

Campbell, Martin and Housing Finance Regulation: A Review of the Debate

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INTRODUCTION

This paper sets out to review the arguments and evidence used to evaluate the effects of Housing interest rate regulation and deregulation, with reference to the Housing Finance Sections of Chapter 37 of the Final Report of the Committee of Inquiry into the Australian Financial System (hereafter termed the Campbell Report).

In essence the Campbell Report argued that regulation of housing finance was inequitable, ineffective and inefficient. That is, because regulation benefited middle to upper income, rather than lower income earners, it was inequitable (37.69). Moreover, because regulation was generally justified on the basis that it was supposed to ensure low income earners could get affordable - that is cheap - housing finance, yet they did not, regulation was ineffective (37.33). Finally, to the extent such assistance resulted in higher house prices due to the capitalization of subsidies (p.643, note 24), and distorted the flow and cost of finance due to price control (37.26 and 37.76) it contributed significantly to inefficient allocation of resources. In short the Campbell Report argued that there was "no justification for retaining interest rate controls as an instrument of housing or welfare policy" (37.77), rather assistance to facilitate "home ownership (or house rental) ... should be dispensed fiscally rather than through regulation of interest rates or credit controls" (37.105).

The Report of the Review Group into the Australian Financial System (the Martin Report) concurred with the Campbell Report on these matters. As the Martin Report offered no new substantive evidence on these issues, only minimal reference will be made to this document.

The paper will first discuss the effects of regulation by examining:

- (1) Who saves where?
- (2) Who gets housing loans?
- (3) The extent and effect of supplementary secondary borrowing on the effective cost of housing finance.
- (4) The overall effects of regulation.

The next part of the paper discusses the postulated (and where possible subsequent actual) effects of deregulation in terms of:

- (1) Efficiency
- (2) Cost of Housing Finance
- (3) The need for new Lending Instruments

The concluding section summarises and pulls together the various aspects of the debate on deregulation of housing finance in relation to their implications for future housing policy.

EFFECTS OF REGULATION

The three areas examined here relate to the issues of financial portfolio allocation practices of various income groups and whether or not those who save with regulated financial institutions receive the benefits of below market regulation interest rates on home loans. That is, do those who bear the costs of financial regulation - less than market rates on their savings - benefit by receiving sufficient proportions and quantities of below market cost finance? In more specific terms are the characteristics of regulated financial institution depositors and borrowers comparable, and is the overall cost of regulated finance offset by the need to borrow large amounts of supplementary housing finance from expensive non-regulated sources?

- (1) Who saves where?

The Campbell Report, on the basis of a selection of data derived from a part of the consultancy report prepared by Yates (1982a), concluded "that lower income earners hold a considerably greater proportion of their wealth in savings bank passbook accounts than do higher income earners" (37.74, and Table 37.3).

While the report also noted that "the trend is much less evident in the case of savings with building societies" (37.74), it seemed to imply that the above was sufficient to suggest that the impact of regulations on deposit rates with Savings Banks was regressive.

However this conclusion was derived from only one of the three following sets of data analysed by Yates.

- (i) The 1966-68 Macquarie Survey of Consumer Expenditures and Finance
- (ii) The 1977 ANU Survey based upon households who had moved into or within Adelaide since 1976.

(iii) The 1980 McNair - Anderson survey commissioned by the Campbell Committee.

The first two sources contained data on holdings of financial and other assets (ownership of property etc.), whereas the third was restricted to financial assets only.

The Campbell Report's conclusion was based on Yates "preliminary" analysis of the 1980 data source which she noted "... contrary to both the Macquarie and ANU results, give some indication that low income groups do hold proportionately more in savings accounts (or in savings plus cheque accounts) than do higher income groups" (Yates 1982a:187).

Interestingly, whereas in the Macquarie data equity in owner-occupied housing was dominant across all income groups, in the McNair-Anderson survey, which was restricted to financial assets, savings bank and cheque accounts were dominant for all income groups (Yates 1982a:184).

In all three surveys the range of assets holdings diversified as income rose. But with the 1966 and 1977 surveys there was no statistically significant relationship between income and proportions of assets in Savings Bank accounts (Yates 1982a:168, 175, 177, 178). Moreover in these as well as in the 1980 data, any tendency to regressivity tended to be related to life-cycle factors (p174, 177, 187). That is older households tended to hold relatively larger proportions of assets in Savings Banks, but as Yates noted "these households represent a large proportion of low income households, they are not necessarily asset poor ... it is only low income renters who

are asset poor." (P.174). In short, while the old might hold a large proportion of their financial assets in Savings Banks, most of these will have benefitted from below market Bank interest rates on home loans when they were younger.

Yates concludes her analysis of these three data sources on this matter thus:

the argument that regulation has regressive effects is not supported conclusively because of the contradictory evidence from the various surveys. There is, however, considerable and consistent evidence to suggest that any tendency for it to be regressive is significantly affected by life-cycle factors. (p.197)

Thus while the Campbell Report may have relied on the most recent data source, they seemed to have adopted a somewhat cavalier attitude to the analysis and conclusions of their rather detailed consultant's report on these matters.

(2) Who gets Home Loans?

On the basis of data culled from Yates' consultancy report and presented as Table 37.2 the Campbell Committee concluded that "... the flow of funds from housing finance institutions is skewed against lower income earners and favours higher income earners" (37.69).

Table 1 reproduces the data presented by the Campbell Report in Table 37.2 (columns A, C, E, F and H of Table 1), together with additional data derived from Yates consultancy report



(columns D & J) and the Victorian Home Finance Survey (HFS) (1982) (Columns G and I).

Unfortunately data from the Victorian Home Finance Survey was not available to Yates when she was preparing her consultancy report. This very comprehensive data source would have been much more suitable than the type of data Yates had to rely upon. The Victorian survey covered virtually all applicants for housing finance throughout Victoria in March 1980. It consisted of 5,808 valid questionnaires with 220 variables from 40 questions. All home finance institutions were included. By comparison Yates had to rely upon survey data collected from a

selection of public and privately owned Banks in Victoria and NSW together with "fragmented data provided by the Australian Association of Permanent Building Societies" (Yates 1981a:231) and data on government lending in NSW from the Home Purchase Assistance Program funded under the Commonwealth-State Housing Agreement.

All of this meant that her analysis was based on data collected at different times, by different people, on different bases, without the comprehensive mix of income, demographic and housing variables included in the Victorian survey.

Table 1

Comparison of Total Adult Population and Housing Borrower Income Distribution 1979-80.

A	B	C	D	E	F	G	H	I	J
Income Range	as % of all	as % of income house-holds		% of savings borrowers			% of PBS borrowers		H/H income of renting h/holds
\$	of AWE	units	holds	NSW	VIC	VIC (HFS)	NSW	VIC (HFS)	
<185	<75	45.1	27.0	3.4	3.2		4.3		31.1
186-245	76-100	13.0	12.3	10.3	9.6	19.1	12.4	14.1	14.4
246-325	101-133	15.5	16.6	18.4	21.8	20.2	21.8	16.9	17.5
326-385	134-157	7.7	10.8	18.6	13.8	32.1	15.9	33.9	10.0
>385	>157	18.7	33.4	49.3	51.6	28.6	45.6	35.1	27.7

NOTES:

- Columns A,C,E,F & H are from Table 37.2 of vol. 1 of the Campbell Report.
- Column D has been calculated from data in Yates' Table 12, part 2, of her consultancy report to the Campbell Committee (vol.4), on the same basis as that used by the Campbell Committee in calculating Col B (see notes to Table 37.3 of the Campbell Report).
- Columns G & I are from Table 5.1 of 'Home Finance Survey'. The income categories in the 'Home Finance Report' refer to 'TOTAL INCOME' of the applicants. The categories are approximately equal to 'LOWER'= 100% AWE, LOWER-MIDDLE = 100-133% AWE, UPPER-MIDDLE = 133-180% AWE, UPPER => 180% see Table 3.6 of that report for details.
- AWE was \$247.90 in 1979-80. The value of \$245 has been used above for simplicity.
- Column J is derived from Yates' Table 13, which is based on the 1975-6 Household-Expenditure Survey, updated to 1979-80 values. The conversion of Yates' data to be comparable with Campbell's categories was carried out in the same as referred to in Note 2.

Table 2

Total Income of Borrowers by Source of Finance.

TOTAL INCOME CATEGORY	BANKS	PBS	GOVT.	OTHER		ALL INSTITUTIONS
LOWER	42.0%	8.9%	43.1%	6.0%	100.0%	25.0%
LOWER-MIDDLE	57.8%	13.9%	21.0%	7.3%	100.0%	19.2%
UPPER-MIDDLE	54.9%	16.6%	23.1%	5.4%	100.0%	32.1%
UPPER	66.1%	23.3%	2.9%	7.7%	100.0%	23.7%
ALL INCOME CAT.	54.9%	15.8%	22.9%	6.5%	100.1%	100.0%

Source: Table 5.1, Home Finance Survey 1.A.E.S.R.(1981).

To carry out the type of analysis Yates did in her consultant's report using the Home Finance Survey, would be a major undertaking. The report prepared by the Institute of Applied Economic and Social Research (I.A.E.S.R.) does some of this. However, the data categories used by Yates and the I.A.E.S.R. were not always identical, so that particularly in regard to income figures, only rough comparisons can be made.

This has meant for instance that the lowest income category from the Victorian Home Finance Survey (HFS) approximates the two lowest income categories used by Campbell. (See Table 1)

The HFS data suggests that about 20% of Bank borrowers had incomes less than Average Weekly Earnings (AWE) compared to about 13% from Yates data (columns G, F and E in Table 1). Moreover Table 2 suggests that to the extent lower income households were able to obtain home finance, they got it from the regulated lower interest institutions (Banks and Government). While the HFS also shows that middle and upper income households also benefitted substantially from regulated interest rates, the overall pattern appears markedly less regressive than Campbell's use of Yates' data.

In addition Campbell appears to have exaggerated the appearance of regressivity by comparing the income distribution of borrowers based on "household income" with that of the population based on "income units". Use of the latter concept, as noted by the Campbell Report (notes to Table 37.2), "has the effect of skewing the income distribution towards the lower end of the income scale". I have attempted to correct this by calculating the income distribution of the population based on "household income" in Column D in Table 1, in a similar manner to that used by the Campbell Report. Why they did not compare like with like, when suitable data was readily available, was not discussed by the Report.

Furthermore, while the report acknowledges that "one would not expect the income distribution of prospective housing borrowers to be the same as that of the total adult population, not least because of differences in age composition..." (37.68), they make no attempt to evaluate the significance of the interaction between age, income and other demographic characteristics of the potential home buying population and the general population. Instead they simply assert, "...that the differences shown in Table 37.2 appear to be too marked to be explained solely in these terms" (37.68). Use of non-comparable income definitions, as well as failure to evaluate the characteristics of the potential home buying population casts doubt on the validity of such a statement. Age is only one such characteristic. Yates (1982b:64) for instance, notes that Bethune's study based on

Australian data found marital status to be the most significant demographic determinant of the home purchasing population. Studies based on US data also show the importance of demographic variables as "primary determinants of home-ownership". Unfortunately, Yates' consultancy report also did not look at this aspect in much detail. For instance she tends to define the potential home-buying population as all tenant households (eg Tables 13 to 16). Column J in Table 1 is calculated from Yates' data. Interestingly the income distribution of this group is very similar to the income distribution of the adult population based on "household income" (Column J, compared with Column D). This suggests that there is no simple relationship between income and tenure.

To properly evaluate the size of a realistic potential home-buying population would require a considerable amount of manipulation and analysis of Census or Household-Expenditure Survey primary data sources. Such would be a major task in itself and beyond the scope of this review paper. However data presented in Tables 3 and 4 attempt to provide some evidence of the link between age and income (Table 3) and then between tenure and age and marital status (Table 4). Table 3 shows that the old (over 65) and the young (15-24) are the largest groups with incomes less than AWE. That is about 80% of people earn less than AWE and over 30% of the population are old or young and earn less than AWE. Table 4 is based on a secondary source's analysis of census data because the ABS does not appear to have published cross-tabulations of age by marital status and tenure or income. However Table 4 does show the close correlation between age and tenure, and between marital status and tenure. For instance, this data shows that young or single people tend not to be home purchasers, whereas older or married people do.

Without going into great detail on this matter I



simply wish to argue that neither Campbell or Yates attempted to evaluate access to housing finance with reference to a realistic population of potential home buyers. While one might wish to suggest that perhaps the regulatory system itself may contribute to the income-demographic characteristics of the actual pattern of home ownership, the point remains that to adequately evaluate such theories one needs to integrate economic and demographic variables. Not all people who rent are potential home buyers. The failure to do so casts considerable doubt on the accuracy of the Campbell Committee judgements on the appearance of regressivity in who gets subsidised home finance.

A more tenable point to make is that many of those who get low interest regulated finance are not low income earners. To this extent regulation could be said to be a blunt means of assisting low income home-buyers.

The argument that low income earners do not get access to low interest regulated finance does not appear to be based on adequate empirical analysis.

However it could be that while low income earners do get access to some cheap funds, they also have to rely on expensive supplementary borrowing which pushes the effective cost of housing finance close to a market-related cost (37.72). We look at this question next.

(3) The Extent and Effect of Supplementary Borrowing

The Victorian Home Finance Survey (HFS) found that about 20% of borrowers needed to borrow additional finance on top of the first mortgage (Table 2.4). This compares with the figure of 8% cited by the Campbell Report (37.71).

Table 3

1981 CENSUS, (TABLE 11) PERSONS 15 YEARS OF AGE & OVER: AUSTRALIA, INCOME BY AGE

\$	AS % OF AWE	AGE											TOTAL INCOME
		15-19	20-24	25-29	30-34	35-39	40-44	45-49	50-54	55-59	60-64	>65	
<12000	78%	10.2%	8.3%	6.5%	6.3%	5.2%	4.5%	4.2%	4.5%	4.7%	4.5%	11.9%	70.7%
12001-15000	98%	0.1%	1.6%	1.8%	1.4%	1.1%	0.9%	0.8%	0.8%	0.7%	0.4%	0.2%	9.6%
15001-22000	144%	.0%	0.6%	1.7%	1.8%	1.4%	1.1%	0.9%	0.8%	0.6%	0.3%	0.8%	10.1%
>22001	>144%	1.1%	0.6%	0.9%	1.3%	1.3%	1.0%	0.8%	0.8%	0.7%	0.4%	0.7%	9.6%
		11.5%	11.0%	10.8%	10.9%	8.9%	7.5%	6.6%	6.9%	6.6%	5.5%	13.7%	100.0%

NOTES

AWE = \$294.30

P.A. \$15,304

Table 4

1981 CENSUS DATA ON TENURE, AGE & MARITAL STATUS

TENURE	TENURE BY AGE					TENURE BY MARITAL STATUS			
	AGE					MARRIED	NEVER MARRIED	OTHER	TOTAL
	15-19	20-29	30-59	>60	TOTAL				
OWNER/PURCHASER	15.0%	43.2%	76.8%	77.2%	70.9%	36.6%	80.7%	61.0%	71.1%
PUBLIC TENANT	2.5%	2.0%	2.1%	4.2%	2.0%	56.4%	12.4%	25.3%	20.7%
PRIVATE TENANT	76.2%	49.4%	15.3%	9.6%	20.0%	2.3%	1.7%	6.2%	2.7%
OTHER	3.3%	5.5%	5.8%	9.1%	6.5%	4.7%	5.2%	7.5%	5.5%
TOTAL	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
						12.9%	66.7%	20.4%	100.0%

OTHER =

SEPARATED, WIDOWED OR DIVORCED

Source: Core Consultants (1983:9,10)

Table 5 shows the sources of first and second mortgage borrowing.

Table 5

SOURCES OF FIRST AND SECOND MORTGAGES

Source of 1st Mortgage	Source of 2nd Mortgage			
	BANKS	PBS	GOVT	OTHER
BANKS	13.6	0.7	3.9	6.2
PBS	0.2	0.0	0.9	3.5
GOVT	2.8	3.7	54.1	5.4
OTHER	3.5	0.4	0.0	0.9

Source: Table 25 Vic. Home Finance Survey

The high figure shown for Government is due to the peculiar institutional arrangement with these loans where the first mortgage from one Government source (Terminating Building Societies), which had a maximum size of \$25,000, was able to be supplemented by cheap second mortgage finance from another Government source (the Home Finance Trust).

The interesting thing about this table is that where additional finance was required by Bank borrowers they mostly got it from a Bank.

However as the HFS report points out:

Approved first mortgages which accounted for at least 90 per cent of total loans arranged occurred in 85.8 per cent of applications to BANK institutions, 89.8 per cent of applications to PBS and 87.8 per cent of applications to OTHER institutions. These figures suggest that while there is a fairly high incidence of secondary (ie other than first mortgage) borrowing, as evidenced by Table 2.4, the actual contribution to total home finance of non-first mortgage funds is for most borrowers quite small. (p.13).

Furthermore, Tables 7.5 and 2.6 of the HFS Report show that the difference between the average total loan and the average first mortgage was quite small (about \$1200 in the case of Banks), and that the average interest rate charged on Bank secondary finance was equal to the rate charged by PBS on first mortgage funds with an average term of about 10 years. The additional cost of secondary finance would not appear to have been onerous.

The above conclusions were also confirmed by Judy Yates in some data she presented from the

Home Finance Survey, (Yates 1982b). This shows that supplementary finance contributed only about 2% of the total loan package of all borrowers across all income groups.

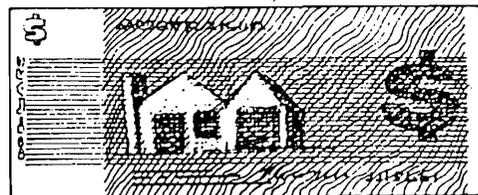
Overall the Home Finance Survey shows that the incidence and significance of supplementary finance is relatively small and contrary to the Campbell Committee's view, unlikely to significantly increase the weighted average cost of housing finance.

(4) Assessment of the Effects of Regulation

The argument and evidence used by the Campbell Report to show that the effects of regulation of housing finance has been regressive, I have argued, is not unassailable. Close examination of their evidence, Yates' consultant's report and evidence from the Victorian Home Finance Survey suggests:

- (i) that there is ambiguity in the evidence and argument by the Campbell Report that the regulation of Bank deposits rates is regressive;
- (ii) that many low income earners do get access to regulated lower interest housing finance. Further the failure to properly integrate economic and demographic data on potential home-buyers casts doubt on the accuracy of Campbell's claims of a regressive impact of regulated bank lending rates;
- (iii) that secondary borrowing appears to be relatively insignificant for all borrowers and thus unlikely to significantly affect the overall cost of regulated home finance.

However, regulation also assists many middle to upper income groups. In this context, the current form of housing finance regulation is not necessarily an effective instrument for promoting greater equity for low income earners.



EFFECTS OF DEREGULATION

(1) Efficiency

The opening sentence of the Campbell Report makes clear that the ideological position of the Committee was "that the most efficient way to organise economic activity is through a

competitive market which is subject to a minimum of regulation and government intervention" (1.1). Such Paretian views concerning allocative efficiency were clearly apparent in the Committee's analysis of housing finance regulation (eg 37.76).

However as Albon and Piggott (1983a) note the Paretian theory underlying Campbell's overall view "is proven only under special and restrictive assumptions". Graham (1984) fleshes out these assumptions in a general review of the Campbell Report's case for deregulation.

More specifically Albon and Piggott argue that by only considering the distortions that directly relate to financial transactions, the Committee failed to evaluate the interaction between financial and other distortions and their relative significance in affecting resource allocations. In the case of housing the interaction between regulation, taxation and inflation is particularly relevant.

They acknowledge that "...the Committee's terms of reference precluded a detailed examination of taxation issues, although it managed to treat some taxation measures (eg company income taxation) where they had important implications for the financial systems Housing finance is one area where taxation interaction is vitally important and could usefully have been examined in more depth" (p39). They argue that their analysis suggests that the tax treatment of owner-occupied housing "...is by far the most important contribution to distortions in the housing market" (40). Here they are referring to the owner-occupier's tax break, which treats the (imputed) income and financial cost of ownership of one type of asset (owner-occupied housing) different to comparable income earning assets.

As a result of (actual and/or expected) inflation, nominal interest rates rise. For most borrowers and lenders this is of little consequence because one person's increased taxable income is another's tax-deductible cost and only transfers between people occur. However owner-occupier's do not pay tax on the income derived from that asset (imputed rent) and neither can they deduct interest costs incurred necessary to earn that income.

Algebraically Ainstie (1981) shows that in "equilibrium" the nominal rate of interest is:

$$i = r(1 + p) + p / (1 - t)$$

Where i = nominal interest rate
 r = the real rate of return or real interest rate
 p = rate of inflation
 t = average marginal rate of taxation.

Thus nominal interest rates need to increase by more than the rate of inflation, due to taxation, to ensure a specified real rate of return is achieved.

Another way to consider this is that in a situation of no inflation ($p = 0$) the tax-inflation effect disappears because tax is only paid on the real interest costs.

The increment to nominal interest rates as a result of inflation is to maintain the real value of the amount borrowed, so that the escalation of repayments effectively relates to repayment of inflation-adjusted principal, not interest per se.

However debt funded purchases of other types of assets are able to deduct the total cost of any interest expenses from taxable income. Home purchasers' interest expenses are not tax deductible. Therefore the effective total cost of debt finance purchase of one type of asset - owner-occupied housing - is increased, compared to purchase of other assets, as a result of interaction of inflation and the taxation system.

Thus it might be argued that regulated low interest rates partially offset these tax-inflation effects by lowering the housing finance rate of interest below the market rate.

In other words removing regulation of such interest rates will not necessarily lead to a more efficient allocation of resources due to the more significant distortions caused by inflation and taxation.

However this is not a sufficient argument to support continued regulation, rather it points to the inadequacy of a simple ideological view that removing one form of regulation is likely to increase the efficient allocation of resources (ie second best considerations apply).

However one could also argue that the inflation-tax distortion leads to even greater inequity in the system because of its regressive nature. Those with below average marginal tax rates are more affected by this inflation-tax effect, because nominal interest rates adjust on the basis of average rates. If the individual's marginal rate of taxation is less than the average, then the increase in nominal interest rates is effectively higher for that person and conversely, if one's marginal tax rate is greater than the average. Thus rich home-owners benefit more than poor home owners.

The way to overcome this distortion is either to tax home-owners in a similar way to other owners of income earning assets, or index the tax system, so tax is only payable on real interest costs.

(2) Cost of Housing Finance

Campbell argued that the effective cost of housing finance was not likely to rise substantially and probably not up to general market levels due to the "security" of this type of lending. Albon and Piggott (1983b) and Yates (1983a) present convincing detailed argument and evidence to suggest otherwise.

Albon and Piggott conclude that "...under plausible assumptions, the market rate of interest that would prevail after deregulation will be approximately equal to the uncontrolled rate under regulation" (p.84).

While the regulated rate for Bank finance is now (March 1985) 13.5%, the actual rate charged by Banks varies between 11.5% and this figure. For instance, most Banks offer rates of 11.5% to people who meet savings and other rationing requirements. Other borrowers are charged higher rates up to 13.5%. Similarly, the de facto regulated maximum rate on Victorian Building Society loans is 13.5%.

Moreover, perusal of the Australian Financial Review on most days will reveal advertisements for mortgage finance at rates of around 13.5% from a wide range of commercial financiers. Current rates on long term (10 to 15 years) Commonwealth securities are also tending around the 13.5 to 14% mark. We appear to be experiencing a convergence of interest rates as regulations are eased.

(3) New Lending Practices

While the Campbell report did make reference to the need for new lending arrangements better suited to the "needs and means of borrowers, including low income earners" (37.49), it did not attempt to outline the nature of such arrangements. It merely expressed the view that as a result of deregulation there would be "greater scope and commercial incentive to use 'income-geared loans of the 'low start' or deferred repayment variety". (37.50).

The fact that less regulated housing financiers like Permanent Building Societies and finance companies have experimented with such innovations, whereas the highly regulated Savings Banks have not, was cited as evidence for the "correlation between freedom from regulation and incentive to innovate". (37.51)

The Martin Report, by comparison, discussed in some detail the need for such innovations, as well as outlining the nature and effects of such innovations on income thresholds and borrowing capacities.

Inflation, the Martin Report argues, introduces major distortions into the repayment patterns under traditional credit foncier loan instruments. The nominal or dollar value of repayments under credit foncier are calculated to be constant for 'given' interest rate and term. Inflation results in dramatic increases in repayments as nominal interest rates rise. (The



net effect is to accelerate the repayment of real principal in the early years of the loan.) This dramatic increase in repayments means that marginal borrowers will be unable to afford repayments on a loan sufficient to purchase a home. This is illustrated in Table 10.3 of the Martin Report.

Yates (1983b) discusses two broad ways to overcome these deficiencies:

(i) Graduated Payment Mortgages (GPM)

Repayments escalate steadily from a low level and can be broken into interest and principal using real or nominal interest rates.

(ii) Shared Appreciation Mortgages (SAM)

The purchaser borrows under a conventional credit foncier loan at either a below market interest rate, or borrows as much as can be afforded at the going interest rate. The lender, or some other third party, accrues part equity in the property in lieu of receiving a full market return on the loan.

Both types of loans have been tried in various countries, and quite a considerable literature on the theory and practice of these lending arrangements has resulted. (eg. Revell 1975).

In general, it would appear GPM's are the more popular. They are the only types of new mortgage instrument discussed by the Martin Report. Some examples of GPM's are where:

- (i) Initial repayments are set on the basis of a low real interest rate. Repayments and the effective interest rate are then indexed for changes in inflation. Tables 10.4 to 10.6 of the Martin Report illustrate one such arrangement of this type.
- (ii) Commencing interest rates are set a few percentage points below the market rate and then escalate each year to a maximum equal to greater than the market rate. Debt outstanding would be evaluated on the basis of the market rate. Such loans are often termed low-start loans and have been introduced by a number of finance companies or building societies at various times.
- (iii) Repayments are set on the basis of what is affordable to the borrower and acceptable to the lender. Debt outstanding is indexed for changes in inflation and a low real rate of interest is charged on the indexed

balance. Repayments escalate by the rate of inflation or some other index of income growth. This type of loan arrangement is often called a Capital Indexed Loan (CAPIL). The Victorian Ministry of Housing is using such a loan instrument in its 1984-85 \$20M pilot to evaluate the feasibility of offering home finance to those on incomes of less than \$200 per week (i.e. those on unemployment benefits, supporting parents and low wage earners). Such an arrangement is also likely to be used in all other Home Purchase Assistance programs of the Ministry from 1985-86.

In other papers I have discussed in detail the nature and relative merits of several different GPM's and SAM's (Nippard 1983, 1984a, 1984b). Staines (1982) develops a mathematical outline of one such partial and full indexation lending arrangement.

However, all of these can achieve the same ends. A lending instrument is simply a means of discounting a flow of payments over time such as to equal a specified present value (i.e. the amount borrowed).

The Capital Indexed Loan (CAPIL) Scheme adopted by the Victorian Ministry of Housing is a particularly flexible lending arrangement designed to service lower income home buyers, although it is equally applicable for lending to middle and upper income borrowers as well. It may also be applicable to non-traditional forms of housing provision such as non-equity rental co-operatives (Ministry of Housing:1984). For details of the CAPIL scheme see Appendix A.

In summary, inflation adjusted mortgages, like CAPIL, can significantly reduce the income threshold needed to service a home loan.



BARRIERS TO THE ADOPTION OF INFLATION ADJUSTED INSTRUMENTS

However two potential barriers may impede the extensive adoption of inflation adjusted lending practices by private financiers.

Cash flow problems could arise for financial institutions if a large proportion of borrowers chose a restructured mortgage with relatively low commencing repayments. However for two reasons this is unlikely to be a major stumbling block. First, such mortgages remove the inflation distortion from repayment patterns and

merely reproduce the situation which prevailed in the low inflation post war years of the 50s, 60s and early 70s. Secondly, not all borrowers are likely to want low starts. For some high start loans or only marginally lower start loans will be sought. Therefore no major net effect need arise (Stroud 1982).

The second major problem is that because restructured loans also increase the borrowing capacity of middle and higher income borrowers, an increase in the size of loans to such borrowers may continue to exclude many otherwise newly eligible low income borrowers. That is, high levels of demand could mean that various risk or non-price rationing procedures persist, which contribute effectively excluding low income borrowers. This is a major problem which has been discussed by a number of writers. Yates (1982a, 1982b) for instance argues that while the substantial tax advantages accrue to home purchase, excess demand is likely to persist. In this situation high income households are still likely to be able to out-bid lower income borrower's demands for private finance (i.e. lower risk, repay quicker, can afford higher effective interest rates etc).

To overcome this, one either abolishes these tax advantages or introduces offsetting income or non-home ownership housing assistance programs like public and private rental assistance programs, common equity rental co-operatives or even government funded home purchase programs specifically aimed at low income earners. In short, fiscal rather than blunt price regulatory assistance programs are needed.

Moreover, while excess demand persists there will be little incentive for private housing financiers to abandon credit foncier mortgages.

Staines (1981) also suggests active supply side policies may be necessary to ensure that any additional demand for housing as a result of greater access to housing finance by more people or access by the same people to more funds, does not spill over into house price inflation in the short to medium term. If this occurred, the benefits of restructured mortgage instruments may be largely offset.

However, despite these problems, there is a clear need to move away from credit foncier loan instruments, to be able to better cope with inflation and potentially increase the range of income groups able to afford home purchase. In short, the current situation produces inefficiencies (distortions of repayment patterns and thus housing choice) and inequities. Therefore some groups are needlessly excluded from housing finance markets.



SUMMARY AND CONCLUSIONS FOR FUTURE HOUSING POLICY.

Review of the arguments and evidence for deregulation of housing interest rates suggests that the empirical evidence is far from conclusive regarding supposed mal-effects of the current form of regulation. Further, Campbell's claims of greater efficiency resulting from such deregulation are not unassailable.

While this article questions Campbell's proposal for housing provision to be regulated solely by the market; it does not necessarily support the current form of regulation as the most appropriate to the achievement of progressive distributional and equity objectives. What is required are discussions about the most appropriate form regulation of housing finance provision should take.

As part of this re-regulation there are arguments for the removal of current interest rate controls. Such removal however should be part of a package of policy measures designed to achieve the distributional and equity objectives that neither the current controls nor the Campbell proposals adequately address.

As Albon and Piggott (1983a-47) observed:

...the strongest arguments for deregulation does not lie in favourable efficiency, stability or unavailability consequences. Rather it is that interest rate controls have not achieved the distributional objective of actually subsidising those for whom assistance was allegedly intended.

In particular, many middle to upper income households have benefited needlessly from such regulation. Moreover given the nature of Australian taxation policy which most advantages high income home purchasers, current regulation further contributes to inequity.

More effective policy outcomes may be provided by direct fiscal assistance, or perhaps as the Martin Report suggested, as a second best option to total deregulation, more tightly specified regulations, which aims to only assist a target population, not all Savings Bank borrowers, may be preferable.

The major distortionary effects of the taxation system have also been highlighted. Three types of responses seem to be available here

- (i) Treat home purchase like ownership of any other income earning asset and tax imputed rent and allow associated interest payments to be tax deductible.
- (ii) Index the tax system particularly in relation to interest payments.
- (iii) Establish offsetting non-home ownership housing or income assistance programs. This would still be necessary even if (ii) was implemented.

However, there is one cautionary note regarding (iii). This is that when such programs enter the fiscal arena, they become particularly vulnerable to political and economic vicissitudes, like the current budget deficit fetishism. While this continues to be perceived as a major problem amongst housing activists and unions there is likely to be continued opposition to removal of the current regulations because these at least provide some assistance to some low income purchasers who might not otherwise get any assistance.

One means perhaps of alleviating this political problem may be the preparation and publication of a National Housing Budget, which shows the full effect of all housing related assistance - taxation, public housing, social security, FHOS etc. Until it becomes widely accepted that it is home-owners who get the bulk of all subsidies and that home owners tend to better off both in terms of income and wealth (e.g. Yates 1982a), fiscal programs like public housing will be vulnerable. (State and Federal Housing Authorities are investigating the preparation of such a National Housing Budget).

Finally the potential of inflation adjusted mortgages is considerable. However, whether this potential can be realised, given the likelihood of continued taxation subsidies to home-owners which leads to artificially high levels of demand, is uncertain.

DISCLAIMER

The views expressed in this paper are those of the author alone and cannot be attributed to the author's employer, the Victorian Ministry of Housing.

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APPENDIX A

CAPITAL INDEXED LOAN (CAPIL) SCHEME

Under CAPIL commencing repayments are set at 25% of the gross income of applicants. Repayments escalate each year by the percentage change in the Consumer Price Index over the past 12 months. At the end of the period, repayments are split into interest and principal on the following basis:

- (i) Opening balance at the beginning of the period is indexed by changes in inflation over the period.

- (ii) A real interest rate of 3% p.a. is charged on the indexed balance.

- (iii) Repayments in the period less the real interest charge, give the payment of principal, which when deducted from the indexed balance, gives the closing balance.

The real interest rate of 3% p.a. is based upon what seems to be a widely held perception that over the long-term the minimum real, low risk, rate of return on finance is about 3% p.a. Results of the SECV indexed bond issue in 1983, in which the tendered rate came in at 2.9% p.a., tends to confirm this. Likewise the experience in the UK, where several government indexed securities have issued at tender and generated real interest rates of between 2% to 3% p.a. supports this. Also the High Court ruled in 1981 (Pennant Hills Restaurant v. Barrel Insurance) that all lump sum damages should be discounted by 3% to reflect the average real rate of return available from investment by individuals. The Victorian Government in its dealings with ALCOA over the Portland Smelter argued that the real public sector discount rate for evaluating endeavours comparable to private investment, should be about 4% p.a. Given that this rate presumably makes some allowance for risk and uncertainty, 3% seems a reasonable rate of return for this type of low risk lending.

Further aspects of Inflation Adjusted Mortgages can be illustrated by reference to a CAPIL style loan.

- (i) With CAPIL, there is no need to specify a fixed term. If we fix the amount borrowed at \$40,000, Table 6 (column D) shows effective loan terms for a range of incomes, assuming an inflation rate of 8% p.a. (a lower inflation rate shortens the term marginally for each income group - e.g. by about 1 year for inflation of about 5% p.a.). For instance, someone whose relative income is fixed in real terms at \$160 per week (less than the current unemployment rate for a couple with one child), can discharge a \$40,000 loan within 30 years at a real interest rate of 3% p.a.

- (ii) Alternatively, if we specify a fixed term, then a maximum loan size can be determined. For example, someone whose relative income is fixed in real terms for 30 years at \$200 per week could discharge a CAPIL loan of between \$47,000 to over \$50,000. Alternatively, someone on \$300 per week (78% of the current AWE for males of \$386.20, Sept 1984) could borrow at least \$70,000.

(iii) For some CAPIL borrowers who have very low levels of commencing repayments, the nominal value of debt outstanding will rise in the early years of the loan because repayments do not cover the effective interest change. Table 6, (column B) shows that borrowers with incomes less than \$300 per week will experience a growth in the nominal value of debt, if they initially borrow \$40,000.

However, because home purchase involves the acquisition of a real asset, the actual situation of borrowers is more accurately evaluated with reference to their real debt situation. Real debt can be represented by the following formula:

$$\frac{\text{Outstanding Nominal Debt}}{\text{Current Property Value}} \times 100\%$$

Provided nominal debt rises at a slower rate than the rate of growth of property value, real debt falls steadily and the borrower is steadily increasing his or her real equity in the property.

Table 6 shows that, even with a commencing loan to valuation ratio of 95%, if houses prices keep up with inflation on average, then real debt declines steadily from year one, even for those on commencing incomes of \$160, whose nominal value of debt nearly doubles over the first 19 years of the loan.

In fact, Valuer General's data shows that average dwelling prices in Melbourne grew at an average annual rate of 11.15% between 1968 and 1983. By comparison, the annual rate of inflation (measured by the CPI) averaged 9.42% and the rate of growth of Average Weekly Earnings was 11.55%. Also Davies' (1981:378) study for the Campbell Report on patterns of asset ownership and rates of return, notes that NSW data shows that house and land prices appreciated at annual rates considerably in excess of inflation between 1952-1977 (up to 12.2% p.a. on average).

Econometric studies tend to confirm this close association between income, price and house price inflation (MacLellan (1982) Neutze and Bethune (1979:86), Williams (1984).

Table 6

CAPITAL INDEXED LOAN, WITH VARIOUS COMMENCING INCOMES AND MONTHLY FHOS PAYMENTS ADDED TO NORMAL MONTHLY REPAYMENTS

REAL INTEREST RATE 3.00%
 INFLATION RATE 8.00%
 LOAN \$40000.00
 HOUSE PRICE \$43500.00

A	B	C	D	E	F
COMMENCING INCOMES	MAXIMUM BALANCE O/S	YEAR	YEAR OF MORTGAGE DISCHARGE	MAXIMUM REAL DEBT	YEAR
\$	\$			%	
160	78060	19	30	89	1
170	67059	16	28	88	1
180	59652	14	26	88	1
200	50436	11	22	88	1
215	46300	9	20	87	1
233	43058	7	18	87	1
252	41086	4	16	86	1
271	40289	2	15	86	1
300	39846	1	13	85	1

NOTES:

1. FHOS IS OPTION 3, FOR A PURCHASER WITH 2 OR MORE CHILDREN (\$3500 LUMP SUM, PLUS \$750, \$650, \$550, \$450, \$350 IN THE FIRST 5 YEARS, PAYABLE MONTHLY.)

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