locking many young people out of the housing market. In Sydney, the home ownership rate for persons aged 18 to 39 plummeted from 29.2% in 2002 to 19.7% in 2014 (Wilkins, 2017).

In addition, although the official unemployment rate is low, around 5%, the rate of under-employment is high. Since the global financial crisis under-employment has increased from 6% to 8.3% in September 2018 (ABS, 2018). To save for a deposit for a home in Sydney, it is essential that at least one member of the household is employed full-time. The weakening of the financialisation of housing has certainly made it easier for first-time homebuyers in Sydney to enter the market. A recent first home buyers report concluded,

> First-home buyers [in Sydney] are operating in a market that has less urgency to purchase – there are fewer investors to compete against, foreign buyer interest has declined, prices are still falling and there are a wider choice of homes on the market. Purchasing conditions have inevitability improved (Powell, 2019).

However, for many, the Sydney property market remains elusive. Thus, nation-wide (Sydney specific data was not available), despite the drop in prices, in December 2019, new lending to owner occupiers fell 6.4%, outpacing the 4.6% drop in loans to investors (Collett, 2019). In 2018, new lending to households dropped 19.8% (Collett, 2019). In September 2017, the Housing Industry Association's housing affordability index reported that in Sydney it takes more than two average full-time salaries to service a mortgage for an average home (in Wade, 2017). Although prices have declined, they have dropped from an extremely high level, and it likely that for many Sydney households, entering the housing market remains an impossibility.

4. Conclusion

The decline in house prices in Sydney from mid-2017 ended what was an intense housing bubble premised on the financialisation of housing. The mad scramble by local and foreign investors for Sydney residential property, ensured a massive escalation in Sydney house prices. The scramble was greatly facilitated and encouraged by easy access to credit in a context of low interest rates and an extremely generous tax regime for investors. The end of the boom was primarily precipitated by the RBA, the financial regulators and the general public in the wake of the Royal Commission into the financial sector. They put pressure on lenders to be more stringent. The more stringent lending regime coincided with a dramatic drop in Chinese investors. The latter added to the perception that the Sydney housing market was no longer a foolproof investment.

It is unclear what the future holds for Sydney's residential property market. Although prices have come down substantially, house prices are still extremely high relative to income. The re-election of a Conservative government in the federal election in May 2019, means that negative gearing and a generous capital gains tax are no longer under threat. Also, there will probably be a further loosening of regulations around lending, and a lowering of interest rates by the Reserve Bank is now viewed as inevitable (Wright, 2019d). In combination, these factors could result in a rekindling of investor interest in the Sydney residential market and the associated negative features – speculation and absurd price rises.

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