RESEARCH BULLETIN

Betting on House Prices: Housing Speculation in Auckland

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This bulletin highlights:

- Widespread housing affordability problems in the Auckland housing market.
- How property investors are pursuing windfall or speculative gains.
- The methods used in this research could be used to activate the largely idle Income Tax Act's intention test which is the main instrument currently available to government to effectively control housing speculation.

Data collected in the 2019 Household Economic Survey suggest that more than $570 million was being directed in the form of Accommodation Supplement to assist Auckland households with Auckland housing costs. Almost 100,000 owner occupier and renting Auckland households receive Accommodation Supplements. Other households are assisted through community housing and state housing through income related rents. Over 40% of renting households in Auckland are paying more than the usually accepted measure of affordable housing costs (30% gross household income). Among the 115,000 renting households at 80% of the median Auckland household income, 59% are affordability stressed and 36% face more than half their gross household incomes being paid out in rent.

Even with government assistance, house prices are out of alignment with the ability of Auckland households to pay. The burden of excess housing costs falls on households, some of whom try to mitigate costs through crowding, and present a significant fiscal liability for government. Understanding the dynamics that generate this misalignment is a critical aspect of finding pathways to affordable housing for low income households and housing affordable to modest income households.

One of the critical issues has been the extent to which housing has become financialised and a commodity for speculative gain by property investors. Research recently has explored precisely that. In addition, it develops novel methods to objectively distinguish speculators from genuine investors and outlines an evidence-based approach to put into practice New Zealand's existing anti-speculation tool, the Income Tax Act's intention test.[1] Despite being 'on the books' since 1976, the intention test is rarely used. This is in-part due to the difficulty of determining an investor's initial intention when buying a property.

This bulletin summarises key findings from a research study by the University of Auckland's Dr Michael Rehm and PhD candidate, Yang Yang. The study looks at speculative patterns in purchases of property for rent in Auckland from 2002 to 2016. The research applies a cash flow model emulating investment calculations used by property investors when purchasing residential

[1] Income Tax Act 2007, Section CB6, http://legislation.govt.nz/act/public/2007/0097/latest/DLM1512414.html

properties. In doing so, Rehm and Yang have found a way to operationalise the intention test so IRD can enforced it.

Purchasing in Auckland to Rent

While the full study considers a variety of property types and modes of funding, this bulletin focuses on leveraged houses, which account for 69% of all properties purchased and then rented (Figure 1). The financial modelling mimics the typical approach to due diligence taken by 'mum and dad' investors in residential property and considers market rents, finance costs, and other holding costs including rates, maintenance, management, and water charges. Together with a property's purchase price, a simplified equation is used to determine the initial (first-year) cash-on-cash return or net rental yield.

Mortgage interest dominates the holding expenses for a typical leveraged investment property irrespective of interest rate fluctuations (Figure 2).

Figure 1. Rental property purchases by type and financing

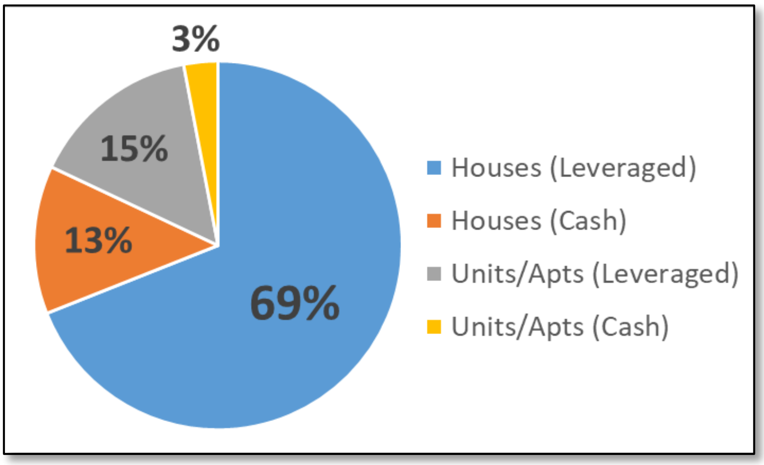
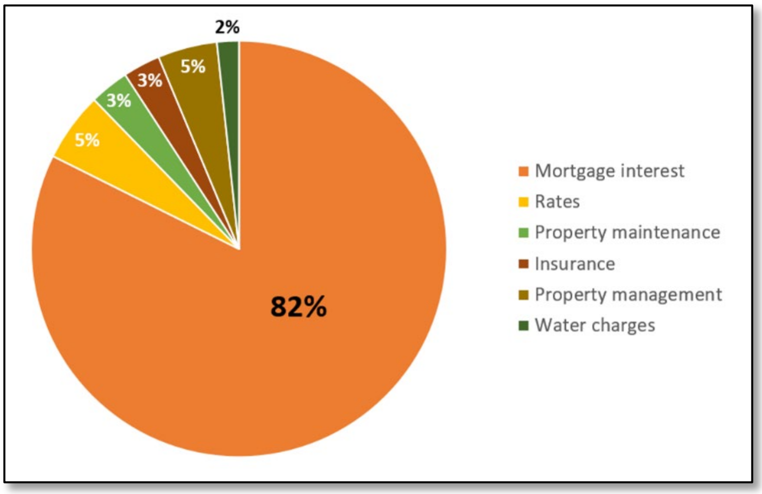


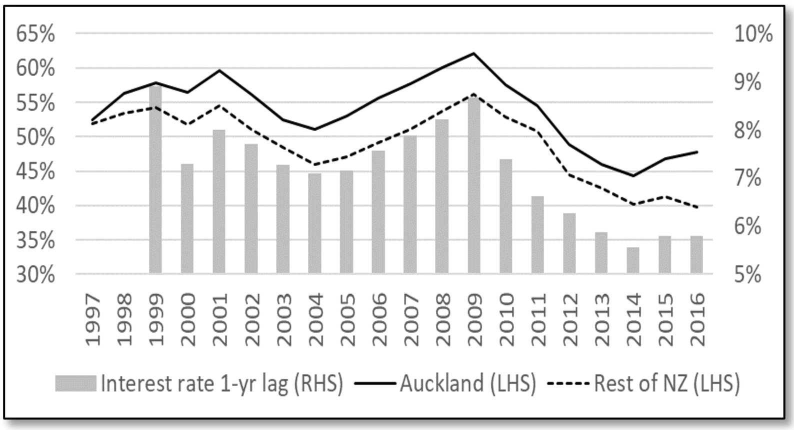
Figure 2. Typical expenses: Leveraged, rental houses



Income and Loss

In the 2009 tax year, a peak of 62% of all Auckland-based rental property owners (residential and non-residential, leveraged and not, seasoned and new) reported a rental loss to the IRD (Figure 3). By contrast, with the low interest rates following the GFC, 'only' 45% of Auckland investors reported rental losses in the 2014 tax year. Interest rates and rental losses are synchronised.

Figure 3. Proportion of property investors reporting rental losses to IRD



Speculative Investment Patterns

Each property purchased and rented was assessed as speculative or not, by benchmarks around modelled net rental yield against alternative investments available at the time of purchase. One key benchmark was the prevailing 6-month term deposit rate. This was adopted as a 'risk-free' rate. Another benchmark is a 'fair rate of return'. The quarterly annualised returns of First Mortgage Trust (FMT) was used as that benchmark. FMT is New Zealand's largest non-bank first mortgage lender. Buyers of rental properties genuinely focused on rental yield without concern for future capital gains could have opted to invest in FMT as an equivalent investment.

Figure 4 provides the share of purchases by year for four rental yield categories. All but the last of these categories (above fair rate of return) indicate some degree of speculative behaviour.

Figure 4. Property purchases by rental yield category: Leveraged houses

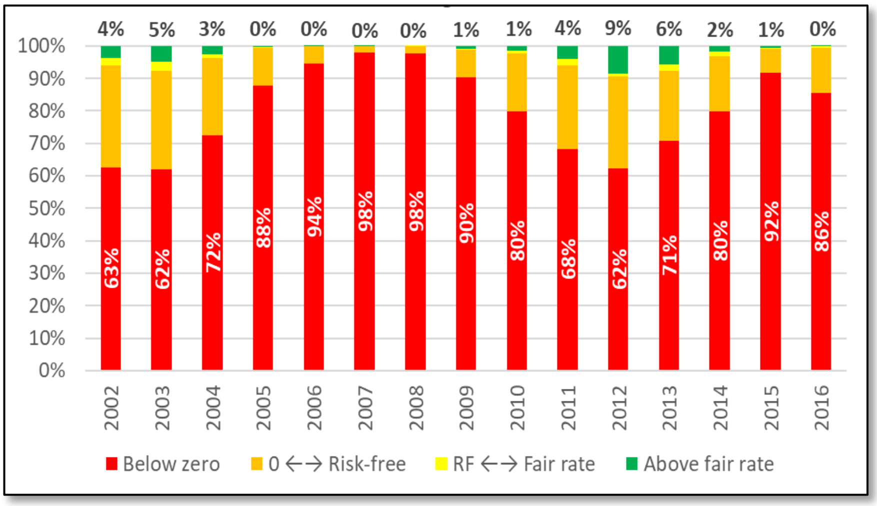
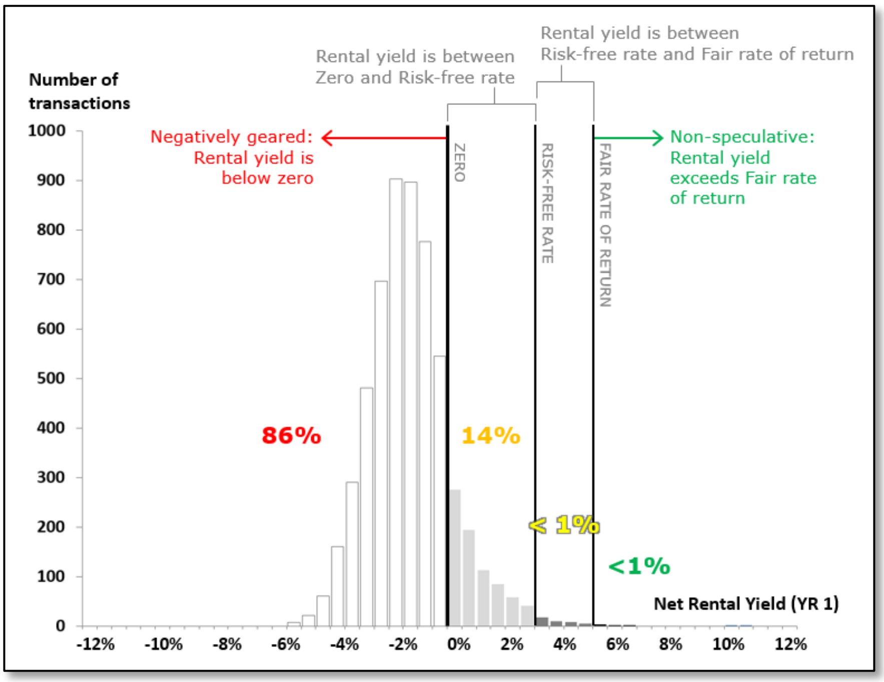


Figure 5. Modelled rental yields of leveraged purchases in 2016



In every year studied, over 90% of leveraged house purchases involved some degree of speculation.

Figure 5 shows the distribution of first year rental returns across purchases in 2016. The average cash-on-cash return was negative 1.3% with 86% of purchases negatively geared and highly speculative. A further 14% generated a positive return but below the risk-free rate indicating that these too were strongly speculative.

Just under 1% produced rental yields that surpassed the risk-free rate but fell short of the prevailing fair rate of return. The remaining fraction of 1% of purchases displayed no intent to profit from the eventual resale of the rental property.

In summary, nearly all rental purchases in Auckland from 2002 through 2016 were speculative to some extent with the vast majority being negatively geared and operating at a loss. That behaviour contrasts to the Auckland Property Investors Association's stance that investors focus on rental income, invest only when adequate returns can be had and do not consider capital gains when buying.[2]

What about Lenders?

Reserve Bank data shows that only 8% of households own one or more investment properties, but they account for 40% of housing debt. Lenders have eagerly extended interest-only mortgages on these investors who are effectively commodifying housing. Interest-only loans account for over half of new lending on property rented after purchase. That compares to roughly one-third of owner-occupier home loans.

Financialisation and House Prices

Speculative investors in dwellings may rent dwellings but the purpose of the purchase is not framed by a desire to be a service industry delivering rental dwellings to tenants. For the vast majority of investors these purchases are primarily speculative. They, and the lenders that provide them with credit, have gambled on sustained house price increases. As such, these influential market participants have an interest on housing and tax policy and its application that support or at least do not mitigate speculative behaviours. In purchasing properties that are destined for the rental market, housing speculation is endemic. 'Betting' on some degree of future capital gains is widespread. Recent calls for a 'new' capital gains tax are moot. There is an enforceable instrument in the Income Tax Act's decades-old intention test. This is a key step towards a sensible, affordable housing market.

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Further Reading

Rehm, M. and Yang, Y. (2020), "Betting on capital gains: housing speculation in Auckland, New Zealand", *International Journal of Housing Markets and Analysis*. https://doi.org/10.1108/IJHMA-02-2020-0010

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[2] APIA press release on 6 April 2017, Stop calling us 'speculators', https://www.apia.org.nz/announcements/press-release-stop-calling-us-speculators