

Home Ownership Inquiry – 2nd Supplementary Submission

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After the 7 August committee hearing in Sydney, I have gone through and considered how a Principal and Interest Loan for investors could help improve home ownership.

Principal and Interest Loan for Investors

- Principal and Interest loans would more likely impact positively geared investors than negatively geared investors because a larger loan portfolio can be taken out as the rent usually covers the interest. (Especially at low rates).
- The principal component adds the equivalent of about 2.4% to a 4% rate and 1.5% to a 7% rate. (Based on 25year loan). The principal increases as rates fall. See Table 1.
- Including the principal means the investor reaches their maximum serviceability limit earlier. (i.e. they have to reduce their loan size, or purchase less properties).
- When positively geared investors are assessed against APRA's 7%, including the principal makes the repayments the equivalent of 8.5% (25 year loan).
- For a loan value of \$30M at 5%, P&I repayments would increase to the equivalent of 7%, or an additional \$600,000 per year. This extra portion would not be deductible.
- With falling interest rates, the principal component increases and thus inherently leans on both positively and negatively geared investors.

Table 1 - Principal and Interest breakdown for 25 year loans

25 Year Loan								
Principal and Interest Components for \$100,000						Loan size with a Servicing Capacity of \$5000 per year		
Interest Rate	First Year Payments			First Year		Loan Size		
	Interest	Principal	Total	Principal % added to Interest Rate	Increase in Repayments (I/O to P&I)	Interest Only	P&I	Loan Size Reduction from (I/O to P&I)
1%	\$984	\$3,539	\$4,523	3.5%	360%	\$500,000	\$110,546	78%
2%	\$1,972	\$3,115	\$5,087	3.1%	158%	\$250,000	\$98,290	61%
3%	\$2,963	\$2,728	\$5,691	2.7%	92%	\$166,667	\$87,858	47%
4%	\$3,957	\$2,377	\$6,334	2.4%	60%	\$125,000	\$78,939	37%
5%	\$4,953	\$2,062	\$7,015	2.1%	42%	\$100,000	\$71,276	29%
6%	\$5,952	\$1,780	\$7,732	1.8%	30%	\$83,333	\$64,666	22%
7%	\$6,952	\$1,530	\$8,482	1.5%	22%	\$71,429	\$58,948	17%
8%	\$7,953	\$1,309	\$9,262	1.3%	16%	\$62,500	\$53,984	14%
9%	\$8,955	\$1,116	\$10,071	1.1%	12%	\$55,556	\$49,648	11%
10%	\$9,957	\$947	\$10,904	0.9%	10%	\$50,000	\$45,855	8%

Table 2 shows that the principal and interest over a number of years.

It shows the principal component of the repayment increases, meaning deductions for investors will reduce over time.

Towards the end of the loan, e.g. the last 5 to 10 years, the majority of the repayment will be the principal. If interest rates were to rise, most of the repayment would be the principal and thus not be deductible.

Table 2 – Yearly breakdown of Principal and Interest

25 Year Principal and Interest Loan					
\$100,000 Loan @ 7% Interest Rate					
	Repayments				
Year	Principal (\$100,000)	Interest	Principal	Total Repayment	Principal % of Total Repayment
1	\$98,471	\$6,952	\$1,529	\$8,481	18.0%
2	\$96,831	\$6,841	\$1,640	\$8,481	19.3%
3	\$95,072	\$6,722	\$1,759	\$8,481	20.7%
4	\$93,186	\$6,595	\$1,886	\$8,481	22.2%
5	\$91,164	\$6,459	\$2,022	\$8,481	23.8%
6	\$88,996	\$6,313	\$2,168	\$8,481	25.6%
7	\$86,671	\$6,156	\$2,325	\$8,481	27.4%
8	\$84,178	\$5,988	\$2,493	\$8,481	29.4%
9	\$81,505	\$5,808	\$2,673	\$8,481	31.5%
10	\$78,638	\$5,614	\$2,867	\$8,481	33.8%

Positive Gearing

An example taken from a property investment magazine recently of 10 properties positively geared is shown in Table 3.

At the current 4.4% interest the investor is making about \$36,000 positive cashflow per year. Assuming a tax rate of 37% leaves \$22,680 of after tax income. But assuming a 25 year P&I loan for the \$2.3M loan portfolio, the principal added is about \$51,000. This is an additional \$28,000 beyond the \$22,680 profit that the investor has to find to service the loan.

At 6% interest rate, the portfolio is about neutral. But after adding the principal component, the investor needs to find \$41,000.

Assessing this investor at APRA's 7% floor, losses applied to gross income are nearly \$25,000 per year. Assuming the investors tax rate is 37%, net loss is \$15,750. Adding the principal component of \$35,000 (\$2.3M @ 7%) is \$51,000 per year out of the investors after tax cash flow.

If the investor were treated as an owner occupier for loan assessment purposes (as I have recommended in supplementary submission No 1) they would need \$60,000 of cash flow.

If the investor had \$100,000 of gross income (I have assumed), which is \$75,053 of after tax income, 68% of after tax income would need to service the loan, (80% as an owner occupier). But only 21% with an interest only loan.

By including the principal component, the investors' cash flow exceeds 1/3 of the investors after tax income. Reducing the portfolio by half from \$2.3M to about \$1.1M (or \$860k as an owner occupier) would meet the 1/3 servicing criteria.

That's a reduction from 10 properties to about 4.8 properties, or 3.7 properties if treated as an owner occupier for the purpose of the loan application.

This example highlights how including the principal repayment and also assessing loan serviceability as an owner occupier, the positively geared investor is significantly slowed from purchasing properties.

The benefits of P&I are that positively geared investors accumulate less properties, thus improving opportunities for home ownership. It would also improve financial system stability.

Table 3 - Positive Gearing Example - (Cashflow at the current 4.4%, then 6%, then 7%).

Investment Properties	Rent \$/week	Rent after Maintenance (0.8 x Rent) (Assumed)	Loan Amount	Interest Rate	Monthly Loan Repayment (Interest Only)	Monthly Loan Repayment (Principal and Interest, 25 year)
Property No 1	\$ 380	\$ 304.0	\$ 305,000	4.40%	\$ 1,118	\$ 1,678
Property No 2	\$ 400	\$ 320.0	\$ 354,000	4.40%	\$ 1,298	\$ 1,947
Property No 3	\$ 240	\$ 192.0	\$ 154,000	4.40%	\$ 564	\$ 847
Property No 4	\$ 480	\$ 384.0	\$ 340,000	4.40%	\$ 1,246	\$ 1,870
Property No 5	\$ 290	\$ 232.0	\$ 215,000	4.40%	\$ 788	\$ 1,183
Property No 6	\$ 325	\$ 260.0	\$ 200,000	4.40%	\$ 733	\$ 1,100
Property No 7	\$ 320	\$ 256.0	\$ 199,000	4.40%	\$ 729	\$ 1,095
Property No 8	\$ 295	\$ 236.0	\$ 170,000	4.40%	\$ 623	\$ 935
Property No 9	\$ 300	\$ 240.0	\$ 206,000	4.40%	\$ 755	\$ 1,133
Property No 10	\$ 325	\$ 260.0	\$ 206,000	4.40%	\$ 755	\$ 1,133
			\$ 2,349,000			
				Per Month	\$ 8,609	\$ 12,920
Per Week	\$ 3,355	\$ 2,684		Per Week	\$ 1,987	\$ 2,981
				Net Cashflow Per Week	\$ 697	-\$ 297
				Net Cashflow Per Year	\$ 36,260	-\$ 15,466

Investment Properties	Rent \$/week	Rent after Maintenance (0.8 x Rent) (Assumed)	Loan Amount	Interest Rate	Monthly Loan Repayment (Interest Only)	Monthly Loan Repayment (Principal and Interest, 25 year)
Property No 1	\$ 380	\$ 304.0	\$ 305,000	6.00%	\$ 1,525	\$ 1,965
Property No 2	\$ 400	\$ 320.0	\$ 354,000	6.00%	\$ 1,770	\$ 2,280
Property No 3	\$ 240	\$ 192.0	\$ 154,000	6.00%	\$ 770	\$ 992
Property No 4	\$ 480	\$ 384.0	\$ 340,000	6.00%	\$ 1,700	\$ 2,190
Property No 5	\$ 290	\$ 232.0	\$ 215,000	6.00%	\$ 1,075	\$ 1,385
Property No 6	\$ 325	\$ 260.0	\$ 200,000	6.00%	\$ 1,000	\$ 1,288
Property No 7	\$ 320	\$ 256.0	\$ 199,000	6.00%	\$ 995	\$ 1,282
Property No 8	\$ 295	\$ 236.0	\$ 170,000	6.00%	\$ 850	\$ 1,095
Property No 9	\$ 300	\$ 240.0	\$ 206,000	6.00%	\$ 1,030	\$ 1,327
Property No 10	\$ 325	\$ 260.0	\$ 206,000	6.00%	\$ 1,030	\$ 1,327
			\$ 2,349,000			
				Per Month	\$ 11,745	\$ 15,131
Per Week	\$ 3,355	\$ 2,684		Per Week	\$ 2,710	\$ 3,492
				Net Cashflow Per Week	-\$ 26	-\$ 808
				Net Cashflow Per Year	-\$ 1,372	-\$ 42,010

Investment Properties	Rent \$/week	Rent after Maintenance (0.8 x Rent) (Assumed)	Loan Amount	Interest Rate	Monthly Loan Repayment (Interest Only)	Monthly Loan Repayment (Principal and Interest, 25 year)
Property No 1	\$ 380	\$ 304.0	\$ 305,000	7.00%	\$ 1,779	\$ 2,155
Property No 2	\$ 400	\$ 320.0	\$ 354,000	7.00%	\$ 2,065	\$ 2,502
Property No 3	\$ 240	\$ 192.0	\$ 154,000	7.00%	\$ 898	\$ 1,088
Property No 4	\$ 480	\$ 384.0	\$ 340,000	7.00%	\$ 1,983	\$ 2,403
Property No 5	\$ 290	\$ 232.0	\$ 215,000	7.00%	\$ 1,254	\$ 1,519
Property No 6	\$ 325	\$ 260.0	\$ 200,000	7.00%	\$ 1,167	\$ 1,413
Property No 7	\$ 320	\$ 256.0	\$ 199,000	7.00%	\$ 1,161	\$ 1,406
Property No 8	\$ 295	\$ 236.0	\$ 170,000	7.00%	\$ 992	\$ 1,201
Property No 9	\$ 300	\$ 240.0	\$ 206,000	7.00%	\$ 1,202	\$ 1,456
Property No 10	\$ 325	\$ 260.0	\$ 206,000	7.00%	\$ 1,202	\$ 1,456
			\$ 2,349,000			
				Per Month	\$ 13,703	\$ 16,600
Per Week	\$ 3,355	\$ 2,684		Per Week	\$ 3,162	\$ 3,831
				Net Cashflow Per Week	-\$ 478	-\$ 1,147
				Net Cashflow Per Year	-\$ 24,862	-\$ 59,627

Negative gearing

As discussed at the 7 August committee hearing with Mr Alexander, the use of deductions for home owners would be difficult to implement with changing interest rates.

The closest thing is the use of the principal component in a principal and interest loan for investors.

As interest rates fall, the principal component increases thus consuming the investors after tax income. This would not induce investors to sell, but would reduce the investors lending capacity if they wished to use their equity to purchase another property.

For existing home owners who borrow to buy another property, they will need to service the principal on both properties.

Table 4 looks at an investor who has a \$1M loan to buy an investment property.

At 7%, the interest only after tax income is a loss of \$21,748. With a P&I loan, the principal is \$15,300, thus increasing total repayments to \$37,000.

If say, the investor had a limit of \$21,748, to ensure enough cashflow for day to day living, the loan size would be reduced from \$1,000,000 to \$741,113 (because of the \$15,300 principal).

If the investor was treated as an owner occupier for the purpose of loan assessment, the loan size would be further reduced from \$741,113 to 669,040 (because the tax refund is ignored).

This highlights the significant difference made by including the principal in sizing the loan, and treating investors as owner occupiers for the purpose of the loan assessment.

This approach aligns investors with owner occupiers, and thus increases the chance of improving home ownership, especially for first home buyers.

Table 4 – Comparison of Interest Only and P&I (25 Years) for an Investment Property Loan

Interest Rate	Loan Value	First Year Interest Repayment	Rental Income (3.5% Yield)	Gain/Loss	Tax Rate 37% (Refund / Payment)	After Tax Cashflow (Interest Only)	First Year Principal Repayment (25 Years)	After Tax Cashflow (P&I)
1%	\$1,000,000	-\$9,840	\$35,000	\$25,160	-\$9,309	\$15,851	-\$35,390	-\$19,539
2%	\$1,000,000	-\$19,720	\$35,000	\$15,280	-\$5,654	\$9,626	-\$31,150	-\$21,524
3%	\$1,000,000	-\$29,630	\$35,000	\$5,370	-\$1,987	\$3,383	-\$27,280	-\$23,897
4%	\$1,000,000	-\$39,570	\$35,000	-\$4,570	\$1,691	-\$2,879	-\$23,770	-\$26,649
5%	\$1,000,000	-\$49,530	\$35,000	-\$14,530	\$5,376	-\$9,154	-\$20,620	-\$29,774
6%	\$1,000,000	-\$59,520	\$35,000	-\$24,520	\$9,072	-\$15,448	-\$17,800	-\$33,248
7%	\$1,000,000	-\$69,520	\$35,000	-\$34,520	\$12,772	-\$21,748	-\$15,300	-\$37,048
8%	\$1,000,000	-\$79,530	\$35,000	-\$44,530	\$16,476	-\$28,054	-\$13,090	-\$41,144
9%	\$1,000,000	-\$89,550	\$35,000	-\$54,550	\$20,184	-\$34,367	-\$11,160	-\$45,527
10%	\$1,000,000	-\$99,570	\$35,000	-\$64,570	\$23,891	-\$40,679	-\$9,470	-\$50,149

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Westpac CEO, Mr Hartzler noted that in Britain, where he had worked previously, interest-only loans could be offered now only as a fully advised financial product.