The Housing Affordability Problem: What Role for Basel?

The housing affordability "crisis" is analogous to the climate crisis. It is a result of long run factors and needs long run solutions. Short term panic responses are likely to cause large harm to many, even if they do help temporarily. Long run solutions are needed.

Where are those solutions to be found. Many point to the supply side of the housing market and the interaction of growing population and lagging dwelling construction. That, no doubt is part of the cause, as are tax distortions and FOMO (fearing of missing out) based on expectations of ever rising property prices. Settle in for a long wait to see our politicians effectively address these issues with anything other than short-term band-aid, vote-buying measures.

But the demand side is crucial and the supply and cost of housing finance is fundamental in this regard. Who, other than perhaps the very wealthy and older home-owners selling to buy a different property, is able to buy residential property without very high reliance on borrowed funds?

A quick examination of the Australian history of housing finance highlights the longer term role which it has played in leading to our sorry state of affairs. The Basel Capital Requirements are a suspect in this regard and warrant reformulation.

Unfortunately, the longer-run statistics available have discontinuities in the series, but good enough to indicate trends. In 1976 RBA statistics (Table B2) tell us that residential loans to commercial (business) loans were around 50 per cent, with the ratio falling to around 40 per cent in the late 1980s. If investor loans for housing were included (which previously appear to have been classified as "commercial") that late 1980s figure was around 47 per cent.

The ratio then climbed to around 100% by end 1994, most likely partly reflecting the problems with business lending in the early 1990s time of "mini-crisis". But the Basel risk-weighted capital requirements, which gave favourable treatment to housing loans also came into effect in the late 1980s. From there it was only up, with residential loans being almost twice the level of commercial loans outstanding in 2021.

In 1990 the share of investor loans in total housing loans was 14 per cent. It then grew steadily to a peak of 40 per cent in 2015, since when regulatory changes have contributed to it stabilising and declining slightly to around 35 per cent.

As former NAB CEO Don Argus is reported to have opined back in 2013, our banks had become "bloody big building societies". The long run explosion in mortgage financing was also buoyed by the growth of securitisation in facilitating non-bank housing lenders.

Some will argue that this growth in housing lending is an effect, rather than a cause of increasing house prices. There is no doubt that both supply (housing stock and demography) factors and demand (particularly finance availability) factors are relevant, but the latter warrants closer attention rather than simply looking for short run "macro-prudential" solutions. The long term decline in housing affordability for younger generations needs long term "macro-social" solutions.

Competition (not always a characteristic of our banking industry) has seen banks chase the relatively high profit, low risk, business of home lending. Of course competition also led to many chasing higher risk, but (unless the housing market goes pear-shaped) profitable business of highly geared investor housing loans.

The Basel system of prudential regulation, involving applying "risk weights" to bank assets in determining capital requirements, has also encouraged the massive swing into residential mortgage lending. By deeming these loans to be of lower risk (and substantially so for the major banks under the Basel II and Basel III internal models approaches), they allowed banks to use less of their expensive equity in funding the loans, which enhanced the high profit nature of home lending.

The Basel regulations, designed to improve bank risk management, have instead turned into factors influencing the pricing and allocation of bank credit.

So the structure of the Basel regulations has been one factor inducing the "bloody big building society" trend – at the expense of lending for commercial business. What can be done to remove this effect?

The Murray Inquiry recommended changes to risk weighting arrangements (which were implemented) to reduce some of the bias. But more needs doing.

A simple solution would be to shift the non-risk-weighted minimum capital requirement (the leverage ratio) from being a "backstop" to the risk weighted capital requirement, and make it the "frontline" requirement backed up by the risk weighted requirement.

Doing so, by increasing the required leverage ratio from its current level of 3.5 per cent, to say 6 per cent would remove regulatory capital incentives towards lower risk-weighted mortgage lending. The risk-weighted requirement would still operate to constrain excessive risk taking, by leading to a higher required capital level – as it was always supposed to do.

It's not a short term fix, and the political capital invested by regulators in the primacy of the risk-weighted approach would undoubtedly cause opposition. But it warrants consideration as part of a longer term fix.

Kevin Davis
Emeritus Professor of Finance, The University of Melbourne
October 5, 2021