From: Nick Renton [ner@nickrenton.com]
Sent: 18 September 2003 10:47
To: housing@pc.gov.au
Subject: Submission to the Inquiry on First Home Ownership

This submission comments on two aspects of housing which have been the subject of recent discussion in the community.

The first addresses the following paragraph from the Terms of Reference:

"Identify mechanisms to improve the efficiency of the supply of housing and associated infrastructure."

The second addresses the following paragraph from the Terms of Reference:

"Identify any impediments to first home ownership, and assess the feasibility and implications of reducing or removing such impediments."

THE JOINT HOME OWNERSHIP PROPOSAL

On 20 September 2002 the Prime Minister, John Howard, gave a press conference in Sydney during which he praised what he described as "innovative approaches to reduce the cost of home ownership through new financing partnership arrangements".

He explained that the proposed partnership scheme, which is to be further investigated, would involve the joint acquisition of a residential property by the person or persons who would "occupy and own it in the traditional sense" and by an outside financial institution. The two participants would share the equity in the property.

If the property were sold later on then both the occupier of the home and the institution in partnership with that occupier would enjoy a proportionate gain out of the increase in the value of the property.

The Prime Minister went on to say: "This would be, I believe, particularly attractive to younger people wanting to enter the housing market in high cost areas of Australia, not only, but in particular, the larger cities such as Sydney and Melbourne."

Clearly, such a scheme would also have considerable electoral appeal. The proposal as described by Mr Howard would indeed sound wonderful for young families starting off in married life, particularly if they did not have much by way of past savings.

They would get the ability to occupy a whole house of their choosing but with the need to raise finance for only one half of it. Presumably they would thus require only one half the normal deposit and one half the normal first mortgage housing loan - although admittedly at the cost of getting only one half of any subsequent capital appreciation, on a sale at some indefinite time in the distant future when it suits them to make such a disposal.

But what is in it for the other half-owner of this valuable asset, the financial institution?

Given a choice of owning, say, 50 investment properties outright or owning only 50 per cent of 100 such properties for the same total outlay, what institution in its right mind is going to go for the latter?

There would be much higher administrative and legal costs involved. The institution would have no effective physical or financial control over the asset. In addition, it would have no say in the timing of its eventual disposal. All round, this would not seem to be a very attractive proposition for the non-occupier partner.

Apart from that, when the time comes to sell up and share the capital gains 50/50 there will be an enormous public relations problem. The occupiers will gloss over the substantial advantages which they enjoyed years earlier at the acquisition stage and will cry foul, feeling cheated of the institution's half of the capital gain which the family would have had in normal circumstances.

If the value of the property were to fall - after all, the hoped-for capital gains can never be guaranteed - then, human nature being what it is, the institution would probably get the blame for encouraging the occupier into an arrangement which when viewed with the benefit of hindsight is perceived to be a poor deal.

The Prime Minister did not elaborate on the question of rent for the institution's half of the property, leaving most people to assume that this would be nil, on the basis that the institution concerned would get its compensation solely from its half share of the capital growth.

But this reasoning would seem totally unrealistic, as the institution could always make other property purchases which would yield a commercial return on the funds invested. Such a return would naturally be [in addition to] any capital gain, so that a capital gain without an associated annual income would not make much investment sense.

A zero sum game is involved here. If the occupying family is really to be better off than under a conventional home purchase arrangement then clearly someone else must be correspondingly worse off. Banks and other financial institutions are unlikely to want to be that "someone else".

So that would mean that a commercial rent would have to be charged in respect of the institution's equity, leaving the occupiers in cash flow terms in much the same position as if they had financed their purchase in the conventional way.

But who would decide the proper rent level from time to time for the half share of the property owned by the institution? The two parties might have very different ideas in that regard. In a normal landlord and tenant situation the tenant, if faced with demands which are considered unreasonable, is always free to find another house and another owner, but this would not be at all easy in the case of the proposed partnership arrangement.

There are also other problems. What happens if the institution ever feels that expensive repairs are necessary in order to preserve the property, but the occupier is unwilling or unable to pay for half of the total cost involved? Furthermore, an occupier who owns only half of a house probably has less incentive to look after it than an occupier who owns it all.

There is also the reverse situation - the occupier might want to make some improvements for lifestyle reasons but the institution might take the view that these would add little or nothing to the value of the property as a whole. The institution would thus probably refuse to meet any of the cost. In fact, the institution might even wish to veto the whole idea, if it feels that the implementation of some design concept might adversely affect the chances of attracting tenants some time in the future.

The likelihood is that the resolution of all such disputes will cost somebody money - the occupier, the institution and probably also the taxpayers as the financiers of the court system.

As some commentators have mentioned, implementation of the proposed plan would be likely to push house prices up further, at least in the short term, as demand will rise immediately but supply in the form of new construction will rise only gradually.

This could be good news for existing home owners, by increasing their asset values and thus their borrowing capacity. This would admittedly also be good for the Australian economy as a whole by generating additional consumption expenditure and further investment.

However, these prematurely increased house prices will harm at least three groups in the community:

- the intending occupiers of the proposed scheme houses themselves, thus eroding some of the scheme's immediate attractions for them
- the financial institutions who are to be their partners, as higher prices at the purchase stage will reduce the scope for future capital gains when the price levels return to the trend line
- house purchasers outside the proposed scheme.

The existence of the proposed scheme or some variation of it would no doubt be welcomed by the housing industry in the same way that the First Home Owners' Scheme was. But, as is common in such situations, the proposed scheme could also stimulate excessive speculative building, leading to an oversupply of homes and thus to falling rather than rising house prices - a feature which would naturally frustrate further the capital growth expectations of both sets of partners.

The Prime Minister's proposal was based on a discussion paper entitled [A Primer on a Proposal for Global Housing Finance Reform] by two economists, Professor Andrew Caplin and Christopher Joye. This paper and a lengthy report published this year are both available on the Menzies Research Centre's web site at www.mrcltd.org.au

However, the paper presents arguments entirely from the perspective of the household that is to take occupancy of the residence and even refers to that occupier as the "Managing Partner". Consistent with this approach it refers to the financial institution that is initially to co-own the asset as the "Limited Partner".

The authors point out that the proposed partnership contract would leave the Managing Partner in complete control of the property, with both the right to determine the time of sale but, in their view, a strong incentive to optimise both partners' interests.

The authors make it plain that they have in mind the unrealistic "nil rent" formula discussed above, as they say: "Housing would be financed with both a mortgage and an institutional investor who provides equity capital for the dwelling in exchange for a fraction of the ultimate sale price, [with no other monetary payments made between the parties]."

Of course, it all depends what that "fraction" is. It does not have to be a "funny money" proposal using 50 per cent. A scheme on the above lines might be viable from the perspective of an institution even on a "nil rent" basis if the institution bought, say, only 25 per cent of the equity on the understanding that it would be able to pocket 75 per cent or thereabouts of the ultimate capital gain.

However, such ratios would probably not appeal to the occupiers. These ratios would do less to overcome any cash shortfall at the purchase stage and they would add to the feeling of being hard done by at the disposal stage.

On the other hand, it has to be remembered that banks are not charities. They have a duty to their shareholders to invest their funds wisely. Similarly, superannuation funds owe a duty to their contributors. It would be ironical indeed if any benefits to individuals as home purchasers were to be offset by lower superannuation benefits in retirement.

HOUSING AS A SUPERANNUATION ALTERNATIVE

The Australian Government seems obsessed with the notion that its citizens should all have formal superannuation to provide money to support them in old age.

However, all forms of long term investment can really be regarded as a form of superannuation, in the sense that they represent a pool of money which can be used at retirement. If that pool is large enough then the income on it alone can make a very satisfactory pension. If the assets are growth assets such as ordinary shares and property then the pension is effectively an indexed one.

Of course, if the pool is not large enough for this purpose then some of a retired person's capital has to be used up as well - but this applies equally to many forms of organised superannuation, including those favoured by the authorities (such as lifetime annuities and allocated pensions).

Regrettably, the possibility that the assets backing an allocated pension can run out long before the death of the person receiving the payments is not always understood. Nor is the fact that the cash which has to be drawn each year can force the realisation of assets even when market conditions at the time might make this most unwise.

From time to time the idea is floated that contributors to superannuation funds should be able to access the money invested by them, or by their employers on their behalf, in order to acquire housing for themselves and their families. For low income groups in particular such an arrangement would eliminate one of their difficulties in entering the housing market - the need for an appropriate deposit before they can get access to loan funds on reasonable terms.

Apart from that, most home purchasers would find it more tax effective to direct savings towards repaying a housing loan (where the tax rate on the interest is zero), rather than to a superannuation fund (which is taxed at 15 per cent on its investment earnings). Such a strategy would also avoid the relatively high charges involved in many formal superannuation arrangements.

It was therefore disappointing that the chairman of the Senate Select Committee on Superannuation, Senator John Watson, recently issued a statement asserting that using superannuation to finance housing was "not an acceptable option". He categorically rejected calls for superannuation savings to be made available to finance a deposit on a house or to reduce a home loan.

His comments apparently came in response to calls by real estate agents for potential home buyers to be able to access their superannuation savings to help realise the dream of home ownership.

Senator Watson said: "This would be completely contrary to the intended purpose of the superannuation system, which is to provide for a financially secure retirement."

This glossed over the reality that owning a fully paid-for house was a very important ingredient for a secure retirement. It also completely ignored the fact that under the present system many people were forced to use their lump sum superannuation benefits to pay off their outstanding housing loans on leaving the workforce. In the meantime they had been required to pay out more in interest than the "after tax, after charges" returns from their superannuation funds.

Senator Watson also raised concerns that using superannuation savings to finance housing would further inflate the housing bubble by pumping more money into the housing sector, "but without addressing the supply of housing".

This overlooked the fact that giving young couples the chance to acquire housing at an earlier age would in many cases lead to the construction of new housing, thus actually adding to the total supply.

Nick Renton 194 Kilby Road Kew East 3102 Australia
Telephone and Fax 613 9859 4958 [BH & AH]
http://nickrenton.com (about 70 pages)
ner@nickrenton.com