Fair Value Lending

Regulating against a Property Bubble

Reform Alliance

A. Fair Value Lending

The same economists and estate agents who talked about soft landings back in 2007 are back on the airwaves now telling the Irish people calmly there is no danger of a bubble as the banks are not lending and the enormous rises in property prices in Dublin are being driven by the simple concept of supply and demand.

The Taoiseach recently told an audience in the United States *"if you had 30,000 three-bedroom detached houses in Dublin you'd sell them all in a week."* Despite the worst crisis in the post industrial world, very little, it seems, has really changed.

Solid policy action is needed to address the boom-bust cycle. In the period from 2002, Ireland saw property price growth far above the rate of inflation, GDP growth or income growth. It was clear growth rate at that pace was unsustainable.

'Fair Value Lending' is aimed at addressing speculative behaviour in the market by reasserting the link between property prices and mortgage size.

The objective of the policy is to:

1. Permanently prevent the return of a property bubble
2. Stabilise property prices
3. Make property more affordable for first time buyers

A snap shot of the market conditions by the Central Bank shows that average house prices are running about 6 times average incomes, above the historical norm of 4 to 5 times.

A mortgage applicant wishes to purchase a €600k home in this market. As such, in line with historical norms (of 5), the Fair Value price of this home would be calculated at €500,000. An LTV limit of 90% is then applied to this value, reducing to €450,000 the maximum loan a financial institution is allowed to offer on the property.

The policy aims to target the source of the international property crash, namely the explosion of cheap credit that induced an unsustainable property price surge.

B. Understanding the Policy

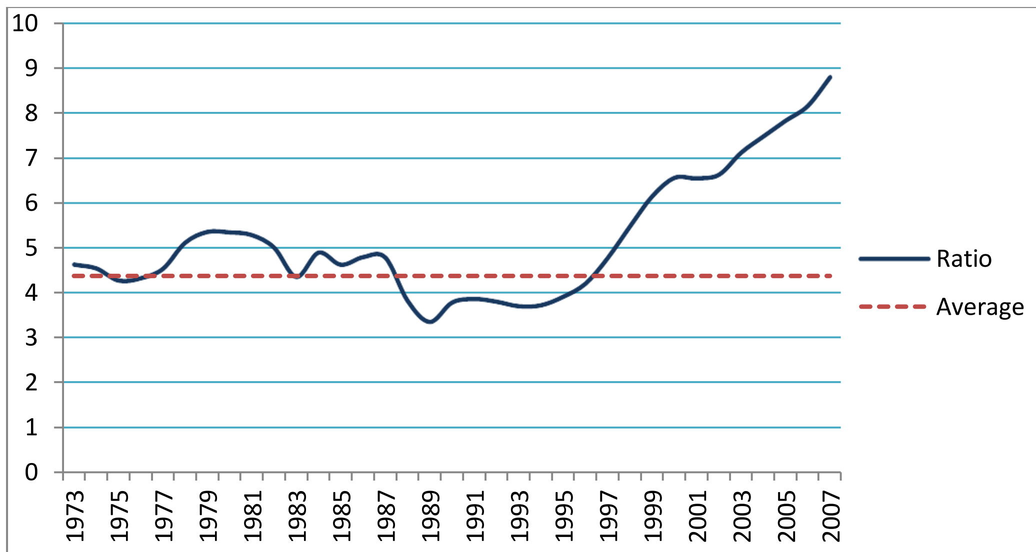
The thrust of this policy is an effort to stem a surge in the ratio of average earnings and re-establish the link between property price growth and wider economic growth. A key feature of property bubbles across the world is the sudden and sustained increase in the ratio of house prices to average earnings. This is a result of property price growth that massively outstrips average price or income growth.

It should be self-evident that to support increasing property prices, you need increasing incomes to carry the burden of higher mortgage payments. A snap shot of market prices at any given time does not give a fair representation of the degree in which property prices are over or undervalued at that moment. It is necessary to benchmark property prices against a more long-term metric or economic performance. The specific measure is not that important: you could measure against workers' income or household income, median or average levels. Any measure should show a rough level of stability over long horizons.

Analysing UK data, we see clearly that in the years leading up to the two property crashes of modern times, specifically the end of the 1980s and 2008/9, there was a surge in this price-to-earnings ratio.

Figures provided by Nationwide building society shows that the UK house price-to-earnings ratio averaged 4.1 in the thirty years from 1983 to 2013. We notice in the date two significant spikes however, 1987 to 1989 and 2001 to 2007. Both these significant spikes led to a severe property bubble and were followed by severe property crashes which plunged the wider economy into recession.

A similar situation can be seen in Ireland, although rough, it gives an indication. In the period from 1977 to 1996, the prices-to-earnings ratio remained roughly stable at 4.2. However, starting in 1996 we see a sudden spike in the data with housing prices rising to 6.5 times the average industrial wage by 2000 and 8 times by 2006. Again, this sudden rise, breaking from the historical norm, led to a systemic financial collapse.



Ratio of average industrial wage to property prices by year, with historical average from 1973 to 1997highlighted. Data provided by CSO.

Empirical data in country after country shows that sudden spikes in the house price-to-earnings ratio invariably lead to boom-bust in the property market. It's clear then that a policy that limits this growth and ensures more sensible lending practices needs to be implemented.

C. Why 'Fair Value Lending' is the Solution

The presence of a house price bust during a recession and the growth of house prices prior to a recession are both significantly and positively associated with the severity of the recession. Increases in property prices, like asset prices in general, improves the owner's net worth, further improving the owner's ability to leverage invest and spend. This process can in itself push up housing prices further, and in turn encourage more invest and property buying.

As such, the residential property market can be seen as a stimulant to wider economic performance and has a severe pro-cyclical nature; accelerating an expanding economy while further depressing a downturn. Developments in the housing markets can both transmit and amplify shocks to the real economy.

Investors in the property market can avail of far more debt than other asset investors however, with financial institutions allowing homebuyers to leverage higher ratios than any other investment activity. In the 2008-09 financial crises in the US, a fall in housing prices forced many over leveraged mortgage holders into negative equity as housing values fell below the nominal values of their loans. These mortgage holders then found themselves unable to sell their property in an overheated market, were forced into default.

It can be seen in both the US, Europe and Ireland how the collateral leverages of property amplifies economic fluctuations, pushing vacillation to extremes, overheating an expansionary climate while depressing a bearish market. Ireland faces particular difficulties in addressing these fluctuations in the property market.

1. Monetary Policy

One of the traditional methods in heading off the threat is the strategic use of monetary policy, and in particular raising benchmark interest rates in order to slow down the supply of credit in the market. Monetary remains however a blunt instrument, and inflicts severe costs to the broader economy and as a limited impact on speculative behaviour. Secondly, as members of the Eurozone Ireland's ability to affect monetary policy is severely restricted. This means that in order to address housing bubbles on a national level, other more tailored policy options should be considered.

2. Fiscal Policy

As Ireland is already dealing with the aftershock of a property crash and as a result has an extremely high percentage of current mortgage holders in arrears, policy makers face a particularly difficult set of circumstances in addressing the risk of future property bubbles. In particular, this makes many of the traditional macro prudential options used by other countries unsuitable. Some policy options employed by other countries would exacerbate existing problems.

For example, in addressing future systemic risk in the property market, countries like the UK, Poland and Netherlands removed many of the incentives for debt financing by limiting mortgage interest tax relief for example. These options would be mainly unsuitable in the Irish context as this would further weaken the position of mortgage payers and exacerbate the arrears crises. Instead, a policy formula is needed that limits the risk of future debt bubbles without negatively effecting existing mortgage payers.

Studies have shown that the introduction of a residential property tax, like the local property tax introduced in Ireland in 2013, can have a positive effect of limiting housing bubbles and short run volatility. Moreover, it has been shown that municipalities with higher property taxes have a lower rate of property growth and a reduction in speculative activity. However, property taxes have significant draw backs. Property taxes raise the effective mortgage repayments of all homeowners, pushing homeowners into arrears. By its very nature it is regressive, and the introduction, though prudent, may have the consequence of hitting already struggling mortgage holders and causing greater instability in the property market at least in the short run.

3. Macro prudential options

The failures of the above fiscal and monetary prescriptions to effectively address the crises has led policy makers to focus on other macro prudential options focused on targeting specific risk factors in the hopes of avoiding the systemic collapse of recent years. Among the macro prudential options discussed is the implementation of DTI (debt to income) and LTV (loan to value) limits. DTI/LTV limits of some kind have been introduced in dozens of countries but usually only in limited circumstances.

The 'Fair Value' proposal incorporates aspects of both DTI and LTV limits. Firstly, by setting limits on the size of a loan that a home buyer can be offered (the Fair Value) by relating the inflated market price back to the historical norm, the policy acts as a form of loan-to-value ratio. Secondly, by limiting banks to offering only a percentage of this Fair Value calculation, the policy acts as a loan-to-value percentage limit.

It's clear that macro prudential policy options would be less invasive than a property tax. It would target one of the main sources of property volatility, namely speculative and unsustainable future price growth without negatively impacting the huge numbers of existing mortgage holders in negative equity and arrears.

D. Advantages of Fair Value Lending

Limits on loan to value ratios in the property market can curb the negative feedback loop between mortgage credit availability and house price growth. By restraining the explosive growth in credit and mortgage backed debt, the policy can effectively limit the possibility of default by individual mortgage homeowners and by extension limit the potential for systemic banking failures.

An IMF report (Igan & Kang, 2011) demonstrates that the higher the average LTV (loan to value) ratio in the wider property market, the more sensitive economic performance is to house price

movement. Furthermore, they've shown that for every 10 percentage point increase in the LTV of first time home buyers, there is a 10 percentage point decrease in the appreciation rate of house prices.

On the back of this evidence, the UK government has recently given the Bank of England new powers to set LTV limits, giving the bank discretion to raise or lower the limit based on market conditions.

Conclusion

Following the crisis, the widely-accepted tenet was one of 'benign neglect', namely, to wait for the bust and pick up the pieces, has been proven to be defunct. It is now recognised that pre-emptive steps must be taken to avoid the devastation caused by the 2008 property crash and subsequent recession. The introduction of a "Fair Value" would be strong tool to try to head off any future property bubbles in the Irish market and ensure sensible, sustainable and prudent lending is maintained into the future.