

Home Ownership Inquiry – Supplementary Submission

Christopher Moore – Individual

7 August 2015

This supplementary submission contains lending side solutions that could improve home ownership

1. Neutral Lending to Investors in either all or existing property
Or
2. Where negative gearing is retained, align investor loan capacity with Owner Occupiers by
 - a. Applying losses to after tax income to **size** the loan, but investors still retain full deductibility
 - b. Investors are moved to Principal and Interest Loans and serviced by after tax income to **size** the loan. This could help improve the stability issues raised from the financial system inquiry.
 - i. Or **sized** as P & I, but investors can opt for interest only.

Neutral Lending for Investors

Neutral Gearing in the media and to my understanding is about quarantining losses and applying them to future gains. This is a tax orientated change.

My design for neutral lending, is about retaining deductions applied to income, but capping lending into existing housing for investors, and then calculating a deposit above the neutral level to direct investors into new supply where negative gearing still applies.

Appendix C provides a detailed data series from 1998 to 2015 of median sales and median rents for a select number of areas of NSW. It includes the Inner, Middle and Outer Circle of Sydney, and regional NSW such as Newcastle/Illawarra, and Bathurst/Orange.

In Appendix C, I have calculated the deposit required above the neutral level for each geographical area over that 17 year period. The neutral level (shown in Appendix A) is calculated as the yearly rent x inverse of the interest rate at that time in history using RBA records. i.e. 5% is a x20 multiplier. Hence a weekly rent of \$400 / week would calculate a neutral level of \$416,000.

The neutral level being where the rent being paid is the same as the interest only component. Meaning at a 0% deposit, it is very attractive for someone to purchase the property they are renting.

At the committee hearing I discussed that if there was a move to neutral lending, i.e. *my assumption is that lending is capped to the neutral level*, that calculation of the neutral level would help differentiate the deposit requirement between different housing markets across the country. And it does as shown in Appendix C. This would address the affordable housing inquiries issue that a fixed 30% similar to New Zealand's would not be appropriate.

Appendix C highlights as of December 2014, for houses, that inner and middle Sydney needs a 51-56% deposit, outer Sydney is 41%, Newcastle/Illawarra is 29%, and Bathurst a 21% deposit.

In Sydney it would be very unattractive for investors to buy a house with a 50% deposit. Hence investor lending could be pushed into new supply where a deposit of say 5% is required, leaving owner occupiers to drive the market for existing housing.

Whereas in Bathurst, the deposit is 21%, so the investor may feel the difference between 21% and 5% is small enough that investing in existing property is preferred. But if excess investors entered the market and drove up prices relative to rents, the deposit would increase to a point that dis-incentivises investors.

Any fear that rising rents may occur, the neutral level will rise, and the deposit requirement will fall, incentivising investors back into the market. (Equal and opposite reactions are built into the design).

Overall the design of neutral lending is a macro prudential tool that links prices and rents together far more tightly, with the spread between prices and rents set by the interest rate.

Neutral lending in my opinion would attenuate the boom and bust cycle, thus improving stability.

Aligning Investors with Owner Occupiers

If negative gearing is to continue,

Recommendation

- To ensure an even playing field between investors and owner occupiers, the **Sizing** of the loan needs to be treated the same i.e.
 - a. Losses are applied to after tax income to determine maximum loan **size**.
 - b. Investors are moved to Principal and Interest loans and serviced by after tax income to **size** the loan.
 - i. Or **sized** as P & I, but investors can opt for interest only

These changes are small, simple, incremental, and they are from the lending side rather than the tax side. It also means that investors and owner occupiers are equalised to the same lending capacity, and investors new and existing retain full deductibility. i.e. No change to negative gearing.

Loan Sizing – Comparison of Investor versus Owner Occupier

Investors can be lent more than an identical owner occupier for negatively geared investments. A sample calculation is found in Appendix B.

The Appendix B calculation assumes that two investors rent to each other both with identical income, property price, rental price and use interest only loans, thus gaining the tax deductions. This is then compared to an owner occupier with the same income buying the same house with the same price and using a principal and interest loan.

The following table is a summary of the three tax rates I have used to calculate the extra loan value an investor can get over and above an owner occupier calculated from Appendix B. The data used is from Appendix C that includes the middle circle of Sydney median house (\$1.1m), median rent (\$550 p/w) and interest rate of 5.5%. A minimum deposit of 20% is used, and maintenance costs are 20% of gross rent.

Depreciation and land tax have been ignored.

Individuals Tax Rate	Investor loan value % greater than an Identical Owner Occupier for <u>negatively</u> geared investments	Same, but investor converts after tax principal cash flow of owner occupier to gross income to service a larger loan
32.5 %	+25%	n/a
37.0 %	+31%	+70%
47.0 %	+46%	+93%

There are four key points that advantage investors over owner occupiers for negatively geared investments. These are as follows:

- The more negative the cash flow, the higher the tax refund for investors thus increasing their loan size, meaning owner occupiers are further disadvantaged.
- Higher tax rates increase the disadvantage to owner occupiers.
- Investors can convert net income for principal loan reduction into gross income to service interest on a larger interest only loan.
- The maximum loan size of an interest only loan is larger than a principal and interest loan (See table below). This disadvantage to owner occupiers is exacerbated with falling interest rates.

If the principal that owner occupiers should not be disadvantaged, this is not being met.

The example in Appendix B, shows that when investor losses are applied to gross income, the investor can increase their maximum lending capacity by 31%. And when the principal loan component is re-converted to gross income to service a higher loan, the investor has a combined 70% larger loan capacity than an owner occupier.

But when the losses are applied to the after tax income of the investor (column 3, Appendix B), the net income of both investor and owner occupier are the same.

Hence when assessing a loan for an investor, losses should be assessed against after tax income, and the loan is assessed as principal and interest.

For the example in Appendix B, this reduces the investor loan capacity by about 41% (i.e. 1.70 reduced to 1.00). Or in other words, the investor had a maximum loan capacity of \$1.5M but is reduced to \$880,000 to align with the owner occupier's maximum capacity.

Principal and Interest Loan

Moving investors (both positive and negatively geared) to a principal and interest loan not only maintains the loan size equivalent to an owner occupier, but also increases savings with each monthly repayment on top of the deposit when the property is purchased.

In addition, housing investment has been called out by the Financial System Inquiry as a stability problem, hence including the principal in the investor loan may assist this.

Hence there are two benefits.

The following table shows a simple calculation of a principal and interest loan over 30 years at different interest rates. Note that as interest rates fall, by retaining the principal component the loan size does not increase with the inverse of the interest rate as it does for interest only. In fact as interest rates fall, the principal component increases for the first year payment. The principal component can be increased by reducing the length of the loan e.g. to 25 years.

Home Ownership
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Principal and Interest Components for \$100,000				Loan size with a Servicing Capacity of \$5000 per year			
				\$5,000	\$5,000		
First Year Payments				Loan Size			
Interest Rate	Interest	Principal	Total	Principal as a % of Total Loan	Interest Only	P&I	Loan Size Reduction
1%	\$987	\$2,873	\$3,860	74%	\$500,000	\$129,534	74%
2%	\$1,978	\$2,458	\$4,436	55%	\$250,000	\$112,714	55%
3%	\$2,971	\$2,088	\$5,059	41%	\$166,667	\$98,834	41%
4%	\$3,968	\$1,761	\$5,729	31%	\$125,000	\$87,275	30%
5%	\$4,966	\$1,475	\$6,441	23%	\$100,000	\$77,628	22%
6%	\$5,964	\$1,189	\$7,153	17%	\$83,333	\$69,901	16%
7%	\$6,962	\$903	\$7,865	11%	\$71,429	\$63,573	11%
8%	\$7,970	\$835	\$8,805	9%	\$62,500	\$56,786	9%
9%	\$8,972	\$683	\$9,655	7%	\$55,556	\$51,787	7%
10%	\$9,975	\$556	\$10,531	5%	\$50,000	\$47,479	5%

Deductions for Owners occupier loans

On the 7 August during the committee hearing, deductions for owner occupiers was discussed as an option.

Moving to say a 50% deduction for both home owners and investors is thought to even the playing field. i.e. owner occupier mortgage repayments after tax may become cheaper than renting. So there is an incentive to buy.

Or something where the deduction moves from interest rate changes. i.e. under high interest rates, there's a need for investors to keep rents down, but under low interest rates there's a need for investors to back off, and let owner occupiers drive the market to increase home ownership.

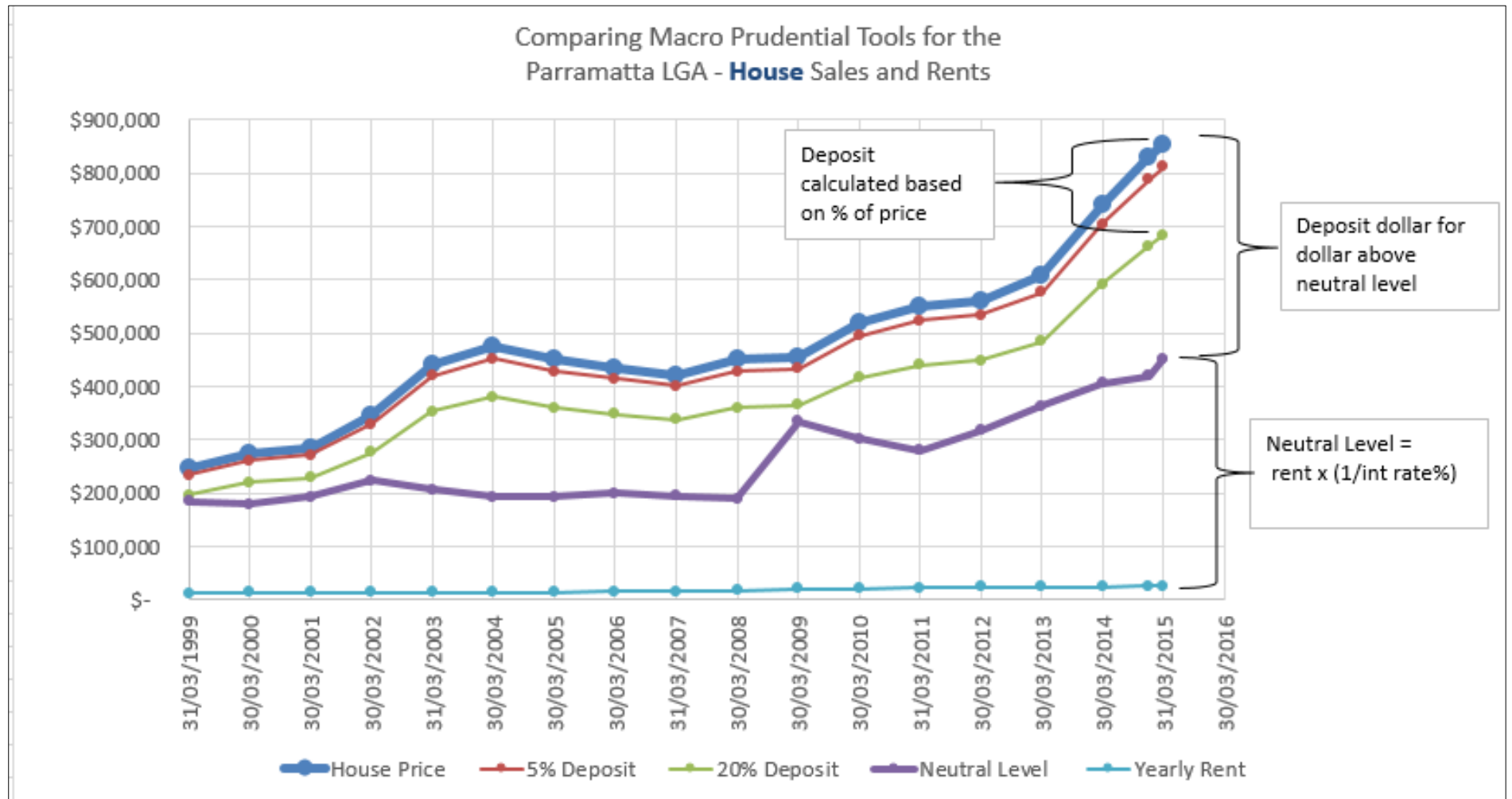
Based on the Appendix B calculator, applying 50% of losses to gross income for both owner occupier and investor, I could not get symmetry.

My thoughts

- This may have the same effect as the first home owners grant. Vendors will just increase prices and possibly rents at the same time if they can.
- Does this thinking include maintenance costs, not just interest costs for deductibility
- Owner occupiers (10 million of them, would need to keep records for tax purposes)
- Will they borrow more to do up the house, meaning less savings for retirement, and which are not means tested.
- Do we place a capital gains tax on the principal residence.
- The tax system loses its progressiveness because higher incomes are making larger deductions on the family home.
- Changing deductions when interest rate movement increases complexity.
- Investors can still get a larger loan (+22% bigger when 5% Interest Rate) as they don't pay down the principal component of the loan. Hence owner occupiers are still disadvantaged. This disadvantage is further exacerbated when interest rates fall.

Personally, my recommendations that come from the lending side, (either neutral lending or sizing of investor loans as P&I) appear to be simpler, retain all of the current tax design and appear to provide an even playing field to ensure that owner occupiers are not disadvantaged.

Appendix A – Using the Parramatta LGA data set from the first submission



Appendix B

"Loan Sizing" Comparison of Investors versus Owner Occupier					
37 % Tax Rate					
Rent and Buy Investment Property		Owner Occupier		Rent and Buy Investment Property - Losses Applied to Net Income	
Home	\$ 1,100,000	Home	\$ 1,100,000	Home	\$ 1,100,000
Deposit	20%	Deposit	20%	Deposit	20%
Deposit	\$ 220,000	Deposit	\$ 220,000	Deposit	\$ 220,000
Loan	\$ 880,000	Loan	\$ 880,000	Loan	\$ 880,000
Interest	5.5%	Interest	5.5%	Interest	5.5%
Repayments (I/O)	\$ 48,400	Repayments (I/O)	\$ 48,400	Repayments (I/O)	\$ 48,400
		Principal	\$ 11,854		
Maintenance \$/week (20% of rent)	\$ 110			Maintenance \$/week (20% of rent)	\$ 110
Maintenance \$/year	\$ 5,720.00			Maintenance \$/year	\$ 5,720.00
Rent \$/week	\$ 550			Rent \$/week	\$ 550
Rent / year	\$ 28,600			Rent / year	\$ 28,600
Net Yield	2.1%				
Loss	-\$ 25,520				
Gross Income	\$ 140,000	Gross Income	\$ 140,000	Gross Income	\$ 140,000
Net Taxable Income	\$ 114,480	Net Taxable Income	\$ 140,000	Net Taxable Income	\$ 140,000
Tax Rate %	37%			Tax Rate %	37%
Tax	\$ 30,304	Tax	\$ 39,747	Tax	\$ 39,747
Net Income	\$ 84,176	Net Income	\$ 100,253	Net Income	\$ 100,253
Rent \$/week	\$ 550	Maintenance \$/week (20% of rent)	\$ 110	Rent \$/week	\$ 550
Rent / year	\$ 28,600	Maintenance \$/year	\$ 5,720	Rent / year	\$ 28,600
		Repayments	\$ 48,400	Loss	-\$ 25,520
Net Income Before Principal	\$ 55,576	Net Income Before Principal	\$ 46,133	Net Income	\$ 46,133
Principal Component	\$ -	Principal Component	\$ 11,854		
Net Income After Principal	\$ 55,576	Net Income After Principal	\$ 34,279		
Net Difference before Principal (Investor over Owner Occ)	\$ 9,442			Net Difference (Net Income) (Investor over Owner Occ)	\$ -
Converted to Gross Income (Investor over Owner Occ)	\$ 14,988			Net Difference (Gross Income) (Investor over Owner Occ)	\$ -
Extra Loan Size	\$ 272,508			Extra Loan Size	\$ -
Extra Loan Size	31.0%			Extra Loan Size	0.0%
Same but includes Principal (Investor over Owner Occ)	\$ 21,296				
Converted to Gross Income (Investor over Owner Occ)	\$ 33,804				
Extra Loan Size	\$ 614,615				
Extra Loan Size	69.8%				

Home Ownership Submission 4 - Supplementary Submission

Comparison of Deposit Required for Neutral Gearing

Data from Housing NSW - Quarterly Sales and Rent Reports

Legend for Deposit

< 0%
0-20%
20-35%
>35 %

Non Strata (Houses)

Report Reference	Rent	Sales	RBA Std Var Interest Rate	Date
			10.50%	31/03/1996
			7.50%	31/03/1997
No43	No44		6.70%	31/03/1998
No47	No48		6.50%	31/03/1999
No51	No52		7.30%	31/03/2000
No55	No56		7.30%	31/03/2001
No59	No60		6.05%	31/03/2002
No63	No64		6.55%	31/03/2003
No67	No68		7.05%	31/03/2004
No71	No72		7.30%	31/03/2005
No75	No76		7.30%	31/03/2006
No79	No80		8.05%	31/03/2007
No83	No84		9.35%	31/03/2008
No87	No88		5.85%	31/03/2009
No91	No92		6.90%	31/03/2010
No95	No96		7.80%	31/03/2011
No99	No100		7.40%	31/03/2012
No103	No104		6.45%	31/03/2013
No107	No108		5.95%	31/03/2014
No110	No111		5.95%	31/12/2014

Sydney - Inner Circle

Non-Strata Median Price	3 Bed Median Rent	Deposit above Neutral
na	\$ 320	
na	\$ 350	
\$ 390,000	\$ 358	29%
\$ 430,000	\$ 365	32%
\$ 456,000	\$ 420	34%
\$ 500,000	\$ 430	39%
\$ 605,000	\$ 425	40%
\$ 709,000	\$ 430	52%
\$ 784,000	\$ 440	59%
\$ 734,000	\$ 450	56%
\$ 740,000	\$ 475	54%
\$ 795,000	\$ 525	57%
\$ 910,000	\$ 600	63%
\$ 820,000	\$ 650	30%
\$ 1,128,000	\$ 660	56%
\$ 1,070,000	\$ 720	55%
\$ 1,035,000	\$ 750	49%
\$ 1,113,000	\$ 790	43%
\$ 1,360,000	\$ 800	49%
\$ 1,470,000	\$ 823	51%

Appendix C

Supplementary Submission to the Home Ownership Inquiry

Chris Moore

Individual

Aug-15

Sydney - Middle Circle

Non-Strata Median Price	3 Bed Median Rent	Deposit above Neutral
na	\$ 240	
na	\$ 250	
\$ 290,000	\$ 260	30%
\$ 320,000	\$ 265	34%
\$ 350,000	\$ 285	42%
\$ 358,000	\$ 300	40%
\$ 440,000	\$ 300	41%
\$ 550,000	\$ 295	57%
\$ 620,000	\$ 310	63%
\$ 560,000	\$ 320	59%
\$ 548,000	\$ 320	58%
\$ 557,000	\$ 350	59%
\$ 590,000	\$ 400	62%
\$ 550,000	\$ 440	29%
\$ 715,000	\$ 460	52%
\$ 723,000	\$ 500	54%
\$ 750,000	\$ 500	53%
\$ 785,000	\$ 520	47%
\$ 935,000	\$ 550	49%
\$ 1,100,000	\$ 550	56%

Sydney - Outer Circle

Non-Strata Median Price	3 Bed Median Rent	Deposit above Neutral
na	\$ 180	
na	\$ 185	
\$ 183,000	\$ 190	19%
\$ 196,000	\$ 195	20%
\$ 230,000	\$ 210	35%
\$ 249,000	\$ 220	37%
\$ 295,000	\$ 220	36%
\$ 360,000	\$ 230	49%
\$ 416,000	\$ 235	58%
\$ 400,000	\$ 240	57%
\$ 387,000	\$ 250	54%
\$ 387,000	\$ 260	57%
\$ 400,000	\$ 290	60%
\$ 380,000	\$ 320	25%
\$ 449,000	\$ 350	41%
\$ 445,000	\$ 370	45%
\$ 468,000	\$ 385	42%
\$ 480,000	\$ 400	33%
\$ 550,000	\$ 410	35%
\$ 625,000	\$ 420	41%

Newcastle+Illawarra

Non-Strata Median Price	3 Bed Median Rent	Deposit above Neutral
na	na	
na	na	
\$ 142,000	\$ 165	10%
\$ 151,000	\$ 165	13%
\$ 157,000	\$ 170	23%
\$ 168,000	\$ 180	24%
\$ 207,000	\$ 185	23%
\$ 265,000	\$ 205	39%
\$ 330,000	\$ 220	51%
\$ 325,000	\$ 230	50%
\$ 325,000	\$ 240	47%
\$ 328,000	\$ 250	51%
\$ 345,000	\$ 280	55%
\$ 330,000	\$ 300	19%
\$ 375,000	\$ 320	36%
\$ 380,000	\$ 350	39%
\$ 395,000	\$ 360	36%
\$ 408,000	\$ 370	27%
\$ 430,000	\$ 375	24%
\$ 455,000	\$ 370	29%

Bathurst + Orange

Bathurst

Non-Strata Median Price	3 Bed Median Rent	Deposit above Neutral
na	\$ 160	
na	\$ 160	
\$ 128,000	\$ 165	0%
\$ 130,000	\$ 165	-2%
\$ 133,000	\$ 165	12%
\$ 137,000	\$ 175	9%
\$ 150,000	\$ 180	-3%
\$ 170,000	\$ 180	16%
\$ 241,000	\$ 200	39%
\$ 263,000	\$ 210	43%
\$ 270,000	\$ 220	42%
\$ 275,000	\$ 230	46%
\$ 265,000	\$ 240	50%
\$ 255,000	\$ 240	16%
\$ 305,000	\$ 260	36%
\$ 296,000	\$ 290	35%
\$ 305,000	\$ 320	26%
\$ 325,000	\$ 320	21%
\$ 335,000	\$ 320	17%
\$ 342,000	\$ 310	21%

Strata (Units)

Reference	Rent	Sales	RBA Std Var Interest Rate	Date
			10.50%	31/03/1996
			7.50%	31/03/1997
No43	No44		6.70%	31/03/1998
No47	No48		6.50%	31/03/1999
No51	No52		7.30%	31/03/2000
No55	No56		7.30%	31/03/2001
No59	No60		6.05%	31/03/2002
No63	No64		6.55%	31/03/2003
No67	No68		7.05%	31/03/2004
No71	No72		7.30%	31/03/2005
No75	No76		7.30%	31/03/2006
No79	No80		8.05%	31/03/2007
No83	No84		9.35%	31/03/2008
No87	No88		5.85%	31/03/2009
No91	No92		6.90%	31/03/2010
No95	No96		7.80%	31/03/2011
No99	No100		7.40%	31/03/2012
No103	No104		6.45%	31/03/2013
No107	No108		5.95%	31/03/2014
No110	No111		5.95%	31/12/2014

Sydney - Inner Circle

Strata Median Price	2 Bed Rent	Deposit above Neutral
na	\$ 250	
na	\$ 260	
\$ 270,000	\$ 280	20%
\$ 288,000	\$ 295	18%
\$ 318,000	\$ 325	27%
\$ 340,000	\$ 350	27%
\$ 388,000	\$ 340	25%
\$ 412,000	\$ 350	33%
\$ 450,000	\$ 350	43%
\$ 455,000	\$ 360	44%
\$ 440,000	\$ 380	38%
\$ 450,000	\$ 410	41%
\$ 485,000	\$ 460	47%
\$ 470,000	\$ 500	5%
\$ 560,000	\$ 520	30%
\$ 560,000	\$ 560	33%
\$ 600,000	\$ 585	31%
\$ 615,000	\$ 595	22%
\$ 705,000	\$ 620	23%
\$ 750,000	\$ 640	25%

Sydney - Middle Circle

Strata Median Price	2 Bed Rent	Deposit above Neutral
na	\$ 175	
na	\$ 185	
\$ 187,000	\$ 190	21%
\$ 203,000	\$ 200	21%
\$ 228,000	\$ 215	33%
\$ 250,000	\$ 230	34%
\$ 292,000	\$ 230	32%
\$ 330,000	\$ 230	45%
\$ 350,000	\$ 250	47%
\$ 350,000	\$ 260	47%
\$ 352,000	\$ 270	45%
\$ 345,000	\$ 290	46%
\$ 360,000	\$ 325	50%
\$ 365,000	\$ 370	10%
\$ 420,000	\$ 380	32%
\$ 439,000	\$ 400	39%
\$ 462,000	\$ 420	36%
\$ 485,000	\$ 430	29%
\$ 545,000	\$ 455	27%
\$ 611,000	\$ 470	33%

Sydney - Outer Circle

Strata Median Price	2 Bed Rent	Deposit above Neutral
na	\$ 160	
na	\$ 170	
\$ 174,000	\$ 170	24%
\$ 178,000	\$ 185	17%
\$ 200,000	\$ 200	29%
\$ 235,000	\$ 220	33%
\$ 255,000	\$ 215	28%
\$ 305,000	\$ 220	43%
\$ 332,000	\$ 230	49%
\$ 336,000	\$ 230	51%
\$ 330,000	\$ 240	48%
\$ 316,000	\$ 260	47%
\$ 325,000	\$ 290	50%
\$ 320,000	\$ 320	11%
\$ 356,000	\$ 340	28%
\$ 370,000	\$ 360	35%
\$ 365,000	\$ 370	29%
\$ 392,000	\$ 380	22%
\$ 420,000	\$ 390	19%
\$ 472,000	\$ 400	26%

Newcastle+Illawarra

Strata Median Price	2 Bed Rent	Deposit above Neutral
na	na	
na	na	
\$ 135,000	\$ 135	22%
\$ 134,000	\$ 135	19%
\$ 146,000	\$ 140	32%
\$ 154,000	\$ 145	33%
\$ 180,000	\$ 150	28%
\$ 245,000	\$ 161	48%
\$ 293,000	\$ 175	56%
\$ 290,000	\$ 185	55%
\$ 296,000	\$ 195	53%
\$ 286,000	\$ 200	55%
\$ 300,000	\$ 225	58%
\$ 290,000	\$ 245	25%
\$ 325,000	\$ 260	40%
\$ 329,000	\$ 285	42%
\$ 328,000	\$ 300	36%
\$ 330,000	\$ 315	23%
\$ 357,000	\$ 320	22%
\$ 395,000	\$ 320	29%

Bathurst + Orange

Bathurst

Strata Median Price	2 Bed Rent	Deposit above Neutral
na	\$ 128	
na	\$ 125	
na	\$ 130	
\$ 109,000	\$ 130	5%
\$ 103,000	\$ 130	10%
\$ 87,000	\$ 135	-11%
\$ 98,000	\$ 140	-23%
\$ 134,000	\$ 140	17%
\$ 157,000	\$ 155	27%
\$ 181,000	\$ 165	35%
\$ 170,000	\$ 170	29%
\$ 185,000	\$ 170	41%
\$ 175,000	\$ 180	43%
\$ 195,000	\$ 185	16%
\$ 190,000	\$ 200	21%
\$ 223,000	\$ 208	38%
\$ 215,000	\$ 230	25%
\$ 220,000	\$ 240	12%
\$ 249,000	\$ 240	16%
\$ 257,000	\$ 245	17%