

BUSINESS SPECTATOR

COMMENTARY

10:38 AM, 9 Feb 2009

CHRISTOPHER JOYE

A housing revolution is needed

This week I have been invited to travel to New York to present some Australian policy ideas to a private summit for the new Obama Administration entitled 'A crisis is a terrible thing to waste: Transforming America's housing policy'.

The summit, organised by The Rockefeller Foundation, The MacArthur Foundation and New York University's Furman Centre for Real Estate, is being convened to consider, among other things, how to use the current crisis to "fundamentally rethink federal housing policy and provide President Obama, Congress, and the President's appointees with specific recommendations for how to reconstruct the mortgage finance system, bring new models for first-time homeownership to scale, [and] link affordable rental housing with economic opportunities".

I will be the only Australian delegate and will be presenting on a panel with the economist Robert Shiller of Yale (famous for predicting both the 2001 tech-wreck and the US housing carnage) on the subject of 'Reclaiming the promise of homeownership: New models to help first-time homebuyers achieve stability and build wealth'.

Amongst the stellar line-up of US thinkers, I am looking forward to hearing from Obama's new housing czar, Shaun Donovan, who is giving the keynote address, leading economists such as Edward Glaeser (Harvard), Susan Wachter (Wharton), and Dwight Jaffee (Berkley) and Austan Goolsbee, who was Obama's primary economic advisor during the presidential campaign.

The policy ideas I will be presenting are some of the (apparently timely) recommendations from my 2003 [report](#) to the Australian Prime Minister's Home Ownership Task Force, which outlined several demand- and supply-side solutions to the housing affordability problem.

I have also been asked to discuss the closely related experiences of my company, Rismark International, developing innovative "shared equity" models here in Australia and a new ASX futures market to enable homeowners to "hedge" or insure against the risk of house prices falling in the city of their choosing using Rismark's indices. Both these opportunities were articulated in my report to the 2003 Task Force.

A final proposal that I will be recommending to the Obama Administration is a very creative, and as yet untested, idea that Professors Joshua Gans and

Stephen King came up with to alleviate short-term housing stress. The President of the ACTU, Sharan Burrow, and I recently wrote an [article](#) in *The Age* imploring the Rudd government consider it.

As Joshua Gans [has observed](#), many of the solutions that have been proposed to remedy the US housing crisis “were all anticipated five years ago in Australia” by our two reports for the 2003 Task Force, notwithstanding the these were “ignored completely by [the Howard] government”. Gans continues: “Australian policy investigation (although not implementation) was well ahead of the game here. Those in the US could do well to read the papers written in those calmer times.”

President Obama could do worse than look at what *The Economist* has previously described as the “wonder down under”. While Australia has a relatively high 70 per cent home ownership rate, and the world’s fourth biggest mortgage securitisation market, it has deftly avoided much of the fallout: no bank bail-outs; no nationalisations; no sub-prime lending; default rates that are 15 and 30 per cent of US and UK prime levels; no serious mortgage credit rationing; and tiny house price falls of 2 to 3 per cent since 2007, notwithstanding higher rates of historical price appreciation.

One of the key lessons from the crisis has been that the global financial system had too much leverage, particularly the household sector, which had assumed unsustainably high levels of debt. Yet instead of assaulting the root cause of this problem, US policymakers have delivered an ad-hoc patchwork of mitigants dominated by private risk socialisation. These band-aids overlook the central reason American homeowners were forced to gear themselves up with so much debt in the first place –because they’ve never been able to draw on external “equity”. The longer-term policy imperative is thus not for taxpayers to supplant credit markets, but for government to help households “deleverage” their balance-sheets via a safer mix of debt *and* equity.

For hundreds of years listed companies have been able to seamlessly issue debt and equity to finance their spending. Yet prior to some innovations pioneered here in Australia, households around the world had never been able to privately source external equity when buying their homes.

Given recent house price falls, the average US homeowner's mortgage now represents an astonishing 95 per cent of the value of their property. That means that around 40 per cent of all US borrowers have “negative equity” (ie. their mortgage is worth more than their home). And this debt is secured against what is in fact a very risky asset. Research shows that a single family home is four to six times riskier than a diversified national property index. Indeed, the risk of an individual property is more akin to that of equities. Yet it represents the average US family’s most important lifetime investment.

In the 2003 report, commissioned by the Prime Minister, my co-authors and I presented a tractable solution to the high levels of household debt that triggered the credit crisis: the development of private markets in “equity finance”.

Under this proposal, households would get access to zero-interest equity finance in exchange for trading away a small portion of the risks and returns of homeownership to outside investors. Instead of taking out, say, a 90 per cent interest-bearing home loan, they could combine a 20 per cent zero-interest equity loan with no monthly repayments with a 70 per cent conventional mortgage product. By doing so, they would permanently slash their monthly mortgage repayments by 30 per cent or more while reducing their vulnerability to adverse economic shocks. Importantly, they also retain complete control of their homes; they choose when to sell, what renovations to make, and at what point during the contract’s 25-year term they wish to repay it.

Portfolio investors, such as super funds, would get extremely low-cost, highly enhanced and long-dated exposures to what has, during the past three decades (including the recent calamity), been the largest and best performing of all asset-classes: residential real estate. Historically, investors have only been able to access highly concentrated, risky development holdings comprising small parcels of properties that incur heinous transaction costs. By investing in a portfolio of thousands of shared equity interests, super funds could avoid these costs.

The former secretary of the Commonwealth Treasury and now the Asian head of super-fund advisor Mercer, Tony Cole, has commented: "We find the case for institutional investment in (shared equity) compelling. Historically, residential real estate displayed a negative correlation with commercial property markets and a low correlation with the share market."

Independent actuarial analysis suggests that about 15 to 30 per cent of all super fund capital should, in theory, be allocated to housing, in part because of its diversification benefits. Compare the circa 50 per cent losses in Australian shares and listed property trusts in the past year with the fact that residential property has delivered a positive total return (while prices have fallen by 2-3 per cent, gross rents have been up about 5 per cent).

Following the recommendations of my 2003 report, Bendigo & Adelaide Bank and Rismark launched the world's first privately-funded, nationwide [shared equity finance program](#) in which the lender participates in both the capital gains and wears the losses associated with homeownership. Many hundreds of families have bought their first home or immediately cut their monthly mortgage costs by 30 per cent or more as a consequence.

The initiative has won unanimous political praise from the unusual troika of [unions](#), [Labor](#) and the [Liberals](#). And investors have experienced strong, low-volatility returns with no moral hazard or adverse selection.

Australia's policy precepts and practical experience have been explicitly used as a guide for several billion dollars worth of government investment in public-sector shared equity initiatives in the UK and NZ, which are helping thousands of families deleverage. (I presented to the NZ parliament on the subject last year.)

And leading US academics including [Ian Ayers and Barry Nalebuff](#) at Yale, [Luigi Zingales](#) at the University of Chicago, and [Edward Glaeser](#) at Harvard have called on the US government to help borrowers swap a portion of their housing debt for equity-style instruments along the lines of the Australian model.

A second powerful Australian policy innovation that I will be advocating to the Obama Administration is the development of "income-contingent loans". Just as households have not historically been able to use external equity when buying a home, it is surprising that the largest and riskiest component of our wealth – our so-called "human capital" (read: earning potential) – cannot be effectively insured or used as collateral for the purposes of raising finance.

The absence of genuine credit and insurance markets for labour income is particularly problematic for poorer households, which when exposed to income shocks are often faced with the prospect of losing their home because they are temporarily unable to meet their mortgage or rental repayments.

In 1955 Milton Friedman advocated the development of government-sponsored income contingent loans in order to allow students to fund the costs of tertiary education.

In 1989 Australia became the first country in the world to successfully introduce income-contingent loans (HECS) to fund higher education on a national basis.

More recently, two Australian economists, Joshua Gans and Stephen King, have [proposed](#) the application of income-contingent loans to mortgage and rental markets in order to help households manage financial duress. They advocate a "housing lifeline" under which means-tested families could draw-down on a small, pre-determined cash sum, which the government would pay directly to their lender or landlord. The qualifying household would then repay the loan (with an appropriate cost) via the tax system if and only if their income returned to a pre-specified level.

The housing lifeline represents a form of income insurance under which households can tax their future earnings in order to help them manage current-day problems. It is particularly relevant in an environment where unemployment is rising and lower-income households face the risk of default or eviction by a landlord.

Governments, like people, typically find it very hard to embrace change. I am

hoping that the current crisis will provide the impetus for governments to seek to capitalise on this chaos and re-engineer the way they think about interfacing with our increasingly complex and globally interconnected financial system.

Christopher Joye is CEO of Rismark International and a research affiliate of Melbourne Business School's Centre for Ideas and The Economy (CITE). He was the principal author of a report produced by the 2003 Prime Minister's Home Ownership Task Force.