Aide-memoire

Potential impacts on existing landlords and tenants of proposed changes to the treatment of rental properties			
Date:	22 December 2020	**Security level:**	Sensitive
Priority:	Medium	**Report number:**	AMI20/21120425

Information for Minister(s)	
Hon Dr Megan Woods **Minister of Housing**	For information

Contact for discussion

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Other agencies consulted
N/A

Minister's office to complete

☐ Noted ☐ Seen ☐ See Minister's notes ☐ Needs change ☐ Overtaken by events ☐ Declined ☐ Referred to (specify) ________________________	**Comments**

Date returned to HUD:

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Aide-memoire

Heading

For:	Hon Dr Megan Woods, Minister of Housing		
Date:	22 December 2020	**Security level:**	Sensitive
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Purpose

1. We understand that the Minister of Finance is considering a range of options to moderate house price growth while enabling higher levels of home ownership and improving rental outcomes. Speculative investor activity has been identified as a concern, and some of these options include changing tax settings to disincentivise property investment.

2. You have asked for advice on the possible impacts on existing housing stock and tenants of potential changes to the treatment of rental properties for investors, namely:

   a. **Extending the bright line period:** disincentivise short-term property speculation

   b. **Limiting interest-only mortgages:** increase the level of repayments for investors (i.e. require principal repayments)

   c. **Removing deductibility of mortgage interest:** increase investors' tax liability (or reduce losses)

   d. **Temporary rent control:** reduce flow on impact to renters of any increased costs or decreased returns to property investors (measures which could be implemented "if needed" to mitigate impacts on rents from a.- c. above).

3. At this point we understand that Ministers have not made decisions about whether all of the above measures would be implemented as a package (with a cumulative impact), or whether individual measures would be selected. Decisions on detailed design (for example the extent of grandparenting) have also not yet been taken but will be significant even if only a limited number of individual measures are implemented.

Executive Summary

4. On 4 December we provided you with a potential package of options to increase housing supply and improve affordability over the short-term. The options focused on:

   a. Increasing supply (across all types of housing tenures and price points)

   b. Reducing the rate of property and rental price increases

   c. Improving outcomes for households who rent

   d. Enabling first home buyers to better compete in the market

   e. Having an initial impact in the next 12 – 18 months, particularly in terms of reducing expectations of significant future house price gains

f. Appropriately targeting the specific constraints and impediments in different priority places (e.g. there are differences between main urban centres and regional centres, and between different places)

5. We note that while the measures being considered by the Minister of Finance will potentially reduce the rate of property price increases (including by avoiding further speculation on existing properties), and could benefit first home buyers, they would not increase supply. In addition, if these measures apply to existing housing stock, they could have a negative impact on the households who rent these properties, particularly those on lower incomes.

6. Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development (HUD) supports measures that:

    a. act as a deterrent to investors buying current housing stock, and

    b. that channel housing investment towards new rental supply.

7. This paper focuses on the potential impacts of the proposed changes if they were to apply to existing landlords, and by extension, tenants. We are particularly focused on the impacts on lower-income tenants who are not in a position to purchase a property. At least 75% of current tenants cannot afford to buy a home and this is unlikely to change even with a 10-20% price drop given the increase in the last 12 months.

8. The potential changes to the treatment of rental properties could impose additional costs on existing property investors. This may result in some of these property investors choosing to sell. Investors may also make other choices to offset the costs, such as raising rents (but this would be moderated by the ability of renters to pay and any potential rent controls), lowering maintenance costs, or moving the property to the short-term rental market (e.g. AirBnB).

9. If investors choose to sell, sales to first home buyers could increase. We note, however, that only some current renters are in a position to become first home buyers. Based on the Housing Affordability Measure, a generous estimate is that up to 25% of renters could afford mortgage repayments, however many of this cohort may not be able to save a deposit. There are also regional variations in affordability.

10. Evidence shows that first home buyers are more likely to buy homes in the bottom half of the market, which may further reduce rental stock at the lower end of the market.

11. Where an existing landlord chooses to sell, the existing tenants are likely to be displaced, either immediately if the landlord gives notice prior to the sale, or subsequently if the sale is to an owner occupier. This risk could be partly mitigated if the Residential Tenancies Act 1986 was amended to prohibit termination of a tenancy if a landlord intends to sell, but would only be a temporary reprieve if the sale is to an owner-occupier.

12. Rental “churn” imposes substantial costs on renters (e.g. moving costs, new bond, rent in advance), particularly those who are not currently capable of becoming homeowners. At the lower end of the market, the churn increases the risk that households may need to rely on transitional housing or emergency housing special needs grants, or increase the numbers of the public housing register. Moving costs also negatively impact the finances of those that are saving for a deposit.

13. If Ministers choose to proceed with one or more of these options, HUD recommends that extending the bright line test will have the fewest consequences on tenants, as it focuses on disincentivising future short term speculation, rather than causing potential churn in the existing rental market.

14. HUD would also recommend that any other changes (e.g. limiting interest-only loans, removing deductibility of mortgage interest) do not apply to investment in new builds, or to currently owned rental properties. We would recommend, however that they apply to short-term holiday

accommodation, to disincentivise shifting property from long-term to short-term rental e.g. AirBnB.

15. The Treasury have also recommended further advice be provided to Ministers on other measures to reduce demand in the housing market, including a deemed rate of return method for taxing investment properties and a stamp duty. We note that the impact of these measures on current and future property investment should be assessed, given the potential downstream impacts on existing renters and new supply.

16. We will be reporting to you on HUD's recommended package of measures in more detail in January 2021, including further advice that you have requested on rent control.

Property investors vary in their portfolio size, length of investment and levels of equity or debt

17. Property investors vary in the number of properties they own, the length of time properties have been held and the levels of equity or debt. Depending on their circumstances, proposed changes will affect property investors differently.

18. Purchasers owning multiple properties have made up between 35%-40% of property purchases over the last decade (by comparison first home buyers have bought 24% of properties in 2020). Multiple property owners with between 2-4 properties (which normally includes their main home) make up more than half of these purchases, with fewer than 15% of purchasers owning 10 properties or more.[1]

19. Approximately 20% of current private rentals have been purchased in the last two years.

20. We do not have detailed information on investor portfolios and levels of equity or debt but do know that:

    a. Longer term investors are unlikely to have high debt and may have significant cashflow from their properties:

        i. Our analysis of rental bonds and residential sales suggests the median holding time for investors is around 7 years, which is comparable to owner occupiers. Long-term investors will also have earned significant capital gains.

        ii. Loan to value restrictions will have limited debt in recent years.

        iii. The 63% of property investors (182,219 taxpayers) reporting rental profits to IRD have an average profit of $14,000.

    b. Some investors will have substantial debt and will be in a negative cashflow position:

        i. The 37% of property investors (107,530 taxpayers) reporting rental losses to IRD have an average loss of almost $9,000. Most allowable deductions reflect real cash costs to investors e.g. insurance, body corporate fees, maintenance.

        ii. New borrowing by investors has trended up over the last 5 years.

    c. The greatest change in behaviour is likely to come from investors who are less able to absorb additional costs, although we expect most landlords may consider increasing rents (discussed further in paragraph 24). These investors are likely to have entered the market recently, and/or be in a tax loss position, and/or have a smaller number of properties.

[1] Information on buyer classification from Core Logic. Note that Core Logic's classification of multiple property owners includes property investors and people owning holiday or second homes and properties on Airbnb.

21. For illustrative purposes removing the deductibility of mortgage interest and/or limiting interest-only mortgages could affect a recent investor in the following ways:

    a. **Denial of interest deduction**: assuming a mortgage of $500,000, which is around 70% of the national median sale price[2], at an interest rate of 2.5% would have interest costs of $12,500 per annum. Denying all interest deductions would add a cost of $4,125 at a marginal tax rate of 33%[3].

    b. **Limiting interest only mortgage:** assuming the same mortgage, moving from an interest only mortgage would add principal repayments of $11,200 per annum. By comparison the median rent for new bonds lodged over the last 12 months was $470 per week, or $24,440 per annum.[4]

22. The number of investors who might be impacted by these potential changes includes:

    a. Approximately 20% of current private rentals have been purchased in the last two years. Half have been bought by small investors (less than 4 properties).

    b. Just over one third of investors are in a tax loss position and may need to meet increased costs from other income sources.

There are a number of actions investors might take in response to these changes

23. Depending on their circumstances, proposed changes will affect property investors differently. Possible responses include:

    a. Increasing rent to cover additional costs

    b. Taking their property out of the rental market

    c. Reducing costs by lowering maintenance

    d. Selling one or more properties.

Increasing the rent to cover additional costs

24. Property investors will weigh up their willingness and ability to pay for any increased up-front costs against the returns to the investment, including rents and untaxed capital gains. It is unlikely that investors will be able to fully pass on additional costs through increased rents. Stressed renters are already at the limit of what they pay and may respond through sharing housing costs and crowding. Rising rents can also lead to more well-off renters opting to buy, subject to being able to raise a deposit, or paying higher rent to secure properties. Both factors would limit the extent rents can be increased.

Investors may take their properties out of the rental market

25. Prior to COVID-19 in many holiday location investors had strong incentives to shift properties to the short-term holiday accommodation market. The extent of the impact is unclear, but certainly contributed to an underlying shortage of rental accommodation in some locations (for example Rotorua, Queenstown and Hastings).

26. Listings on short term holiday accommodation platforms have declined this year and revenues remain low compared to the same time last year. While the risk of leakage to the holiday rental market is low at this point, this risk will increase once borders reopen and tourism levels

[2] The Real Estate Institute of New Zealand report median sale price of $749,000 for November 2020.
[3] Allowable expenses are deducted from gross rental income to determine taxable income, then tax is payable at the investor's marginal tax rate.
[4] This takes the average of the monthly median rent for new bonds lodged between December 2019 and November 2020. The median rent for new tenancies in November 2020 was $500 per week

recover. For this reason, proposed changes should also apply to short-term holiday accommodation, if they apply to rentals, to ensure landlords are not incentivised to take properties out of the rental market. In practice, however, it may be difficult to amend the law to clearly distinguish between AirBnB-type properties and some other more traditional holiday accommodation (e.g. traditional B&Bs or motels).

27. We do not believe there is a high risk that properties will be left vacant. Forgone rent would exceed costs of the proposed changes.

Investors could look to save costs by lowering maintenance costs

28. A further potential unintended consequence of increasing the costs to property investors is that they reduce expenditure on maintaining their properties. It is difficult to quantify this risk, and we note that this is more likely on the margins, and with landlords who are unaware, or unconcerned about compliance.

29. A baseline survey that will track compliance with the healthy homes standards found that 93% of landlords had heard of the standards, and 77% had done some things to prepare their properties to meet the standards. Around 40% displayed strong commitment to meet the standards. Eight percent were described as “difficult” or in “denial”.

30. Compliance activity by Tenancy Services could address this, but remains a small function relative to the size of the rental market.

Investors could sell one or more properties

31. Lower expected returns and higher costs will reduce investor demand for housing. This will reduce what investors are willing to pay for properties and lead to some divestment. Investors who are unable to cover increased costs from other income sources are more likely to sell.

Some landlords are currently considering selling one or more properties

32. Two recent surveys of landlords have found around 20% are seriously considering selling one or more rental properties in the next 12 months. Key reasons for wanting to sell include recent house price rises, freeing up money for their own financial situation, compliance costs or Government policy changes, changes to rental laws or new requirements for landlords.

Would sales of investment properties increase first home buyers into the market?

33. Only some current renters are in a position to become first home buyers. Based on the Housing Affordability Measure, we estimate that up to 25% of renters could buy, subject to the ability to save a deposit, and with variations depending on location.

34. We expect that those investors most likely to exit the market are those with high debt related to their investment properties, whether they are investors with one or multiple properties.

35. However, we won’t see a significant fall in prices if demand from investors with higher levels of equity and first home buyers (with deposits) remains strong. The underlying demand drivers for these purchasers – low interest rates and high rents are likely to remain unchanged.

36. Analysis of property sales and current rental bonds suggests that most homes bought by investors would be considered by first home buyers. Apartments are the exception, with only 3% of first home buyers purchasing apartments since January 2019, while they make up around 10% of rentals. First home buyers are also more likely to buy homes in the bottom half of the market compared to multiple property owners who tend to purchase across all price points. First home buyers are also more likely to purchase stand-alone homes (80%) compared to investors (67% of rental properties).

How are tenants impacted when their landlords sells?

Renters in the private market have variable ability to pay rent and/or move into home ownership[5]

37. The proportion of New Zealand households that rent has increased from 22.9% in 1991 to 31.9% in 2018, and just over 1.4 million people make up these households. Most of these households (83.5%) rent privately.

38. Renters are more likely than homeowners to be on lower incomes, and non-partnered. People of Pacific, Māori or Asian ethnicity are more likely to be renters than homeowners.

39. The proportion of households that rent varies across the country, with the highest proportions in Gisborne and Auckland (around 40%), and the lowest in Tasman and Marlborough (around 24-28%).

40. Housing costs are a greater burden for renters than for homeowners, when looking at proportion of income spent on housing costs.

41. Renters in the private rental market can be categorised into the following groups[6]:

    a. **Potential first home buyers:** This group of renters can afford their rent, and have been able to save a deposit. *Housing in Aotearoa: 2020* reported that in 2018, one fifth of renters who had moved in the past five years had become homeowners.

    b. **Intermediate housing market:** This group of renters can comfortably afford their rent, but do not have sufficient disposable income to be able to save a deposit. A report by the Building Research Association of New Zealand (BRANZ) in 2015 identified that there were 181,500 intermediate households nationally, with 85,400 of these located in Auckland.[7]

    c. **"Price takers" and stressed renters:** This group of renters (a sub-set of the intermediate market) are those who do not qualify for public housing (or qualify but would be relatively low priority), but have high rental costs relative to their income. As a general indicator, based on the housing cost to income ratio, between 25% and 30% of renters paid 40% or more of their income on housing costs over the past ten years, and around 45% paid 30% or more. At the lower end of this group are "price takers", who rent at the lower end of the market and "take" the lowest price offered, which may or may not be affordable. Rental unaffordability is generally greater in places in New Zealand where rents are high (eg, Tauranga, Thames-Coromandel, Rotorua, parts of Auckland).

If a number of landlords choose to sell, the associated "churn" in the rental market can impose significant costs on renters

42. Frequent moves and insecure tenure can affect a household's wellbeing. Renters in New Zealand move more frequently than non-renters and evidence shows that frequent moves can be detrimental to health and wellbeing. Research from the Growing Up in New Zealand study found that between birth and nine months, "children born into families residing in private rental accommodation were the most likely to have experienced early [residential] mobility, with nearly

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[5] Data for this section is taken from Statistics New Zealand, *Housing in Aotearoa 2020,* December 2020 unless otherwise referenced.

[6] We note that there are also sizeable populations who are either in public housing (around 63,000 households at the time of the 2018 census; approximately 12% of renter households), on the housing register (21,415 households as at September 2020), and either homeless or in transitional housing (almost 9,000 across Special Needs Grants, COVID-related transitional housing, and other transitional housing).

[7] BRANZ, *Can Work, Cannot Afford to Buy the Intermediate Housing Market,* April 2015, https://d39d3mj7qio96p.cloudfront.net/media/documents/ER5s_Summary_of_can_work_cannot_afford_to_buy_the_intermediate_housing_market.pdf

1 in 2 (49 percent) having moved at least once, compared to fewer than 1 in 5 experiencing mobility if their families were home owners”.[8]

Direct costs to renters

43. From 11 February 2021, landlords who are terminating a tenancy due to the sale of the rental property will be required to give 90 days’ notice (for a periodic tenancy).

44. In the 2018 General Social Survey, just under 30% of tenants were on a fixed term tenancy, which cannot be terminated early due to a property sale – although the tenant may have to move after the fixed term ends. Other landlords choose to sell a property with their tenants in place, even if they are on a periodic tenancy. In those cases, the new owner can either continue the tenancy, or give notice if they intend to the move into the property.

45. The risks to tenants of having to move when a landlord sells could be partly managed by amending the Residential Tenancies Act 1986 to remove the ability of a landlord to terminate a tenancy when selling. However, this would only give the tenant security of tenure if the property sold to another investor, which is not the intention of these proposed tax changes.

46. For the affected tenants, the search for a new property incurs a number of upfront costs. Significant one-off payments include:

    a. payment of advance rent and bond: this can be several thousand dollars comprising up to four weeks of rent in advance, plus four weeks rent for a bond payment

    b. moving costs: these will depend on the ability to call on family or friends to help, and size and composition of the household.

47. A tenant’s existing bond can be transferred to a new tenancy, if the new landlord agrees. Tenancy Bond services data indicates that around 700 out of 11,000 bonds are transferred between tenancies each month. However where this is not possible, renters can wait up to three weeks for their bond to be returned after their tenancy ends.

48. In addition, for an average rental there is likely to be an ongoing increased rent of approximately $50 per week. A comparison of weekly rents in Census and Household Economic Survey data with Tenancy Bond data indicated an approximate difference of $50 per week, indicating the price of new tenancies is set higher than the price for those in existing rentals.

A number of tenancies ending at once causes prices to spike

49. While the number of houses in the market doesn’t change, evidence shows that a number of tenancies changing over at the same time causes spikes in prices. Tenancy Services bond data shows that in markets where there are significant numbers of tenancies ending at the same time, prices spike over that period (for example in Wellington, where many tenancies change over during the summer months).

50. Consequently, if a significant number of property investors choose to sell, and give notice to their tenants, this could increase costs to displaced tenants.

Some stressed renters may have difficulty finding a property

51. There is a risk that for some renters in the lower-priced parts of the rental market, that they will not be able to find a new rental property at a price they can afford. This could lead to either further pressure on emergency special needs grants, transitional and public housing, or to overcrowding to enable rent to be affordable.

52. This risk is greater in the current supply-constrained market, and has much more significant long-term costs, both for the individual and for the Government. For example, in the September

2020 quarter 9,823 households received one or more Emergency Housing Special Needs Grants (EHSNG). These households were temporarily unable to access private rentals or one of the 3533 Transitional Housing places across the country. In locations such as Gisborne, Rotorua and Napier-Hastings EHSNG are high reflecting the underlying tightness in the rental market and difficulty in accessing secure affordable rentals when existing tenancies are ended.

Rent control to counter the risk that investors increase rents to recoup their costs

53. The Treasury advice noted that rent control measures could be drafted to offset or limit negative impacts of adjustments to tax policy changes on rent prices. If the government introduces a temporary rent control then this could incentivise more investors to sell, but international evidence shows that those that retain rental properties will try to find other ways to increase rental income and/or increase rents up as soon as the period of rent control ends.

Next steps

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