Home Ownership Inquiry – Supplementary Submission

Christopher Moore - Individual

7 August 2015

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

- 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 <u>size</u> 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.

<u>Loan Sizing – Comparison of Investor versus Owner Occupier</u>

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 negatively 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.

Principal a	nd Interest	Componen	ts for \$100,000		Loan size with a Servicing Capacity of \$5000 per y					
					\$5,000	\$5,000				
	Firs	st Year Pay	ments		Loan S					
Interest				Principal as a %			Loan Size			
Rate	Interest	Principal	Total	of Total Loan	Interest Only	P&I	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.

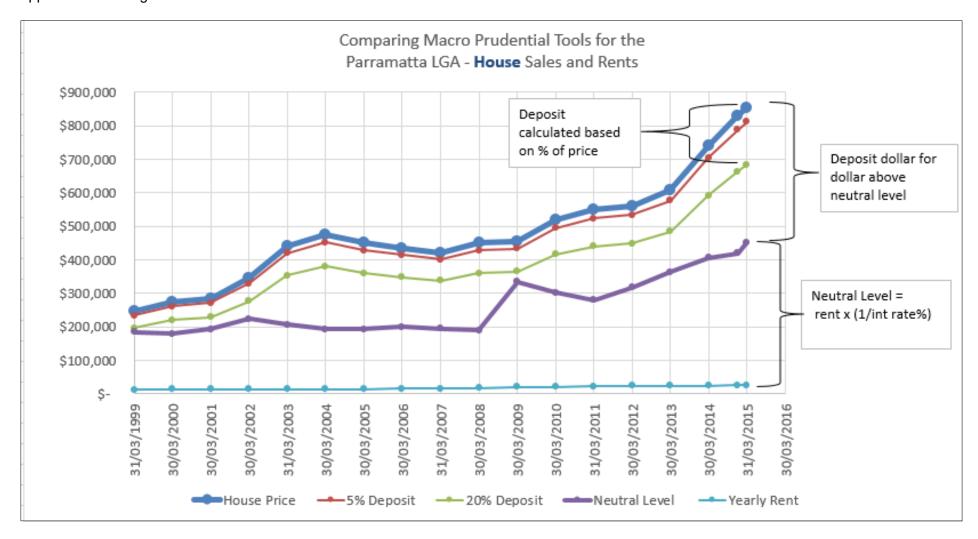
Based on the Appendix B calculator, applying 50% of losses to gross income for both owner occupier and investor, I could not get symmetry.

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 Ir	vestors v	ersus 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	1	20%	Deposit		20%	Deposit	1	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		5.59
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		1		Maintenance \$/year	Ś	5,720.00
Transcendince of year	Ť	3,720.00		1		That terrained by year	-	3,720.00
Rent \$/week	\$	550		1		Rent \$/week	\$	550
Rent / year	\$	28,600		1		Rent / year	\$	28,600
Net Yield	Ť	2.1%				nency year	Ť	20,000
l a ca	-\$	25,520						
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%			37%			379
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	\$	- 55,576	Principal Component	\$	11,854	Net income	3	40,133
·	\$			\$				
Net Income After Principal Net Difference before Principal	ş	55,576	Net Income After Principal	Ş	34,279	Net Difference (Net Income)	+	
(Investor over Owner Occ)	\$	9,442				(Investor over Owner Occ)	\$	
Converted to Gross Income	٠	2,444	+	1		Net Difference (Gross Income)	+	
(Investor over Owner Occ)	\$	14,988				(Investor over Owner Occ)	\$	_
Extra Loan Size	\$	272,508				Extra Loan Size	\$	
LACIO LOGII SIZE	ڔ	212,306				LATIG LOGIT SIZE	٦	
Extra Loan Size		31.0%	ļ	<u> </u>		Extra Loan Size		0.09
Same but includes Principal	+			+			+	
(Investor over Owner Occ)	\$	21,296						
Converted to Gross Income	1	, , , ,						
(Investor over Owner Occ)	\$	33,804						
Extra Loan Size	\$	614,615						
Extra Loan Size		69.8%		1				

Com	parison	of Depos	it Requ	ired	l for Neutra	al Gearing		Appendi	x C												
		g NSW - Quar						Supplementry S	ubmission to t	he Home Ov	wnership	Inquiry									
		8	,					Chris Moore				,									
		Legend for D	Deposit		4.00/	Ì		Individual													
		Ŭ			< 0%			Aug-1	15												
					0-20%																
					20-35%																
					>35 %																
					Non Strata (Hou	roc)															
Report Re	ference				Non Strata (1100	363)												Ва	athurst + Oran	ge	
Rent	Sales				Sydney - Inner C	Circle		Sydney - Mic	ldle Circle			Sydney - Outer	Circle		Newcastle+III	awarra		Ba	athurst		
		RBA Std VarInterest Rate	Date		Non-Strata Median Price	3 Bed Median Rent	Deposit above Neutral	Non-Strata Median Price	3 Bed Media Rent	Deposi n above Neutra		Non-Strata Median Price	3 Bed Median Rent	Deposit above Neutral	Non-Strata Medi Price	an 3 Bed Mediar	Deposit above Neutral	No Pri	on-Strata Median	3 Bed Median	Deposit above Neutral
No35		10.50%	31/03/1996		na	\$ 320		na		240	,,	na	\$ 180		na	na	ivedital		na	\$ 1	.60
No39		7.50%	31/03/1997		na	\$ 350		na		250		na	\$ 185		na	na			na	\$ 1	.60
No43	No44	6.70%	31/03/1998		\$ 390,000	\$ 358	29%	\$ 290,000	\$	260 3	80%	\$ 183,000	\$ 190	19%	\$ 142,0		165 109		128,000	•	.65 0%
No47	No48	6.50%	31/03/1999		\$ 430,000	\$ 365		\$ 320,000			84%	\$ 196,000	\$ 195		\$ 151,0		139		130,000		.65 -2%
No51	No52	7.30%	31/03/2000		\$ 456,000	\$ 420		\$ 350,000			2%	\$ 230,000	\$ 210		\$ 157,0		170 23%		133,000	\$ 1	
No55	No56	7.30% 6.05%	31/03/2001	-	\$ 500,000 \$ 605,000	\$ 430 \$ 425		\$ 358,000			10% 11%	\$ 249,000 \$ 295,000	\$ 220 \$ 220		\$ 168,0		180 24%		137,000		.75 9% .80 -3%
No59 No63	No60 No64	6.05%	31/03/2002 31/03/2003		\$ 605,000 \$ 709,000	\$ 425		\$ 440,000			1% 7%	\$ 295,000 \$ 360,000	\$ 220		\$ 207,0		239		150,000 170,000	•	.80 -3% .80 16%
No67	No68	7.05%	31/03/2004		\$ 784,000	\$ 440		\$ 620,000			3%	\$ 416,000	\$ 235		\$ 330,0		220 519	6 \$	241,000		00 39%
No71	No72	7.30%	31/03/2005		\$ 734,000	\$ 450		\$ 560,000			9%	\$ 400,000	\$ 240		\$ 325,0		230 50%		263,000		10 43%
No75	No76	7.30%	31/03/2006		\$ 740,000	\$ 475	54%	\$ 548,000	\$		8%	\$ 387,000	\$ 250	54%	\$ 325,0	00 \$ 2	240 47 %	6 \$	270,000	\$ 2	20 42%
No79	No80	8.05%	31/03/2007		\$ 795,000	\$ 525	57%	\$ 557,000			9%	\$ 387,000	\$ 260		\$ 328,0		250 51 9		275,000		30 46%
No83	No84	9.35%	31/03/2008		\$ 910,000	\$ 600		\$ 590,000		_	2%	\$ 400,000	\$ 290		\$ 345,0		280 55%				40 50 %
No87 No91	No88 No92	5.85% 6.90%	31/03/2009 31/03/2010	-	\$ 820,000 \$ 1,128,000	\$ 650 \$ 660		\$ 550,000 \$ 715,000			29% 52%	\$ 380,000 \$ 449,000	\$ 320 \$ 350		\$ 330,0 \$ 375,0		300 199 320 369				16% 160 36%
No95	No96	7.80%	31/03/2010	1	\$ 1,070,000	\$ 720		\$ 723,000		_	54%	\$ 445,000	\$ 370		\$ 380,0		350 39 %		296,000		90 35%
No99	No100	7.40%	31/03/2012		\$ 1,035,000	\$ 750		\$ 750,000			3%	\$ 468,000	\$ 385		\$ 395,0		360 369		305,000		20 26%
No103	No104	6.45%	31/03/2013		\$ 1,113,000	\$ 790	43%	\$ 785,000	_		17%	\$ 480,000	\$ 400		\$ 408,0		370 27 %	6 \$	325,000	\$ 3	20 21%
No107	No108	5.95%	31/03/2014		\$ 1,360,000	\$ 800		\$ 935,000		_	19%	\$ 550,000	\$ 410		\$ 430,0		375 24 9	_			20 17%
No110	No111	5.95%	31/12/2014		\$ 1,470,000	\$ 823	51%	\$ 1,100,000	\$	550 5	6%	\$ 625,000	\$ 420	41%	\$ 455,0	00 \$ 3	370 29 %	<u>\$</u>	342,000	\$ 3	10 21%
					Strata (Units)																
Reference	2																	Ba	athurst + Oran	ge	
Rent	Sales				Sydney - Inner C	ircle		Sydney - Mic	ldle Circle		_	Sydney - Outer	Circle		Newcastle+III	awarra		Ba	athurst		
		RBA Std					Deposit			Deposi				Deposit			Deposit				Deposit
		VarInterest Rate			Strata Median Price	2 Red Pont	above Neutral	Strata Median Price	2 Bed Rent	above Neutra		Strata Median Price	2 Red Pont	above Neutral	Strata Median Pr	ica 2 Rad Pont	above Neutral	C+.	rata Median Price	2 Red Pont	above Neutral
		10.50%	31/03/1996	1	na na	\$ 250		na		175	21	na	\$ 160		na	na na	iveutidi	Sti	na na	\$ 1	
		7.50%	31/03/1997		na	\$ 260		na	T	185		na	\$ 170		na	na		1	na		25
No43	No44	6.70%	31/03/1998		\$ 270,000	\$ 280	20%	\$ 187,000	\$	190 2	21%	\$ 174,000	\$ 170		\$ 135,0	00 \$ 1	135 229	6	na	\$ 1	30
No47	No48	6.50%	31/03/1999		\$ 288,000	\$ 295		\$ 203,000			21%	\$ 178,000	\$ 185		\$ 134,0		135 199	\$	109,000		30 5%
No51	No52	7.30%	31/03/2000		\$ 318,000	\$ 325	27%	\$ 228,000		_	33%	\$ 200,000	\$ 200		\$ 146,0		140 329	6 \$	103,000	+ -	30 10%
No55 No59	No56 No60	7.30%	31/03/2001	╁	\$ 340,000 \$ 388,000	\$ 350 \$ 340		\$ 250,000		_	34% 32%	\$ 235,000 \$ 255,000	\$ 220 \$ 215		\$ 154,0 \$ 180,0		145 33% 150 28%	6 Ş	87,000 98.000	•	.35 -11% .40 -23%
No63	No64	6.05% 6.55%		1	\$ 388,000	\$ 340		\$ 292,000			15%	\$ 255,000	\$ 215		\$ 180,0		150 289 161 489		134,000	•	40 -23%
No67	No68	7.05%			\$ 450,000			\$ 350,000			7%	\$ 332,000	\$ 230		\$ 293,0		175 56%	6 \$	157,000		.55 27%
No71	No72	7.30%			\$ 455,000	\$ 360		\$ 350,000			7%	\$ 336,000	\$ 230		\$ 290,0		185 55%		181,000		.65 35 %
No75	No76	7.30%			\$ 440,000	\$ 380	38%	\$ 352,000			15%	\$ 330,000	\$ 240		\$ 296,0		195 53 %	6 \$	170,000		.70 29 %
No79	No80	8.05%			\$ 450,000	\$ 410		\$ 345,000			16%	\$ 316,000	\$ 260		\$ 286,0		200 55%	_	185,000		70 41%
No83	No84	9.35%	31/03/2008		\$ 485,000	\$ 460		\$ 360,000			0%	\$ 325,000	\$ 290		\$ 300,0		225 589				80 43%
No87 No91	No88 No92	5.85% 6.90%			\$ 470,000 \$ 560,000	\$ 500 \$ 520		\$ 365,000		_	10% 32%	\$ 320,000 \$ 356,000	\$ 320 \$ 340		\$ 290,0 \$ 325,0		245 25% 260 40%	_			.85 16%
No95	No96	7.80%			\$ 560,000	\$ 560		\$ 439,000			89%	\$ 370,000	\$ 360		\$ 329,0		260 40 9 285 42 9		223,000		108 38%
No99	No100	7.40%			\$ 600,000	\$ 585		\$ 462,000	_		86%	\$ 365,000	\$ 370		\$ 328,0		369				30 25%
No103	No104	6.45%			\$ 615,000	\$ 595		\$ 485,000		430 2	_	\$ 392,000	\$ 380		\$ 330,0		315 239	6 \$			40 12%
No107	No108	5.95%			\$ 705,000	\$ 620		\$ 545,000			27%	\$ 420,000					320 22 9				40 16%
No110	No111	5.95%	31/12/2014	1	\$ 750,000	\$ 640	25%	\$ 611,000) \$	470 3	<mark>3%</mark>	\$ 472,000	\$ 400	26%	\$ 395,0	00 \$ 3	320 29%	6 \$	257,000	\$ 2	45 17%