

## Financial System Inquiry

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### Executive Summary

- Rather than remove negative gearing, a different idea is for new Investors in existing housing to be regulated to either
  - Neutral gearing
  - A maximum leverage based on a percentage of long term rental yield and loan interest.

### Housing Issues

Home ownership has declined in the past two decades due to the poor design and regulation of the tax, financial and banking system.

The Grattan Institutes Paper on “The Wealth of Generations” published in December 2014 highlighted the intergenerational wealth for younger Australians has gone backwards when compared to their previous cohorts. Yet the age group of 65 to 74 has increased their wealth by \$200,000, mostly due to housing price increases.

If the objective of providing home ownership through the support of the tax and the financial system, then why is the system designed to excessively lend to investors who essentially work against this objective, and they are provided a tax incentives upon which their investment does not lead to any productivity improvement.

Most pro Negative gearing people say that rents are suppressed for the most vulnerable. Well yes that’s probably true, because when investors flood the market like they did in 2002-03, rents had no increase for about 3 to 4 years, but house values escalated at +20% for two years in a row. And this is happening again in 2013-14.

But it’s the long term trend that house values have appreciated a lot more than rents. Which is shown in the following table. In 1999 rent versus house value were probably considered fair value at around 4.9% gross yield. In the following 15 years investors have been piling into the market buying up everything, and not increasing supply. And thus the long term trend becomes less home ownership. Housing now has a gross yield of 3.1% and continues to decline.

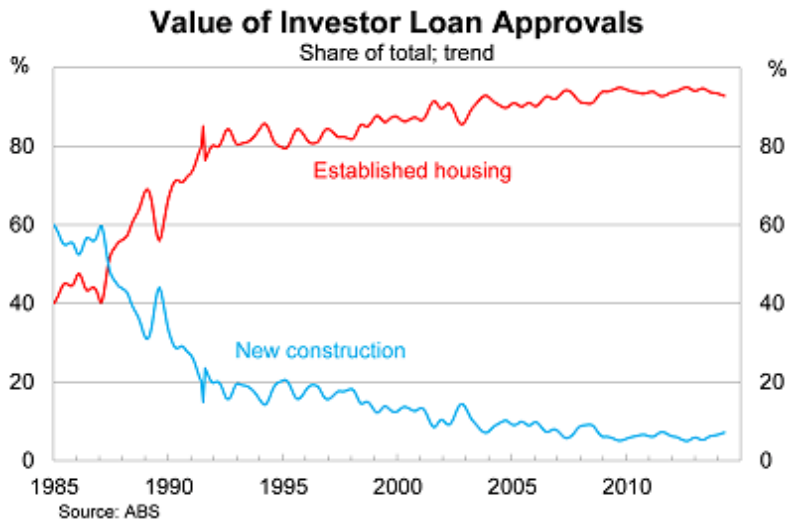
The following table is from NSW Land and Property Information for a greater Western Sydney LGA

	House Value \$	Rent \$/ week	Gross Yield
Mar 1999	245,000	230	4.9%
Dec 2014	795,000	480	3.1%
Annual Increase	8.2 % p.a.	5.1% p.a.	

Lending to investors over the past two decades has skewed towards existing housing. In recent months lending to investors for housing reached over \$11bn per month (ABS 5609). Nearly 95% of investor lending is placed into existing housing.

The following graph is probably skewed by so much money flowing into existing housing. But it highlights how distorted the system is.

(Source ABS via [www.businessspectator.com.au](http://www.businessspectator.com.au))



Other analysis from ANZ Research via the Eureka Report, shows the state of investor lending in NSW. It's a re-run of 2002-03. It's all investor driven.



In recent months both the RBA and APRA have stepped up their (Jawboning) verbal warnings, because lending for housing essentially has held the economy to ransom. APRA's 10% growth in lending is all too late, with the previous 2013 and 2014 periods easily exceeding this rate. APRA's approach has been reactive rather than preventative.

With a further rate cut in February 2015, the following comments from the Sydney Morning Herald appeared with comments from Dr Andrew Wilson, that *“Despite the megaphone warnings we’ve been getting more investors not less”*.

Mr David Murray in the Sydney Morning Herald on the 4 March 2015, stated that *the current environment was not only making housing unaffordable, but putting the entire financial system at severe risk*.

Now as economic growth slows, the levers that are used to pull highlight how ineffective the design of our system is. Everyone is piling into housing especially in Sydney to a point that has become dangerous.

Affordability continues to worsen for the next generation, yet they are asked to have their pay capped to inflation, and support aged pensioners, who’s high house prices are not included in the asset test. This is something that the Productivity Commission highlighted that needed addressing.

Projecting into the future, many single people who cannot afford to buy will be left to rent in retirement and have all their assets assessed for the pension, or if they buy, will use their superannuation to pay down their debt, which places the superannuation system at risk into the future.

Clearly the system is inequitable and shows signs of a lack of robustness when seriously challenged with extreme events where very low interest rates are required.

The objective of housing should be affordability, stability and home ownership. All three of these have become worse under the current regime.

### Suggested Alternatives

Two alternatives are considered.

Alternative 1 is neutral gearing

Alternative 2 is to regulate maximum % lent based on a ratio of interest rates and gross yield.

The objective is to:

- Strengthen the resilience of the financial system, by improving its capacity to adjust to both the normal business cycle as well as severe economic shock (FSI Paper).
- Increase home ownership
- Find the right balance between savings and debt
- Make it more attractive for investors to leverage into new housing supply during low interest rates to stimulate the economy

## Alternative 1

### Neutral Lending for Investors in Existing Property

Neutral Lending has recently been mentioned by David Murray in a speech to the Australian Centre for Financial Studies on the 4 March 2015.

Because the interest has to match the rental income, then possibly only other expenses such as council rates are a tax deduction. For the purpose of this paper, a maximum of 90% is assumed.

$$\text{Max \% Lent} = \text{Lesser of } 90\%$$

or

$$\frac{\text{Gross Yield \%}}{\text{Current Interest Rate \%}}$$

Neutral Lending will reduce the amount of money investors can be lent, thus reducing the activity of investors. Though its robustness under falling interest rates is questionable.

The following data shows 15 years of data, where the average lent would be 56% of the value of the house.

Data: NSW Land and Property Information, NSW Housing, and RBA.

Neutral Gearing - Western Sydney Suburb LGA					
	RBA Std Var	Median House Value	Rent \$/week	Gross Yield	Max % Lent
31/03/1999	6.50%	\$ 245,000	230	4.9%	75%
31/03/2000	7.30%	\$ 275,000	250	4.7%	65%
31/03/2001	7.30%	\$ 285,000	270	4.9%	67%
31/03/2002	6.05%	\$ 346,000	260	3.9%	65%
31/03/2003	6.55%	\$ 441,000	260	3.1%	47%
31/03/2004	7.05%	\$ 475,000	260	2.8%	40%
31/03/2005	7.30%	\$ 450,000	270	3.1%	43%
31/03/2006	7.30%	\$ 435,000	280	3.3%	46%
31/03/2007	8.05%	\$ 421,000	300	3.7%	46%
31/03/2008	9.35%	\$ 450,000	340	3.9%	42%
31/03/2009	5.85%	\$ 455,000	375	4.3%	73%
31/03/2010	6.90%	\$ 520,000	400	4.0%	58%
31/03/2011	7.80%	\$ 550,000	420	4.0%	51%
31/03/2012	7.40%	\$ 561,000	450	4.2%	56%
31/03/2013	6.45%	\$ 606,000	450	3.9%	60%
31/03/2014	5.95%	\$ 740,000	465	3.3%	55%
Average	7.1%			3.9%	56%

Note that the maximum lent would have not changed much from 2013 to 2014, even though prices climbed 22%, the maximum lent would be 50-60% which you would think would blunt investor demand, but it highlights that as interest rates are lowered investment becomes more attractive. This would be a problem where interest rates are at emergency levels.

### Example

The median house value in Greater Sydney is about \$720,000 with rent at \$450 / week (NSW Land and Property Information). This is a yield of 3.2%.

With loan interest at 5%, this means a maximum of 65% of the house value could be lent. And thus a 35% deposit is required.

If someone owned their \$720,000 home outright, and wanted to use it for collateral to buy another existing property for \$720,000, they could only borrow 65%. They would still need a further \$252,000 cash deposit, as collateral cannot be used (*this would be a design requirement*). Hence the purchase is not possible if they don't have the extra money. But they could borrow the full amount and use negative gearing if they bought a new property.

### Weakness of Neutral Lending

Firstly, it's quite possible that if neutral gearing was introduced, someone who owns their home outright would just borrow against their own home to make up the deficit from the neutral level of lending and place that money as the deposit on the investment property. Meaning they have borrowings on both their own home, and the investment property, but because the interest is on their own home, there is no tax deduction.

But the point is that it doesn't really reduce that amount lent. (*This maybe in correct, but is worth considering if gaming of the rule occurs*).

The following table shows the maximum % lent based on interest rate and gross yield. It is assumed 90% is the maximum lent. In Sydney the current yield is about 3% with interest rates near 5% and is shown as brown cell in the table.

It shows the maximum % lent increases as interest rates fall. This would possibly make the stability of the financial system worse because it becomes more attractive for investors. So when interest rates return to their norm or higher, investors have to de-leverage.

And it still doesn't help with affordability. Because as interest rates fall, the neutral level of lending increases. So investors are still competing with first home buyers.

Hence the inverse is probably required as interest rates fall. This would require another alternative.

		← Interest Rate										
		4.0%	4.5%	5.0%	5.5%	6.0%	6.5%	7.0%	7.5%	8.0%	8.5%	9.0%
Gross Yield	3.0%	75%	67%	60%	55%	50%	46%	43%	40%	38%	35%	33%
	3.5%	88%	78%	70%	64%	58%	54%	50%	47%	44%	41%	39%
	4.0%	90%	89%	80%	73%	67%	62%	57%	53%	50%	47%	44%
	4.5%	90%	90%	90%	82%	75%	69%	64%	60%	56%	53%	50%
	5.0%	90%	90%	90%	90%	83%	77%	71%	67%	63%	59%	56%
	5.5%	90%	90%	90%	90%	90%	85%	79%	73%	69%	65%	61%
	6.0%	90%	90%	90%	90%	90%	90%	86%	80%	75%	71%	67%
	6.5%	90%	90%	90%	90%	90%	90%	90%	87%	81%	76%	72%
	7.0%	90%	90%	90%	90%	90%	90%	90%	90%	88%	82%	78%
	7.5%	90%	90%	90%	90%	90%	90%	90%	90%	90%	88%	83%

## Alternative 2

### Using rental yield and interest rates to regulate lending to Investors in Existing Property

The concept is that beyond the long term average of gross yield (Say 5%) and interest rates (7%), investor leveraging into existing property is considered speculative and thus should require a higher deposit as a proportional percentage of the average rates.

For example, the long term average for gross yield is say 5% and the interest rate is 7%. From this a maximum % lent is calculated as follows. For the purpose of this paper, a maximum of 90% has been assumed.

$$\text{Max \% Lent} = \text{Lesser of } 90\%$$

or

$$(90\%) \times \frac{\text{Current Interest Rate \%} \leq 7\%}{7\%} \times \frac{\text{Gross Yield \%}}{5\%}$$

When interest rates and or gross yields fall, it is assumed there is an inverse price rise. Hence the equation tries to offset the price rise with a matching reduction in money lent or increasing the deposit required. Thus neutralising any collateral made from increasing prices which would lead to a leverage on leverage effect that currently exists at the moment.

To buy a second property, the investor is forced to build collateral from savings or paying down their principle.

The following table provides an example of what the maximum % lent would be for a matrix of numbers. Currently in Sydney, the gross yield is near 3% and interest rates at 5%. Hence the maximum lent is about 39%. Or a 61% deposit or collateral.

		Interest Rate										
		4.0%	4.5%	5.0%	5.5%	6.0%	6.5%	7.0%	7.5%	8.0%	8.5%	9.0%
Gross Yield	3.0%	31%	35%	39%	42%	46%	50%	54%	54%	54%	54%	54%
	3.5%	36%	41%	45%	50%	54%	59%	63%	63%	63%	63%	63%
	4.0%	41%	46%	51%	57%	62%	67%	72%	72%	72%	72%	72%
	4.5%	46%	52%	58%	64%	69%	75%	81%	81%	81%	81%	81%
	5.0%	51%	58%	64%	71%	77%	84%	90%	90%	90%	90%	90%
	5.5%	57%	64%	71%	78%	85%	90%	90%	90%	90%	90%	90%
	6.0%	62%	69%	77%	85%	90%	90%	90%	90%	90%	90%	90%
	6.5%	67%	75%	84%	90%	90%	90%	90%	90%	90%	90%	90%
	7.0%	72%	81%	90%	90%	90%	90%	90%	90%	90%	90%	90%
	7.5%	77%	87%	90%	90%	90%	90%	90%	90%	90%	90%	90%

Note that when interest rates fall, the maximum amount lent reduces not increases as it does in the first alternative.

The following table shows the maximum percentage lent to a set of real data from a Western Sydney Local Government Area. (Land and Property Information, Housing NSW and RBA data)

Maximum % Lent - Western Sydney LGA Housing Data					
	Median House Value	Rent \$/week	RBA Std Var	Gross Yield	Max % Lent
31/03/1999	\$ 245,000	230	6.50%	4.9%	82%
31/03/2000	\$ 275,000	250	7.30%	4.7%	85%
31/03/2001	\$ 285,000	270	7.30%	4.9%	89%
31/03/2002	\$ 346,000	260	6.05%	3.9%	61%
31/03/2003	\$ 441,000	260	6.55%	3.1%	52%
31/03/2004	\$ 475,000	260	7.05%	2.8%	51%
31/03/2005	\$ 450,000	270	7.30%	3.1%	56%
31/03/2006	\$ 435,000	280	7.30%	3.3%	60%
31/03/2007	\$ 421,000	300	8.05%	3.7%	67%
31/03/2008	\$ 450,000	340	9.35%	3.9%	71%
31/03/2009	\$ 455,000	375	5.85%	4.3%	64%
31/03/2010	\$ 520,000	400	6.90%	4.0%	71%
31/03/2011	\$ 550,000	420	7.80%	4.0%	71%
31/03/2012	\$ 561,000	450	7.40%	4.2%	75%
31/03/2013	\$ 606,000	450	6.45%	3.9%	64%
31/03/2014	\$ 740,000	465	5.95%	3.3%	50%
31/12/2014	\$ 795,000	480	5.95%	3.1%	48%
3/02/2015	\$ 795,000	480	5.65%	3.1%	46%
Average			7.1%	3.9%	67%

The table above highlights that in 2002-03 and 2012-15, the maximum lent reduces significantly and rapidly. For February 2015 a deposit of \$429,300 is required for a \$795,000 home.

#### Example

An owner occupier bought their home with a 10% deposit or \$50,000 for a \$500,000 home. The rental yield in the area is assumed to be 5% and interest rates at 7%. After a year, a price increase of 20% occurs due to investors flooding the market with no increase in rents, pushing the rental yield down to 4%. They now have \$150,000 as collateral. They wish to buy an investment property identical to their home for \$600,000. The \$100,000 collateral for the investment property is 16% of the value of the new investment.

But under Alternative 2, they require collateral of  $\$600,000 \times (1 - (0.9 \times (7/7) \times (4/5))) = \$168,000$  or 28%. They are \$68,000 short.

Then it is announced interest rates are to be reduced from 7% to 6%. Sellers push up prices by a further 16.67% or (7/6) to \$700,000. If this was the valuation, the collateral in their own home would be \$250,000. Also assumed is that rents stay flat and thus yield falls further to 3.5%.

The maximum lent then becomes  $(1 - (0.9 \times (6/7) \times (3.5/5))) = 54\%$ . Hence the deposit required increases to  $(1-0.54) \times \$700,000 = \$322,000$ . Again the remaining collateral of \$200,000 for the investment property is still not enough.

But they would have the minimum 10% (\$70,000) to buy a newly created house or unit from a developer.

### Discussion

As rental yields and interest rates fall below the target rates, the collateral made from speculation beyond the target cannot be used because the deposit required also climbs at the same rate. This stops the leverage on leverage effect.

Only collateral built from savings or paying down the principle own their own home would work.

This puts investors on equal footing with first home buyers for existing housing when yield and/or interest rates are lower than the target rates.

The design also makes it more attractive to buy a new house over existing housing as yield and interest rates fall. The example above highlights the difference to be \$70,000 (10% deposit) versus \$322,000 (46% deposit) respectively.

When interest rates are lowered to stimulate the economy, this design takes a preventative approach to reduce the problem of excessive lending on existing housing before it occurs.

### Comparison of Alternatives

Alternative 2 uses a fixed balance point considered neutral at 5% yield and 7% interest rate, this is compared with neutral gearing where the balance point can vary up or down. Hence Alternative 2 is probably the inverse design of neutral gearing.

Alternative 2 tries to reduce the variation of prices and rents closer to the mean of 5% yield.

Hence at low interest rates, speculation driven by investor loans would inversely reduce and be replaced with the need to build collateral by saving rather than hoping for price rises.

Alternatively, at higher interest rates investors are incentivised with maximum lending percentage and negative gearing to keep the yield closer to 5% (keep prices high and rents low), whereas neutral gearing doesn't.

At lower interest rates investing in new housing becomes significantly more attractive than compared with neutral gearing, and thus a better economic response would be expected.

When the economy is overheating and interest rates are high with high yields, investing in new housing becomes less attractive as both new and existing are treated the same.



## Conclusion

For too long lending to investors has not achieved the outcomes of increasing supply of housing, and has made housing affordability and financial stability worse.

Neutral gearing has been mentioned by Mr David Murray as an alternative for lending to investors.

This paper offers another alternative of using yield and interest rates together. At first glance it appears to provide design attributes of stability, affordability and fairness both during the normal business cycle and during emergency situations where rapid movements in interest rates are required.

Alternative 2 would require further analysis as it is unknown whether this alternative has been considered before.