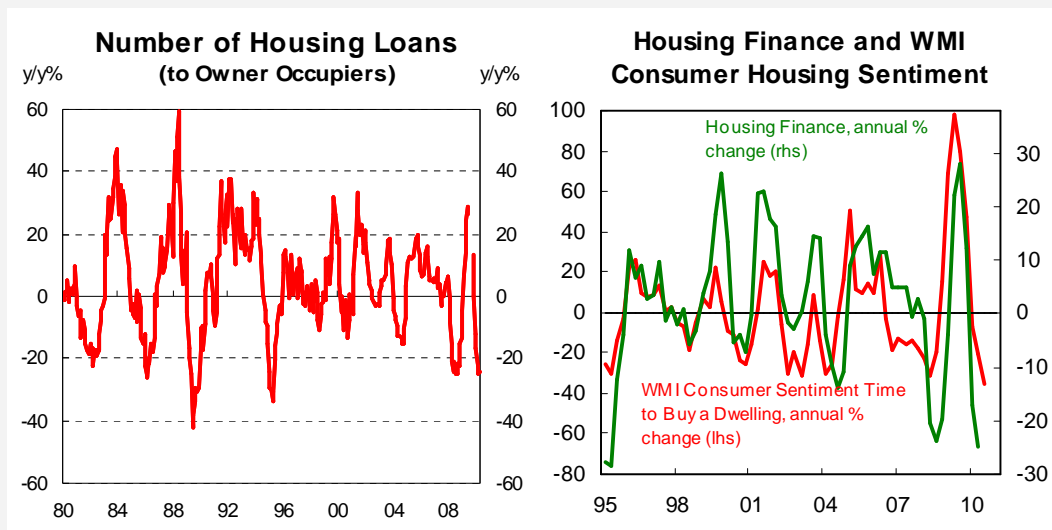


# RESEARCH REPORT

## Housing Finance: entering an interesting juncture Thursday 15 July 2010

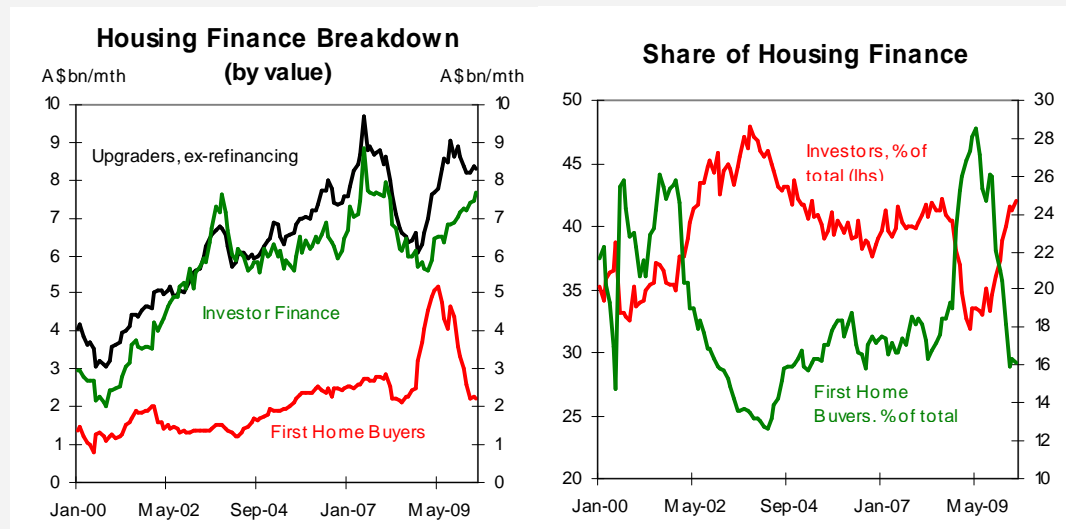
- Housing finance has now contracted in nine out of the last eleven months. For the year, owner occupied housing finance is down more than 24%. Finance approval numbers to owner-occupier are now down 24% in seven months.
- However, housing finance strengthened in May, rising for the first time in seven months. A month does not make a new trend and we still have to see if this resilience in housing finance is not just a flash in the pan, or rather something more enduring. The strength of the labour market and the recent moderation in fixed term rates are positives. But the fading of the first-home buyers grants and the prospect of further rate rises from the RBA are negatives. So while the bulk of the adjustment to first-home buyers has occurred, further declines in housing finance are still possible.
- Finance for construction weakened for the sixth consecutive month, falling 4.8% in April. For the year, finance for construction is down 5.0%. However, finance for this purpose is up 42.3% from the low point touched in October 2008. So the outlook for dwelling construction activity remains robust through most of 2010, although 2011 is likely to see a slowdown in activity.
- On a positive note, the value of investor finance rose 2.6% in May, the third consecutive monthly increase (and the ninth increase out of the last ten months). For the year, investor housing finance is up 17%.



### Housing Finance

Housing finance approvals rose 1.9% in May, the first increase in eight months. But we are conscious that one month does not define a new trend. In particular, with further rate rises expected from the RBA and a dearth of first-home buyers, we remain very cautious on the outlook. First home buyers came to represent a large force in the housing finance figures in 2009, with housing finance to first home buyers hitting a record high in mid-2009, of more than 28% of all housing finance commitments and accounting for more than 40 per cent of total housing turnover. It is also important to note that loans to first-home buyers are, on average, larger than loans to non first-home buyers. The phasing out of the FHOB, higher interest rates and stretched affordability have seen the supply of first home buyers dry up, so while first home buyers inflated housing finance figures in 2009, this year, we've seen the effects of the absence of any new first home buyers, weighing on housing finance and it came off highs. With the decline in first-home buyers, investors have stepped into the housing

market in greater numbers. As such, the bulk of house sales in recent months have been concentrated in the upgraders and the upper end of the housing market.



#### Debt Versus Cash to Buy a House

The upper end of the housing market may be utilising cash to pay for their house purchases, so that housing finance is declining more than turnover would suggest. In its May Statement on Monetary Policy, the RBA notes first home buyers are more likely than other buyers to use debt to purchase dwellings, with around 90% of purchases by first home buyers involving a mortgage, compared to just 65% of sales to repeat buyers. Households who have been in their dwelling the longest are less likely to still have a mortgage, with some of them having already paid off their mortgage. Even those who have not are likely to have accumulated a large capital surplus.

On average over the past 15 years, the HILDA household survey data has indicated that around one-quarter of dwelling transactions do not involve a mortgage, although this would vary over time. Given first home buyers are more likely to utilise a mortgage than repeat buyers, it follows as likely that housing finance was boosted by the number of first home buyers, and then fell away, as first home buyers left the market and repeat buyers filled the gap in the housing market, with repeat buyers far less dependent on mortgage to finance their purchases. This explains why in recent months we have seen a bit of a disconnect between what the housing finance numbers are telling us (less finance activity) and what the housing market numbers are telling us (somewhat less activity, although it's holding up well, particularly in those markets less dependent on first home buyers). So, the mismatch between housing finance and other indicators of the housing market, such as housing activity and house prices is being driven in part by compositional shifts in housing market.

#### Composition of Housing Finance

Changes in the composition of housing finance have implications for the housing market. First-home buyers tend to buy less expensive dwellings than other buyers. Hence, as first-home buyers have dropped off, housing market activity in less expensive suburbs has slowed. The difference in the apparent level of housing finance and other housing activity indicators, can also be partly attributed to the fact that housing finance approval numbers often lead, by up to six months, house buying activity and house prices. The sharp declines in housing finance activity over the past six months raises questions about the outlook for house prices.

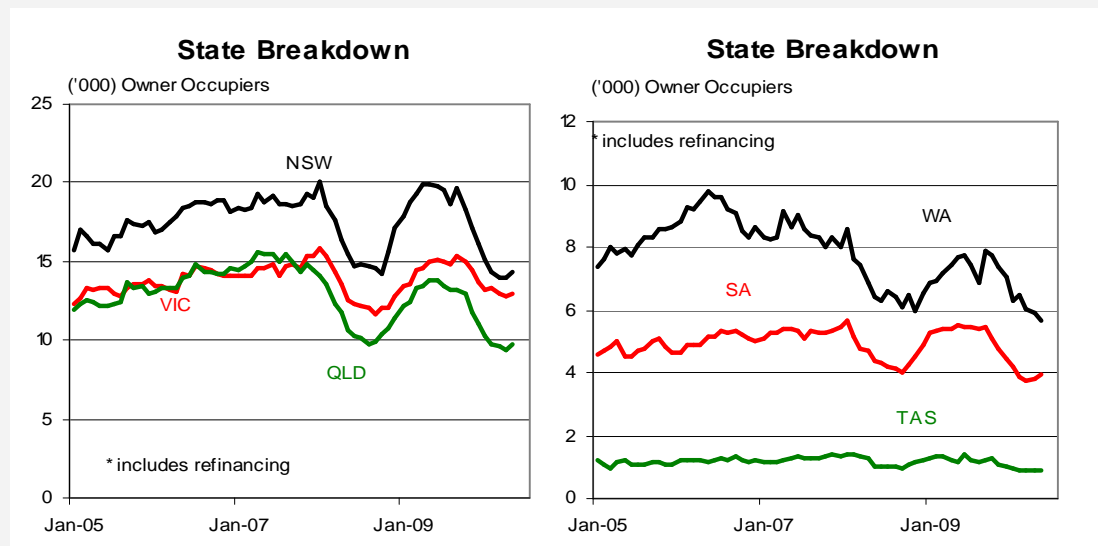
The combination of tighter monetary policy, with higher interest rates from the RBA, and a winding back in fiscal stimulus, with the removal of the Government's first home buyer boost, has clearly begun to weigh on housing finance. Rising house prices have put further strains on affordability for owner-occupiers and thus sentiment towards buying a house (which can be captured by the Westpac-Melbourne Institute time to buy a dwelling index from the Consumer

sentiment survey. However, rising house prices can be seen as a positive for investors who may enter the housing market in search of capital gains. This is a sobering sign for the housing market. Housing finance tends to be a good indicator of housing demand, with a lead of six months. So although house prices have continued to rise through May (with some capital cities showing declines for May), auction clearance rates eased in May, suggesting demand is moderating.

#### Implications for Housing Activity

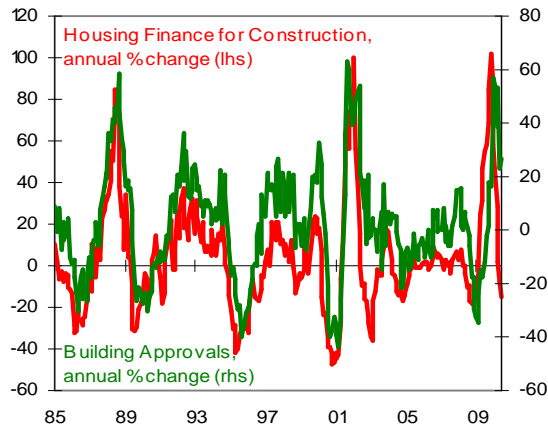
Despite the recent differences between housing finance and housing market activity, due to compositional changes, the sharp decline in housing finance is a concerning sign that bears looking into. While the influx and subsequent exodus of first-home buyers has distorted the housing finance numbers, housing finance excluding first-home buyers has softened in recent months as interest rates have increased. This suggests house prices could flatten in coming months, after having shown sharp increases earlier this year. Housing finance to upgraders is off its 2009 highs, although it remains solid, while home loans to investors have increased since late last year, providing underlying support for the housing market.

This impact may not be evenly felt across, and indeed, even within different capital cities and regional areas, with areas which attracted first-home buyers expected to be more interest rate sensitive, with more people having mortgages, and the mortgages to first home buyers being, on average, larger. On the other hand, some areas have fewer first-home buyers, and also fewer buyers who have a mortgage at all, so these areas are expected to be more immune to higher interest rates.

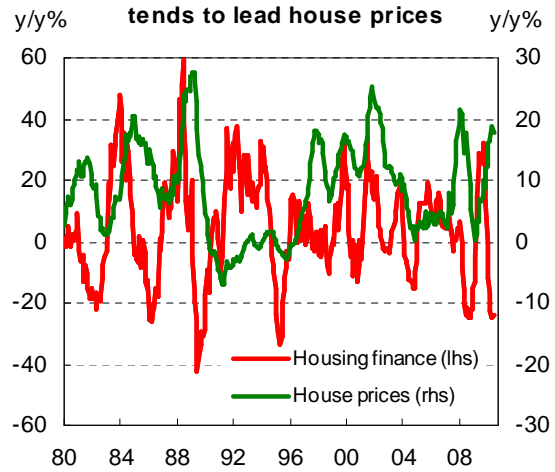


Dwelling starts continued to grow in the March quarter, rising 4.3%, which was a little lower than expected, but follows two very strong quarterly gains (and the December quarter's increase was revised higher.) While these solid dwelling starts should continue to support housing activity for the remainder of 2010, the softness seen in housing finance suggests that in 2011, housing construction activity could weaken significantly.

**Construction Finance and Dwelling Activity**



**Number of Housing Loans**



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