ASB

Economic Note

Changes to housing policies

25 March 2021

Housing investors singled out for special treatment

- The Government has recently announced three policies to bolster housing affordability and provision, primarily by acting to slow investor demand.
- These changes present a headwind to property investor demand, particularly for highly-indebted investors with stretched cashflows. The impacts are more manageable for established investors who are not as highly geared.
- Our economic and house price forecasts are under review.

Summary

With this week's housing announcements, the Government has markedly changed the incentives for property investors in the here and now while taking some steps to help boost housing supply over the medium term.

Of the announcements, the end of the ability to deduct interest rate expenses is arguably the most significant. It will change the after-tax position of the typically geared property investor, with the impacts most acute for new investors, who are typically more highly geared with stretched cashflow positions. For a fresh investment purchase of a typical investment property at 40% deposit, to achieve the status-quo after-tax position implies paying 30% or so less for the property, charging nearly 30% more rent, or stumping up with a 60% deposit. In the real world, a more likely outcome would be a more moderate rent increase and a preparedness to pay slightly less now for the house – which then leaves the market price being more influenced by owner occupier preparedness to pay. For less highly geared investors with healthy cashflow positions, the impacts will be more modest.

The removal of interest rate deductibility has been done without any thorough policy impact assessment. There are many potential impacts to consider. To what extent will price growth cool (or prices fall)? How will any change in house prices influence construction demand? How readily will first-home buyers pick up the market slack if investors increasingly hold off from buying? How will the demand/supply balance in the rental market shift? Will rents be pushed up by the measures, particularly if geared investors try to recoup part of jump in their costs?

It is difficult to know in advance how large the impacts of extending the bright-line test from 5 to 10 years will be. This will effectively see a longer lock-in period for property investors and could result in fewer property sales. Although some supply measures were announced this week, factors such as well-designed overhaul of the Resource Management Act will be pivotal. More supply side measures will be announced with the May Budget.

Off the back of the announced policies, the heat is likely to come out of house price growth much quicker now as investors become more conservative about purchasing, leaving the door more ajar for first-home buyers. These demand shifts are coming at a time when the housing shortfall remans chronic and not likely to be overcome until 2025. That relative scarcity of homes will continue to keep a floor under the market this year. We will be tinkering over the next week with our house price, construction, and consumer spending forecasts. These are the areas that helped drive NZ's initial bounce back from lockdown, but increasingly the economy needs broader support from business investment and export earnings.

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The Government's housing announcements and potential impacts

On March 23 the Government announced three major housing policies. First, the bright line extension on investor property sales will be increased from five to ten years. Second, interest rate deductibility on interest payments for property investor lending will be fully removed by 2025. Third, a $3.8bn package to boost infrastructure, lift affordable housing construction and raise price and income limits for the First Home Buyers Grant.

In what follows we outline what each policy is and sketch through the potential impacts.

1) Removing interest rate deductibility

What is the policy

Interest deductions on residential investment property acquired on or after 27 March 2021 will not be allowed from 1 October 2021. Interest on loans for properties acquired before 27 March 2021 can still be claimed as an expense. However, the amount that can be claimed will reduce by 25% over the next 4 income years until it is completely phased out by April 2025. Property developers (who pay tax on the sale of property) will not be affected by this change. They will still be able to claim interest as business expense. The Government will consult on whether new builds will be included, and will decide by October 1st 2021, but will backdate any policy impact to the 27th of March.

Potential impacts

Removing interest rate deductibility was the major announcement. Even at today's record-low interest rate settings, mortgage interest payments will be the major expense for many property investors. Removing the tax deductibility of interest payments is unusual as this would be considered an expense for a business. The $82bn nationwide mortgage debt associated with rental properties will no longer be generating a significant interest expense for property investors to use to offset rental income. It will generate a significant amount of additional tax to be paid by property investors, that is likely to be in the region of $0.5-$1bn per annum according to our estimates.

Our housing investor model takes into account the impact of changes to rental incomes and after-tax expenses (that will be impacted by removing mortgage deductibility). It suggests that expenses for the typical rental property would be just over $5000 higher per year. This would force investors to either accept lower income (and chip in some of their own funds if the property now makes an operating loss) or to recoup the higher costs via increasing rents. All else equal, the purchase price that an investor would be willing to pay for an investment property would be around 30% lower to achieve the status-quo after-tax position. Alternatively, rents would have to increase by up 30% (dependent on the investor's marginal tax rate), which looks to be excessive considering high housing costs and the generally low incomes of rental tenants. Alternatively, the investor would have to increase their deposit to 60% from the 40% minimum under the impending loan-to-value ratio limits. What actually occurs will depend on the relative bargaining power of investors and tenants. We can envisage a combination of modest rent increases and a more modest decline in the price an investor would be prepared to pay. In addition, any market shifts may still leave investors in a weaker after-tax position, rather than fully compensating for the tax change as we assumed in our illustrations.

The analysis above only applies to new investors rather than established investors, many of which have lower gearing and higher cashflow buffers and are able to cope with the proposed changes. The direct impacts of the policy will not be borne evenly. Every borrower will have different levels of debt repayments, and the removal of interest rate expense will be phased in over several years for currently-held investment properties. New investors are likely to be in the minority: figures from Core Logic suggest that around 25,000 investor properties are purchased each year, which is modest in comparison to the number of existing rental dwellings (just over 600,000).

2) Bright-line test extended from 5 to 10 years

What is the policy

The sale price above housing costs is to be taxed at the marginal tax rate of the seller. This will be extended from 5 years to 10 years for purchases of existing properties (i.e. not new builds) from the 27th of March 2021. Inherited properties and those which have been the owner's main home for the entire time they owned it will continue to be exempt from all bright-line tests. The extension will not apply to investor properties purchased prior to the 27th of

March. New builds purchased on/after the 27th of March will keep the 5-year window (to help incentivise investors to buy new builds). The definition of "new" will be defined, and could be linked to issuance of Certificate of Code of Compliance e.g. purchase within 12 months of CCC issuance.

Potential Impacts
It is difficult to know in advance how large the impacts of extending this policy would be. Extending the bright-line test from 5 years to 10 will effectively see a longer lock-in period for property investors and fewer property sales. It would reduce the number of properties listed for sale and might support house prices at the margin, although household borrowing may be a fraction lower. In our view most property investors tend to buy and hold and don't tend to sell within 10 years of purchasing. Partly backing up this view is that the home ownership rate has been declining over the last few decades (suggesting that investors as a whole have been buying more properties than selling them). However, the impacts could be significant if investors who purchased property 5-10 years ago could no longer afford to own the property given higher after-tax operating costs. The circa $400,000 increase in median house prices over the last 10 suggests a potentially sizeable pool of taxable funds.

3) ***$3.8bn Housing Acceleration Fund***

What is the policy
Half will be a contestable fund for councils to apply for, to help with pipes, roads, and other infrastructure to housing developments. Half will be to large-scale projects. Kāinga Ora will be allowed to borrow $2bn to build more affordable and state housing. There will be changes to First Home Buyers Grant, with house price and income limits increased from April 1. First Home Buyers Grant income caps have been lifted from $85,000 to $95,000 for single buyers, and from $130,000 to $150,000 for two or more buyers.

Potential Impacts
This is a combination of demand-side and (primarily) supply-side policies, and quantifying their overall impact is challenging. Moves to increase the supply of affordable dwellings are welcome. Our estimates suggest that NZ has a shortfall of close to 40,000 dwellings. Infrastructure is expensive for councils to put in place, so the supply moves are welcome, considering councils are constrained by debt limits and there is the need to update existing infrastructure. However, it will take time for these measures to kick in, increase the dwelling stock and reduce the housing shortfall. Dwelling consent activity is already at its highest since the 1970s and there is limited spare capacity in the construction sector to build new dwellings. Increasing house price caps and income limits are intended to increase affordability. However, experience overseas has tended to show that increases in income caps/income limits tend to result in higher house prices.

There is more to come on the supply side. Although some supply measures were announced this week, factors such as well-designed overhaul of the Resource Management Act will be pivotal. More supply side measures will be announced with the May Budget.

But wait, there's more

The Government is also waiting to hear back from the RBNZ in May on whether imposing debt-to-income limits and ruling out interest-only mortgage lending for investors should also be introduced. These are specifically targeted at slowing the demand from investors. Considering the size of residential debt secured on investor properties ($82bn, with around 40% of investor lending over the past year being interest only mortgages) and the likelihood that some multiple property owners have large DTIs, the impacts on investor cashflows and demand could be sizeable and would reinforce the impacts of the proposed changes by the Government. We await the RBNZ's announcement for the necessary details.

Forecasts under review

We will be tinkering over the next week with our house price, construction, and consumer spending forecasts. Our initial thinking is that house price growth will *slow* more sharply than we had factored in, but that the policies will not necessarily trigger outright price falls. The supply shortfall and starting point of record-low listings will help to keep a

floor under the market for 2021. Furthermore, there are plenty of would-be first home buyers waiting in the wings. Much will depend on what current investors do. Some investors might make a run for the exit and attempt to offload properties; if so that would amplify the downward pressure on house prices. Many established investors are in a much sounder position to wait out the changes to the regulatory landscape. With deposit interest rates still historically low, investors will still be seeking alternative investment options.

At the margin, the weaker outlook for house price inflation might temper the buoyancy in domestic demand, with the outlook for consumer spending and construction sector activity not as strong as it would have been prior to the introduced changes. Dwelling construction could ease. The fact that dwelling consent issuance is at its highest levels since the 1970s is partly a result of how expensive existing dwellings are. The outlook for retail activity (particularly durable goods retail) is also likely to be weaker than otherwise. However, we are likely to be talking about a slowing in growth in domestic demand not outright contraction.

At this stage we don't envisage sizeable forecast changes elsewhere, with modest downward tweaks for the outlook for overall economic activity, employment and inflation. The risks are now likely tilted more towards the pushing out of OCR hikes (our current forecast is August 2022 for first hike). Nevertheless, the next move on the OCR is still likely to be up.

Government actions on Housing

Govt	*Impacts*	*Pros*	*Cons*
From Oct 1 Interest deductibility on investor rental income from properties acquired after 27 March to be phased out in 25% increments by 2025. Loans against business secured on residential property exempt.	Reduces after tax incomes by investors. Assuming full deductibility at 33% this could be in the $500m-1bn range per annum. For a new investor, the changes are potentially $100 per week.	Raises revenue for govt. Tilts balance in favour of owner-occupiers and potentially boosts home ownership. Complements RBNZ objectives, as RBNZ perceives investor lending to be riskier from a financial stability point of view.	Non-deductibility of interest payments despite this being a business expense. Reduces house prices with risk of slump if investors sell. Rent increases and lower rental dwelling supply, potentially increasing the supply shortfall of available dwellings. Slows the demand for borrowing by investors and the number of house sales/credit growth. Reduces after-tax returns of property investors.
Extend bright-line (BL) test from 5 to 10 years for non-owner occupier properties acquired after 27 March 2021. Family home/inherited property exempt. Five-year BL for new builds and for properties purchased prior to 27 March 2021.	Reduces after-tax returns from investor property sales if property owned 5-10 years. Reduces investor demand.	Raises revenue for govt. Reduces after-tax returns to investors selling property and investor demand. Tilts balance in favour of owner occupiers. Complements RBNZ objectives.	Lowers house prices, increases rents and lowers rental dwelling supply. Discourages churn and potentially limits properties on the market, which will slow housing credit growth
$3.8bn Housing Acceleration Fund. Actions to increase dwelling supply via combination of loans/funding for infrastructure. Increased grants for first-home buyers.	Aim to increase the provision of infrastructure and affordable dwellings. Boost buying power of first-home buyers.	Increased provision of affordable dwellings. Tilts balance in favour of owner-occupiers.	More dwelling supply will dampen house prices. Capacity constraints in construction sector. Increase in grants could ratchet up house prices.

Source: ASB

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