INTEREST RATE CONTROLS AND HOUSING LOANS:
A CRITIQUE OF CHAPTER 37 OF THE
CAMPBELL REPORT

Robert Albon and John Piggott

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ABSTRACT

It is argued that deregulation of housing interest rates would substantially increase the cost of housing finance in Australia, contrary to the impression created by the Final Report of the Australian Financial System Inquiry (The Campbell Report). Characteristics of the market for owner occupier housing finance, on both the demand and supply sides, suggest that the uncontrolled rate under regulation will be equal, or almost equal, to the deregulated market rate. The weighted average interest rate for owner occupier housing finance, using December 1981 offers, is more than three percentage points below the uncontrolled rate. The authors conclude that while this result does not of itself constitute an argument against deregulation, it will amplify calls for compensation arrangements.
I Introduction

The Final Report of the Australian Financial System Inquiry (Campbell Report, 1981) advocates the deregulation of interest rates on finance for housing. This controversial recommendation is consistent with the market-oriented stance of the Report, and is further supported by a number of specific arguments related to housing finance. While we are in broad agreement with the general thrust of the recommendation, we argue in this paper that the Report is misleading about the likely effects of deregulation on the cost of housing finance.

The case against housing interest rate controls is substantially presented in Part I of Chapter 37 of the Report. There, the Committee has cautiously expressed the view that "the effective cost of housing finance would [not] necessarily rise appreciably on average as a result of deregulation of interest rates" (37.54). Funds would be available at a rate between the controlled and uncontrolled rates which may not be significantly above the current weighted average rate. Thus, although the Report does not make any categorical statement about the magnitude of this weighted average after deregulation, it gives the strong impression that the Committee does not believe that the increase in this average would be large if deregulation were to proceed. This optimistic scenario has been questioned in public discussion, on the ground that a majority of loans are currently made at controlled rates, so that the dominant weights in the average pertain to those rates that will rise significantly.

Chapter 37 of the Report does not explicitly distinguish between those borrowing for owner-occupation and those with other purposes in mind (e.g. landlords and holiday homebuyers). This means that it is uncertain whether the Committee's comments on the effects of deregulation on interest rates for housing are confined to the owner-occupier segment of the trade. It is, however, our impression that in public debate the Committee's remarks have been interpreted to be so confined, and we shall make this assumption as well. On this basis, we argue that under plausible assumptions, the interest rate on housing after deregulation would be equal, or almost equal, to the uncontrolled rate under
II The Weighted Average Interest Rate on Housing

We may begin by considering the Committee’s views on the structure of housing debt as evidenced in their Table 37.1. According to this Table, major trading banks, savings banks, and building societies hold 85.7% of housing mortgage debt outstanding. This is not, however, necessarily the proportion of balances outstanding for owner-occupiers negotiated at regulated rates, because a substantial proportion of balances outstanding to finance companies is for commercial loans (that is, loans for purchase of housing intended for rental), and because three categories of institution engaged in lending for owner-occupier housing have been omitted – minor trading banks, defence services homes, and government housing commissions. It does not follow that because these two considerations have opposite effects on our perception of the importance of regulation for owner-occupier finance, they will offset each other.

Table 1 gives a more complete picture of the institutional and public sector lending for housing over the period 1965/66 to 1979/80. Estimates exclude loans for the purchase of housing intended for rental, unless otherwise indicated in the notes. In 1979/80, about 91% of balances outstanding on these loans were negotiated at regulated interest rates.

The estimates in Tables 1 and 2 add further support to the idea that most owner-occupier housing finance is negotiated at controlled rates. We use the 1979/80 weights calculated from Table 1 and rates of interest reported in Table 2 to calculate a weighted average interest rate for owner-occupiers as of late 1981. The rates used err on the conservative side where there is some room for doubt. The estimated weighted average rate is just over 13.6 per cent, nearly a percentage point less than the
Sources for and Notes on the Construction of Table 1

A Savings Banks

Sources: 1966-1976: ABS 5605
1976-1980: ABS 5608

B Major Trading Banks

Source: Reserve Bank Statistical Bulletin

C Minor Trading Banks

Sources: Annual Reports of the Rural Bank of NSW, the Agricultural Bank of Tasmania, the Rural and Industries Bank of WA, and the Auditor General’s Report of the State Bank of SA.

Note: No estimate is made for the Queensland Agricultural Bank. For 1980 official data were not available for the Agricultural Bank of Tasmania. An estimate was made based on previous years’ values.

D Permanent Building Societies

1969-1975: ABS 5.45
1975-1980: ABS 5610

Note: Reserve Bank estimates for 1966-69 were increased by 5.5% to make them consistent with estimates for later years reported in ABS series.

E Terminating Building Societies

Source: Reserve Bank Statistical Bulletin, Financial Flow Accounts Supplement, various issues

F Life Insurance Offices

1968-1980: ABS 5621

Note: These estimates are for loans on mortgage for housing; they are not confined to owner-occupier mortgages.

G Finance Companies

Sources: ABS 5614, 5617

Note: There are no separate figures for housing advances outstanding to individuals (that is, for owner occupation). Estimates were obtained using the following procedures.

1. Estimates of principal outstanding on instalment credit for retail sales plus personal loans (it was assumed that 20% of balances outstanding represented interest changes), were obtained for 1975-1980 from ABS 5614.

2. Estimates of principal outstanding from both Finance companies and general financiers, for housing finance to individuals plus instalment credit and other loans to individuals, were obtained from ABS 5617. (Definitional discrepancies between finance companies covered in ABS 5614 and those covered in ABS 5617 are insignificant for present purposes).
3. The difference between these two series represents principal outstanding for housing finance to individuals.

4. For other years, the proportion of the value of these loans to the total value of loans was assumed constant, and equal to the average proportion observed in the years 1975-1980.

H Defence Services Houses

Sources: 1965-1971: Balance sheet of War Services Houses, Parliamentary Papers


I Government Housing Commissions

Sources: Auditor General’s reports for NSW, SA, Tasmania, Commonwealth (ACT) and Queensland; Victorian Housing Commission Annual Reports.

Note: WA and the Northern Territory were not included in these estimates.

J Credit Unions

Sources: ABS 5618

Note: Pre-1975 figures are not available, but are thought to be small.
**TABLE 2: AN ESTIMATE OF THE WEIGHTED AVERAGE INTEREST RATE FOR OWNER-OCCUPIER HOUSING, AUSTRALIA, DECEMBER 1981**

<table>
<thead>
<tr>
<th>LENDER(S)</th>
<th>(1) WEIGHT</th>
<th>(2) RATE</th>
<th>(1) x (2)</th>
</tr>
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<tbody>
<tr>
<td>Major and Minor Trading Banks, Savings Banks</td>
<td>.4663</td>
<td>12.5</td>
<td>5.83</td>
</tr>
<tr>
<td>Permanent and Terminating Building Societies</td>
<td>.3650</td>
<td>14.5</td>
<td>5.29</td>
</tr>
<tr>
<td>Finance Companies, Life Offices</td>
<td>.0752</td>
<td>20.0</td>
<td>1.50</td>
</tr>
<tr>
<td>Credit Unions</td>
<td>.0113</td>
<td>16.0</td>
<td>.18</td>
</tr>
<tr>
<td>Government Authorities and War Service Loans</td>
<td>.0821</td>
<td>10.0</td>
<td>.82</td>
</tr>
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</table>

**1.0**          **13.62**

**Sources:**

Weights are calculated from the data in Table 1 as the proportions of debt outstanding attributable to the different lenders in 1979/80.

Interest rates are based on quotations in "Australian Business" (17-12-81) and on enquiries to various lenders.
average building society rate — already a controlled rate. This calculation assumes that current rates will be applied to all existing loans. In fact, some loans of long standing will have been negotiated at fixed rates, presumably lower than those currently prevailing.

Table 1 does not give an absolutely accurate picture of the structure of owner-occupier housing finance, for two reasons. Firstly, a certain number of loans intended for owner-occupation end up as loans for purchase for rental, either because of changed circumstances of the purchaser or because he has deliberately misled the lending institution about his intentions. In addition, a small number of loans by permanent building societies are explicitly for rental housing.

Secondly, non-institutional loans and some personal loans and overdrafts arranged to provide supplementary owner-occupier housing finance are not included. Non-institutional loans fall into two categories: solicitors' and mortgage brokers' funds, and family finance. There are no official data on the sums involved in loans of these kinds. The Campbell Report offers a speculative estimate that balances outstanding to solicitors and mortgage brokers' funds total $5 billion. A high proportion of these balances are borrowed to finance rental housing. There is no reliable guide to the importance of family finance, although the average rate of interest payable on funds from this source is probably quite low. Many such loans are in fact interest free. Similarly, no data are available to gauge the importance of non-mortgage loans for housing, but they are not thought to be substantial.

The effect of these considerations on the weighted average rate is not great. The most important qualification relates to solicitors' and mortgage brokers' finance. Even if we were to accept the Report's estimate of $5 billion for 1980, and make the further extreme assumption that all these funds were used for owner-occupation, the weighted average is still less than 14%.

While discussion so far has emphasised owner-occupier demand for housing finance, the interest rate question cannot be fully appreciated in isolation from other demands for housing finance. The private rental sector accounts for about 20 per cent of the total of dwellings so that one may expect a significant financing requirement. Further, there is a considerable demand for financing of holiday homes. It is instructive to enquire as to the source of this finance and to the likely consequences of deregulation for the relative satisfactions of owner-occupiers, and landlords and purchasers of holiday homes. This investigation also throws some light on the likely interest rate outcome after deregulation.
III Some Observations on the Market for Housing Finance

The observation that most owner-occupier finance is negotiated at controlled interest rates has, by itself, no implications for the average owner occupier rate in the absence of such controls. This will depend on the relationship between the controlled rate under regulation, the uncontrolled rate under regulation, and the deregulated market rate. If, for example, the uncontrolled rate under regulation were much higher than the deregulated rate, it would even be possible that the regulated weighted average would equal the unregulated market rate. Indeed, a relationship of this kind seems to underlie the thinking of the Campbell Committee.

In order to investigate the possible repercussions of deregulation we have constructed a simple model of the market for loans to analyse the relationship between the uncontrolled rate under regulation and the deregulated market rate. There are two classes of borrowers - "owner-occupiers" and "landlords". Landlords can be thought of as including holiday home buyers. Figure 1 portrays an overall supply curve of loans, S, and the owner-occupiers' (D₀), landlords' (D₇) and total (D₄) demand curves for loans. In a free market loans of L₄ would be made at a real rate of interest of r₄. The split between owner-occupiers and landlords is indicated by L₀ and L₇ where L₀ + L₇ = L₄.

Now suppose that the government intervenes in the market and sets a real rate of interest of r₀ for loans to owner-occupiers borrowing from certain institutions. Even if funds can be attracted from depositors at below-market interest rates, institutions will have to be persuaded to make such loans. It is assumed that loans with a total value of L₀ must be made at r₀ where L₀ is the amount of funds that can be attracted at the controlled rate (less the institutions' margin).

To determine the consequences of these regulations, behaviour in the unregulated sector of the market must be analysed by way of "residual" supply and demand curves, Sₐ and Dₐ, respectively. The nature of these residual curves requires some explanation.

The residual supply curve reflects the supply prices of funds contingent on owner-occupiers borrowing L₀ and r₀ and constitutes the
remainder of the aggregate supply curve drawn from the vertical axis at $r_0$. This raises the question of why any funds are supplied at the controlled rate. In common with other commentators on financial markets, we do not have a completely satisfactory answer. 11

The residual demand curve is more complicated as its nature depends on the actual form of rationing employed and on the extent of income effects arising from the dispensation of low-interest loans. If it is assumed that those with the highest willingness to pay receive the available loans and that there are no income effects (i.e. low-interest loan recipients have on average a zero income elasticity of demand for housing), then it follows that $D_R$ is the curve marked in Figure 1 constituting the summation of $D_L$ and the unsatisfied portion of $D_0$.

Under the above assumptions, equilibrium in the uncontrolled market occurs where $D_R$ intersects $S_R$ at $r_R$, $L_R$. Notably, $r_R$ is equal to the overall rate that would prevail after total decontrol (i.e. the market rate, $r^*_M$).

Alternative assumptions could result in $D_R$ intersecting $S_R$ at a higher rate than $r^*_M$. This could come about via the existence of positive income effects and/or the granting of low-interest loans to more marginal borrowers. If, for example, all $L_0$ loans were made to the most marginal borrowers and income effects were absent, the residual rate of interest would be $r_R$ at the intersection of $D_L$ and $S_R$. Positive income effects could produce an even higher residual rate.

In order to assess the predicted actual outcome it is necessary to draw on available information about the loans market. The available data suggest that any divergence between $r_R$ and $r^*_M$ is likely to be of a small order of magnitude. On the demand-side we have the information provided in Yates' consultancy report (1981a) on the nature of bank and building society loan recipients. Broadly speaking the low-interest loans are granted to middle- and higher-income applicants who might be expected to have higher willingness to pay. Estimates of the income-elasticity of demand for owner-occupied housing given in (Yates (1981b)) suggest a very low figure of about 0.15.

Supply-side considerations suggest that it is not necessary to rely on Yates' empirical work in order to predict that $r_R$ and $r^*_M$ are approximately equal. If
we regard loans to owner-occupiers as good substitutes (from the point of view of the lender) for other financial assets (for example, debentures), then the elasticity of supply to owner-occupier finance will approach infinity. This idea is presumably what the Committee had in mind in emphasising that deregulation of housing interest rates (in conjunction with general monetary stability) can be expected to ensure adequate housing finance stability (Chapter 37, Part I, Section B). Conditions of infinite supply elasticity would, of course, be a consequence of integrating the Australian financial system with the world money market.

An implication of the result that \( r_h \) and \( R_t \), coincide is that landlords would not, after deregulation, encroach on funds currently going to owner-occupiers. Further, deregulation must raise the weighted average rate to the rate previously prevailing in the uncontrolled segment of the market.

The Campbell Committee has been interpreted as setting an upper bound to the deregulated interest rate of 2 percentage points above the long-term Commonwealth bond rate. The Committee's view is expressed in 37.41 where an estimate attributed to Yates' consultancy report is discussed. This estimate was disputed by the Committee which felt that "the inherent 'quality' of an investment secured by mortgage over residential land and buildings [led it]...to question why housing finance rates should command a 2% premium over the government bond rate" (37.41). While the Committee prudently refrains from offering a forecast of what the deregulated rate might be, a reader could be forgiven for concluding that the Committee viewed a 2 per cent premium estimate as unrealistically high.

Our forecast of the upper bound is a rate of around 17-23 per cent, the rate prevailing in the uncontrolled segment of the market (see Table 2). It would be prudent to err on the conservative side, suggesting a rate of around 17-18 per cent. Given the current (December 1981) long term bond rate of 15 per cent the Committee would question why such a high rate should prevail after deregulation. This paper has attempted to provide some answers.
IV Conclusion

This paper has questioned some of the views expressed and impressions created (justifiably or not) by the first part of Chapter 37 of the Campbell Report. In particular, it makes the following points.

1. The bulk of debt outstanding on owner-occupied housing is subject to controlled interest rates. The "weighted average rate", using current offers, is estimated at 13.6 per cent, compared with an unregulated rate of between 17 and 23 per cent (All rates are current for December 1981). These magnitudes suggest that deregulation will lead to a substantial rise in the weighted average rate, thus amplifying calls for some form of compensatory government intervention.

2. A simple market model was constructed to show among other results that, under assumptions which are plausible given the nature of the housing loans market, the deregulated market rate facing borrowers for owner-occupation would be the same, or almost the same, as the uncontrolled rate under regulation. Given the rates reported in (1) above, this suggests an increase in the weighted average rate of more than three percentage points, from 13.6 per cent to at least 17 per cent.

3. The Committee's oversight in not distinguishing between owner-occupier finance and housing finance generally is confusing. But, assuming that the first part of Chapter 37 focuses on owner-occupier finance (an interpretation certainly made in public debate) then points 1 and 2 above lead us to disagree with the impression created by that part of the Report, that deregulation of housing interest rates will not appreciably increase the weighted average rate.

In conclusion, we would like to repeat what we emphasised in the introduction: that our sympathies lie with the Committee's recommendation concerning interest rate deregulation. In particular, we agree that "interest rate controls are an inefficient and ineffective means of assisting low-income potential home buyers" (37.76). This view is based on the empirically supported assumptions that regulated interest rates imply rationing, and that preferred borrowers will generally not be from low-income brackets. With the additional assumptions that those with higher
income will have a higher willingness to pay for owner-occupier housing finance, that income effects are small, and that the elasticity of supply of housing finance is large, we have the implication that deregulation would lead to a market rate of interest on owner-occupier mortgage debt approximately equal to the uncontrolled rate under regulation.
FOOTNOTES

1 The market orientation of the Report should not be interpreted as an implicit rejection of the validity of assistance programmes. The Committee took the position that "where sectoral assistance is to be given ...... it should be effected...directly through the Budget process - and not indirectly through the financial system" (36.48). The economics literature on sectoral assistance was reviewed for the Committee in a commissioned study (Albon and Cheok (1981)).

2 Important specific arguments included the adverse distributional impact of interest rate controls on housing finance, (37.76), a view given empirical support in a major consultancy report prepared for the Committee by Dr Judy Yates of the University of Sydney, (Yates (1981a)). The Committee also emphasized that deregulation would help to stabilize the supply of funds for housing finance (37.26).

3 By "deregulation" we refer to the complete elimination of all explicit and implicit controls on interest rates and lending directives. A policy which deregulates interest rates, but which adds that government will intervene if rates increase "too much", does not, therefore, constitute "deregulation". We assume that the Campbell Committee gives the term this interpretation as well.

4 It is sometimes suggested that increased interest rates will be capitalised into the price of a dwelling, and will therefore not add to the "cost" of housing. While in the short run such an effect is feasible (it is in our view unlikely to be very significant), in the longer run there will be an adjustment in the quantity of housing services produced which will tend to cancel this "capitalisation" effect. Other elements of cost, such as pre-deposit requirements, do not appreciably change the effective interest rate on mortgages because of the length of the term normally negotiated. These issues have been examined by Stroud (1981).
5 In a letter to the "Financial Review" (25-11-81, p.13) Mr Ralph Willie, the Labor Party spokesman on economic affairs, claims that "almost 87 per cent of home lending is currently from banks, building societies and credit unions". This figure is consistent with the Report's Table 37.1. Credit union rates are not subject to control.

6 The estimates in Table 1 agree closely with those of the Priorities Review Staff (1975), Table 4, for the three years that the two tables both report.

7 Permanent building societies are restricted in their deposit base to the extent that in order to be taxed as a co-operative they must have as a primary objective the obtaining of funds from their shareholders for on-lending to their members to enable them to acquire land or buildings to be used as a residence or as a residence and business. In practice, about 90% of loan approvals each year are for owner-occupation. The remaining loans are for all other purposes and may include other loans for non-commercial purposes (e.g. to finance the construction of a church hall) as well as loans for rental housing. Loans for other than owner-occupation tend to be short term (3-5 years). The proportion of balances outstanding accounted for by commercial loans is therefore likely to be very small.

8 This view is evidenced in paragraphs 37.41, 37.54, and 37.72.

9 This model is similar to that set out in Albon (1981) for the purposes of analysing rent control situations where only part of the market is controlled. We have also examined the literature on black market behaviour. This turned out to be of limited relevance to our case because of its preoccupation with the effects of legal restrictions on black market trading. See, for example, the review and analysis by Browning and Culbertson (1974).

10 Some lending institutions do operate under restrictions that specify amounts that have to be allocated to housing loans.
Of course such funds are supplied. Reasons may include the following: endeavours of welfare recipients not to exceed means-test income levels; inertia; a "social conscience" on the part of depositors feeling they are contributing to the welfare of the poor; reduced riskiness of bank loans as a consequence of employers guaranteeing employees' loans; savings to qualify for low-interest loans.

In an article in the "Financial Review" (20.11.81), Yates is quoted as claiming that the Committee has misinterpreted her report in this respect.

The government bond rate is unsatisfactory as a benchmark for evaluating the mortgage rate in either a regulated or deregulated environment. Under regulation we would expect the bond rate to be below the mortgage interest rate in the uncontrolled segment of the market for various reasons, including lower transaction costs and the existence of a captive market for bonds.
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