Addressed To:
Ms Heidi Richards
General Manager, Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

Dear Miss Richards

Thank you for allowing for submissions. The following is a small contribution regarding the use of rental income in the serviceability of debt.

Rental Income for Loan Serviceability Requirements

Rental properties are increasing to nearly 30% of stock across the country, with Investors crowding out first home buyers. This is more apparent in the Sydney and Melbourne markets.

Pre-existing property owners who wish to buy a 2nd property have a financial advantage over first home buyers especially in a rising market. Existing owner occupiers can leverage against untaxed capital gains, compared to first home buyers who earn after tax returns in a savings account.

To better balance the financial system and social outcomes, the reduction or removal of the rental income component for loan serviceability assessment for residential property should be considered.

This means lending for any residential property (owner occupied or investment) can only be assessed against personal income only. This is effectively lowers the LVR for the second and subsequent properties.

In the Appendix is an example from the Australian Financial Review of some mortgage providers already disregarding rental income.

Impacts of this Change

- No change to Negative Gearing and Capital Gains Tax
- No change for first home buyers who can leverage up to the maximum LVR of 90-95%. It's their first loan.
- No change to existing Home Owners with a single loan
- There is a change for those with two or more properties where the interest payments exceed personal income used to service the debt. They would need to reduce their debt.
- Positive Gearing would be significantly impacted, as investors rely solely on rental income. Investors with 10, 20 and even 30 properties would need to offload properties when refinancing their debt, depending upon options in this submission.

Analysis

Table 1 shows an example of a person with a savings capacity of $40,000 per year (they have paid off their first loan) and potential rental income from the 2nd property of $20,000.

The table shows an example where the buyer's loan size reduces with reduced rental income assessment. Normally it would take 2.5 years to save for a deposit, but with full removal, that increases to 7.5 years.

Removing rental income effectively reduces the LVR, but only for two or more loans purchases, generally speaking.

Table 1 – Comparison of Maximum Purchasing Power with and without Rental Income included in serviceability of a 2nd property loan.

Investor Spare Income	Rental Income Factor	Rental Income	Max Loan Size (P&I 7%)	Property Price	LVR %	Deposit	Years to Save Deposit	5% Interest on Loan	Positive / Negative Cashflow
$ 40,000	**100%**	**$ 20,000**	**$ 750,000**	$ 800,000	94%	$ 50,000	1.3	$ 37,500	$ (17,500.00)
$ 40,000	**90%**	**$ 18,000**	**$ 725,000**	$ 800,000	91%	$ 75,000	1.9	$ 36,250	$ (16,250.00)
$ 40,000	**80%**	**$ 16,000**	**$ 700,000**	$ 800,000	88%	$ 100,000	2.5	$ 35,000	$ (15,000.00)
$ 40,000	**70%**	**$ 14,000**	**$ 675,000**	$ 800,000	84%	$ 125,000	3.1	$ 33,750	$ (13,750.00)
$ 40,000	**60%**	**$ 12,000**	**$ 650,000**	$ 800,000	81%	$ 150,000	3.8	$ 32,500	$ (12,500.00)
$ 40,000	**50%**	**$ 10,000**	**$ 625,000**	$ 800,000	78%	$ 175,000	4.4	$ 31,250	$ (11,250.00)
$ 40,000	**40%**	**$ 8,000**	**$ 600,000**	$ 800,000	75%	$ 200,000	5.0	$ 30,000	$ (10,000.00)
$ 40,000	**30%**	**$ 6,000**	**$ 575,000**	$ 800,000	72%	$ 225,000	5.6	$ 28,750	$ (8,750.00)
$ 40,000	**20%**	**$ 4,000**	**$ 550,000**	$ 800,000	69%	$ 250,000	6.3	$ 27,500	$ (7,500.00)
$ 40,000	**10%**	**$ 2,000**	**$ 525,000**	$ 800,000	66%	$ 275,000	6.9	$ 26,250	$ (6,250.00)
$ 40,000	**0%**	**$ -**	**$ 500,000**	$ 800,000	63%	$ 300,000	7.5	$ 25,000	$ (5,000.00)

Macro Perspective

Removing rental income from servicing the loan creates a bias to invest in other forms of investments. But this may not be the case if this proposal didn't apply to new property.

Property investment already enjoys a high LVR compared to other forms of investment. Removing rental income effectively reduces the LVR to similar levels in comparable investment classes, such as margin lending for shares, without compromising first home buyers and owner occupiers who can still receive a higher LVR because they use their own personal income anyway.

The example in Table 1 shows that the LVR can be effectively reduced to 63% for a 2nd property. This figure can obviously change as the market changes.

Implementation Options

There are several options to consider rental income.

1. Rental income removed and applies to all new and refinancing of loans
2. Rental Income removed and applies to new loans only from a chosen date
3. A percentage haircut on rental income that is higher than normal e.g. 50% to 100%.
4. The 50 to 100% haircut only applies to existing properties (New properties have a minimum haircut of 20%).

Option 1, would impact existing investors and rental properties would be sold off over the 5 year cycle of re-financing. This may create financial instability. But this would be a buying opportunity for first home buyers who currently rent.

Option 2, would only apply to new investors from a chosen date, meaning rental properties would not be dumped onto the market. This would reduce investor demand, and thus create opportunities for first home buyers.

Option 3, a percentage factor on rental income maybe used to lean on investor activity as a counter cyclical measure to improve opportunities for home ownership rates. This can be changed based on the current operating context. But a suggested factor maybe 50%.

Option 4, investors of new property still receive a minimum 20% haircut on rental income, but a higher percentage preferably 100% for existing property. This creates an asymmetrical design, and would encourage purchases of new property as a larger loan and LVR are available with smaller haircuts.

Conclusion

It’s highly unlikely that changes like this submission will be implemented. That’s obvious.

But our financial system, tax and lending standards certainly need changing to not only benefit full employment, but to ensure better social outcomes, something that seems to have been forgotten.

APPENDIX

Financial Review – 20 July 2016

http://www.afr.com/real-estate/more-lenders-hit-the-brakes-on-housing-20160719-gq9erq

More lenders hit the brakes on housing

Lenders are getting nervous about apartment glut. *Craig Abraham*

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by **Duncan Hughes**

Credit Union Australia will no longer lend money for apartments less than 40 square metres and for buildings with more than 50 units as non-bank lenders join the crackdown on borrowing conditions.

CUA has also reviewed its definition of new or existing units. An existing high density unit is now defied as a property at least 12 months old.

Existing units valued at less than $1 million will face tougher loan-to-value of 80 per cent and 75 per cent, depending on whether the buyer is an investor or owner-occupier.

For new units the loan-to-value ratios have been decreased to 70 per cent and 75 per cent respectively.

Units worth more than $1 million will be individually reviewed.

More lenders are discreetly toughening borrowing conditions amid growing concerns about over-supply, falling demand and off-the-plan buyers capacity to complete purchases.

Firstmac, a non-bank lender, has also tightened lending for apartments in developments with more than six floors. It has also excluded rental income for servicing the loan.

Australian First Mortgage, a non-bank lender, is toughening lending for outer-suburban estates.

The lender uses independent valuers to physically assess properties being considered and provide reports on their condition and location.

Most major banks generally rely on desk-top valuations using information provided by data companies.

"We are very thorough," said general manager Trayce Groppo.

Its new criteria will apply to dwellings located within 50km of a city with a population more than 20,000; or, 20km of a two with a population greater than 10,000.

Earlier this month, Citi, a leading US bank with extensive networks across Asia, and ING Direct, a whole owned subsidiary of ING Group, announced tougher terms and conditions for investors and owner-occupiers.

They have flagged loan applications for suburbs with concentrations of high density apartments for closer scrutiny.

Other lenders are imposing tougher lending conditions on borrowers seeking multiple properties on separate titles located within the same block, or using multiple private properties as security.

AMP, the nation's largest diversified financial services group, is tightening lending limits and borrowing criteria for about 25 cities and outer suburbs, typically about one hours commute from the central business district, including Singleton, Morwell and Altona.

Cities include those hit hard by the mining downturn, such as Broken Hill, NSW; Gladstone and Emerald, in Queensland, where dwelling construction started during the boom are being launched into flat markets.

Read more: http://www.afr.com/real-estate/more-lenders-hit-the-brakes-on-housing-20160719-gq9erq#ixzz4EwjxXh3A
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