- right loans
- right structure
- right results

TRILOGY news

"the property investor's mortgage broker"

NEWSLETTER | ISSUE 14

REGULATORS RAIN ON THE PROPERTY INVESTMENT PARADE

Gone is the rhetoric, and as finance industry regulators move to prevent the type of questionable sub-prime lending practices that brought America to its knees during the 2008 GFC, it seems Australian property investors are in for a rude awakening.

With its proverbial hands tied for close to two years now, the Reserve Bank recently began (rather overtly) pleading for assistance to tighten monetary policy, in a bid to rein in certain sectors of our housing markets (i.e. Sydney).

Now it seems the cavalry has finally arrived in the form of the **Australian Prudential and Regulatory Authority** (APRA).

After looming threateningly for the last 12 months, APRA has turned its eagle eye on Aussie credit providers and their practices, with regard to investment related lending in particular.

The regulator made its move in the wake of home loan data for the year ending March 2015, which indicated a 20.9 per cent rise in loans attributable to investor activity – more than double the 10 per cent speed limit identified by APRA at the beginning of the year.

Now, property investors are at risk of being blindsided by loan rejections from banks that are under increasing pressure to put the brakes on hyped up investment activity in certain property sub-sectors, as a result of ongoing access to 'cheap' debt.

In the wake of this unprecedented macro-prudential policy implementation, APRA chairman Wayne Byres was quick to quell concerns around the health of our financial services industry.

At a recent **Customer Owned Banking Association** event reported by The Australian, Byres assured his audience that, "Australian ADIs (authorised deposit-taking institutions) are thankfully well away from the types of subprime lending that have caused so many problems elsewhere (for example, lending with loan-to-value ratios in excess of 100 per cent, at teaser rates, to borrowers with no real capacity to repay).

"Nevertheless, our overall conclusion from this hypothetical borrower exercise was that there were clearly examples of practice that were less than prudent."

Byres warned that lenders aggressively chasing investor business could "expect to find APRA increasingly at their doorstep."

Banks fall in line

Having gained APRA's unswerving attention, all the majors have started withdrawing the discount offers we were seeing a lot of up until recently, for investment related funding.

Some commentators believe that in trying to appease APRA and their request to keep investor loan growth to less than 10 per cent per annum, available lender capital will be slashed by at least a third within the weeks to come.

This means a lot of potentially disappointed property investors whose applications now won't make it across the line.

Along with the abolition of 'special pricing' on interest rates for investors, offers like the Commonwealth Bank's $1000 Investment Home Loan Rebate was scrapped in May, while the ANZ promised to grow its portfolio in a 'balanced way' and make immediate changes to the way it manages investor loans.

Meanwhile, BankWest has started applying a maximum LVR of 80% for investment loans.

While this might seem like 'no big thing' at first glance, when you consider they were dishing out LVR's of 98% to property investors just a couple of months ago, it's clear the banks are not prepared to aggravate APRA any further.

What it means for property investors

Interest rates minus the perks of discounts and rebates means increased holding costs for investors in the first instance, with higher monthly repayments.

Beyond this, we anticipate that tighter serviceability models, where banks are less generous when assessing things like rental income levels and negative gearing benefits, will mean a reduction in the number of investor loan approvals.

Real estate with higher price tags will now be evaluated for rental income based on 60%, rather than the traditional 80% in some states and 'cash out' facility requests are being met with an increasing amount of questions and conditions.

In this new APRA world order, lenders want a viable reason for your cash out request and I hate to be the bearer of bad news, but responding with a 'buffer' or to 'service negatively geared properties' is unlikely to be met with bank approval.

Typically, lenders are restricting cash out to:

1. **New property investment acquisitions,** with the proviso that the security must meet their servicing model requirements. Depending on the LVR, a Contract of Sale for the new property must also be provided before the lender will release funds.

2. Renovations where again, depending on the LVR, builder's quotes might be requested before 'cash out' approval is granted.

Obviously, these new restrictions could create cashflow obstacles for those looking to grow their portfolio by leveraging existing equity, or obtain a new loan product.

And for those who think this is just a knee jerk reaction to a few fast paced property markets, you might need to reconsider your perspective.

With interest rates anticipated to go nowhere but south for the remainder of 2015, it's likely that this is the new normal you'd be well advised to embrace and learn how to work with, in order to continue growing a wealth producing investment portfolio.

A for instance…

Let's say a client comes to us with $1 million worth of existing property debt. In April, we could have guided them to a lender that would calculate 'Other Financial Institution' or OFI debt at the actual interest rate and repayment.

With a 4.5% interest rate applied, this means their existing loan expense would be $45,000 per annum (interest only).

Now though, all OFI lending is assessed at the 'stress level' rate of 7.25%, with both principal and interest accounted for. This means the investor's OFI debt exposure on a $1 million loan portfolio could equate to $82,000.

In other words, an additional $37,000 will be deducted from the applicant's servicing calculations.

When you work backwards, that equates to interest repayments worth $822,000 of additional lending…or $822,000 that the investor can now longer afford, according to the bank.

Suck it up buttercup!

Given we seem to be stuck with this tough new regulator regime, property investors must acclimatize to a much colder lending climate than we've been afforded so far in our low interest rate environment.

So here are some tips to prepare for a frostier financial services sector…

Seek expert advice from a properly qualified mortgage broker who understands the specifics of property investment, and can assess your current and future borrowing capacity and optimise your finance structure.

Talk to your buyer's agent and consider making a few adjustments to your current strategy. If you want to purchase multiple properties over the coming years for instance, you may need to look for more neutrally or positively geared opportunities to help with servicing and borrow as required to reach your target.

Get creative! Think about different ways you can improve your serviceability if it might come under extra scrutiny. You can potentially manufacture equity and improve cashflow through strategies like:

1. renovations,
2. rental allowances that make your property more attractive and could mean charging a higher rent (such as allowing pets)
3. the addition of a granny flat.

Now is the ideal time to review your financial portfolio, particularly if you plan on securing capital for things like OTP investments in this changing lending environment.

Why not connect with the Trilogy team for an evaluation of your current finance structure? We have the necessary expertise and industry knowledge to optimise your cashflow and borrowing position, in any type of market.

IS FOREIGN INVESTMENT A GENUINE FLY IN THE OINTMENT OR THE HOUSING AFFORDABILITY RED HERRING?

Much ado has been made around Abbott and co's apparent failure to address the so-called 'housing affordability crisis' in their recently released budget.

A number of lobby groups and industry commentators insist that the 'Great Australian Dream' of home ownership is fast becoming an unattainable fantasy for future generations.

But how the government might resolve the apparent predicament is anyone's guess. Particularly when they're so heavily reliant on the buoyancy of property to keep the budgetary wheels turning, albeit slower than they might like.

Should it extinguish the only bright spark in an otherwise gloomy economic outlook, placating affordability advocates with more restrictive policy around the only two only market fundamentals it overtly controls, being foreign buyers and property related tax legislation?

Tony recently assured property punters that favourable negative gearing and capital gains tax concessions for real estate investments are here to stay.

But the debate is far from over. Early last month, a Senate committee made over 40 recommendations around housing affordability, including calls to review negative gearing and the appointment of a federal minister for housing.

Not surprisingly, Coalition senators immediately rejected the findings, at a time when questions continue to mount over the inconsistent enforcement of foreign investment policy, which some commentators say has caused irreparable long-term damage to Australia's housing sector.

Admittedly, it's difficult to argue against the reality of a growing wealth divide between equity-laden homeowners and their offspring, who will likely struggle to get a foot up the property ladder in the future.

The question is, what's been going on with foreign investment in our residential property markets and should we vilify overseas buyers for brutalizing the Great Aussie Dream?

Failing to police foreign investment

Although the Libs have made assurances that the ATO is forensically investigating all past property transactions that may have contravened foreign investment laws, some industry professionals are saying more needs to be done to put the brakes on future overseas investor activity immediately.

In a recent Property Observer article, director of Sydney's Richardson Wrench Mosman and Neutral Bay, Robert Simeon, pointed to issues with the vast number of overseas purchasers pushing prices up, in the off the plan apartment sector specifically.

He observed that the underlying issue with affordability, particularly in the very tightly held inner Sydney market housing market, is a lack of sufficient high-density development to meet the burgeoning demand of a rapidly growing local population.

The state government is attempting to address this with a charter that would see local municipalities merge, in order to reduce the red tape currently restricting mid to high-density dwelling construction across the Harbour city.

Airing some dirty laundry

Getting in the way and pushing up land prices however, are Chinese developers who are legally allowed to on-sell Australian OTP products directly to foreign buyers, meaning a glut of accommodation never actually makes it to the local market.

"A vast number of these properties are land banked," explains Simeon, "So they remain vacant which again is self defeating and ludicrous that this can happen in this day and age."

Accusations have also been leveled at criminals from abroad, allegedly attempting to launder dirty money by investing in Australian bricks and mortar.

Simeon says this is a concern that Australian officials would do well to rein in sooner, rather than by the time it's too late.

"Thailand has had serious problems with the Russian mafia who have bought up significant parts of that country where the government announced a few years ago that it was cracking down on these transactions," warns Simeon.

"This is a global problem where Australia immediately needs to take decisive action which also means tightening the many legal loopholes."

What's the answer?

With record low, global interest rates making real estate the hottest commodity around right now – and the Sydney market sizzling – it's unlikely that overseas investors will lose interest in our housing sector any time soon.

As such, if anything is to be done to ensure our future accommodation needs are met here at home, the government will need to consider how OTP apartments in particular are transacted offshore.

Simeon suggests a selling ratio of foreign buyers to Australian residents is a good starting point, along with the need for greater clarity around the long-term legalities of overseas property purchasers.

Of course the other side of the argument is that foreign investment in Australian housing has assisted in sheltering our broader economy from the recent resource sector slow down.

Perhaps it's our perceptions that need to shift, as the world continues relying on real estate to keep the economic gears in motion and property becomes less about our basic human need for shelter, and more about a commodity of trade.

That's the thing about these socio-economic debates…they're generally far from one-dimensional and never one-sided.

BOOMER PROPERTY INVESTORS SHOULD THINK ABOUT SHIFTING GEARS

There's been an awful lot of err…less than favourable commentary…around negative gearing of late.

Of course a lot of the controversy was (either consciously or sub-consciously - who can say?) stirred up at a point when a number of concerned parties (each with their own agendas), were making noise about housing bubbles and affordability issues, allegedly driven by a property investment boom of sorts.

But negative gearing is not an evil villain. In fact the capacity to leverage into a stable, wealth producing asset like bricks and mortar, has made it possible for many mum and dad investors to reclaim control of their retirement funds.

When accumulating investment properties, negative gearing provides working investors with the potential to reduce their income tax exposure, thereby harnessing optimal cashflow with which to sustain a growing portfolio and all of its associated costs, like mortgage repayments.

However, negative gearing does become less effective as your marginal tax rate starts to decline.

So for those heading into retirement, it's essential to plan ahead when it comes to easing the debt burden over your asset base, in order to successfully create a sufficient income stream for your post-work needs.

Winding down your debt

Whilst in the midst of a highflying investment career, negative gearing is a very smart strategy to employ when approached in the right way and with the right finance structures in place.

But as with life itself, there comes a time when the foundations have been laid, the financial house has been built and now is the time to move into your retirement portfolio and relax – metaphorically speaking.

Ideally, you probably want to call full time work quits and head into the office two or three days a week once you hit the big 6-0 milestone, with a view to being a permanent man or lady of leisure from 65 onwards.

Servicing property related loans and other investment expenses will obviously become less plausible as you reduce your working commitments and in turn, your income.

Hence, you need to shift gears gradually as you ready yourself for retirement, progressively reducing your debt exposure down to zero, in an ideal world. Because the last thing you want to bequeath to your loved ones is a massive financial burden.

A super idea?

Currently, Australian retirees enjoy the possibility of exceptionally low tax rates in retirement, via generous legislation governing super funds in pension phase.

As such, a possible strategy for investors heading into their fifties and sixties is to pull back on leveraging into additional real estate, in favour of perhaps offloading a few property holdings and contributing the profits to your Super.

Using the 'bring forward' provisions for after tax (non-concessional) contributions for instance, allows you to inject an extra $720,000 into your fund over two years as an individual, or a hefty $1.44 million for couples.

By rights, you could sell off a property or two at the age of say, 55 and deposit the proceeds directly into your Super in the following way:

- By June 30 – make an after tax contribution of $180,000 for this financial year.
- In July – contribute another $540,000 to your fund using the 'bring forward' clause for the 2016, 2017 and 2018 financial years.

No further contributions, aside from the legally required 9.5 per cent employer one of course, are allowed again until the fourth year, when you could consider doing the same thing again at the age of fifty-nine.

This is just one approach to a successful portfolio transition from asset and gearing accumulation, to gearing reduction and income generation.

You might also consider things like adding a neutrally geared property investment to your SMSF, where you can enjoy the benefits of an income producing real estate asset in a low tax environment.

Or selling off surplus property or other investments to reduce your gearing to a more manageable, cashflow neutral or preferably, positive position as you wind down work and approach full retirement.

Seek counsel

As with all things financial planning, there's no real one-size approach to shifting gears as you approach your golden years.

One thing every smart investor would be well advised to do, is seek the guidance of a suitably qualified and experienced professional when it comes to this particular stage of your wealth creation journey.

The road can get rocky here if not approached with caution and traversed with care, or it can lead to a very lucrative pot of gold at the end of your very own retirement rainbow!

Let sound future financial modelling be your guide!

If you would like to speak to an industry professional for advice on how to plan today's optimal finance structure, in order to meet tomorrow's investment objectives, please click here now to connect with a member of the Trilogy team.

IS THIS THE FUTURE OF AUSTRALIA'S LENDING LANDSCAPE?

As industry regulators crack down on credit providers and make conventional investor related property loans tougher to come by, an increasing emergence in alternative funding, facilitated by technology, could portend a very different lending trend.

The Internet is a wonderful modern resource, which some would argue is largely under-utilized when it comes to evolving the way we interact with and transact housing, as both a place to live and a commodity.

But as the generational baton is passed from the baby boomers to their more tech savvy offspring, we're seeing the emergence of a new digital age.

Young people are recognising the opportunity to assume greater control over their own financial destiny, with an increasing number of crowd funding and peer to peer (P2P) lending initiatives emerging across the information superhighway.

Now it's possible to become a property developer within your SMSF for instance, contributing a nominal amount of money into a collective fund, which is in turn used to bypass bank lending and develop residential housing for profit.

We were promised a 'brave new world' of infinite possibility with the onset of our new digital age, and it seems that for investors exploring potentially different methods of funding, it's finally arrived!

Of course with the handful of majors in Australia still holding a 95% plus monopoly over our four pillar-banking sector, it's unlikely the traditional methods of obtaining a property mortgage will be entirely replaced in our lifetime.

But the prospect of some much-needed competition in the lending arena – that could conceivably come from 'everyday investors' – is an exciting possibility, and one worth exploring further.

The crowd-funding craze

Not for profit organisations have been forced to innovate or die a natural death in recent times, with governments increasingly tightening the budgetary purse strings post-GFC.

In response, we saw an emergence of online crowd funding platforms earlier this decade, in a bid to create a more direct transfer of capital - from those who had money to give, to those who most needed it.

Sites like gofundme.com have since taken off in a big way, providing everyday people and charities with the financial capacity to connect directly and effect change that might not have been possible via conventional, money raising initiatives.

The premise is simple – if you want to donate to a cause, you can jump online, find something worthy and provide direct, immediate funding.

This begs the question…could property investment be facilitated in a similar way?

Banks set to get a $20 billion dollar run for their money

According to a recent Morgan Stanley report, Australia, China and the UK are emerging as front-runners in global peer-to-peer lending, with the potential to capture around 8 per cent of the unsecured consumer finance market by 2020.

P2P lending is gaining popularity with entrepreneurial types as a faster, more convenient and cheaper way to access capital than traditional methods, which still rely largely on what many would consider 'stone age' paper pushing.

A growing number of commercial lending platforms are being developed to operate in the online and mobile banking environments. And given that Australians love our mobile technology even more than we love bricks and mortar, Morgan Stanley says ours is fertile ground for P2P lenders.

Additionally, the big four players have historically neglected Australia's unsecured personal and business lending markets, where higher margins allow for aggressive price competition.

"We believe that margins in unsecured consumer lending have expanded more since the financial crisis than in any other major product segment," the Morgan Stanley report stated.

Then of course there's our new stricter credit reporting laws, making it easier for P2P lenders to assess a loan applicant's capacity to repay.

A new approach for a new age

Morgan Stanley estimates the combined value of unsecured consumer debt in Australia to be in the region of $101 billion, with the "addressable market" for P2P lenders around $75 billion.

Up until now, the focus of P2P lending has largely been in the unsecured SME market, which is worth around $72 billion.

It's anticipated that both sectors will grow considerably by 2020, with P2P lending set to capture 8 per cent or $10 billion of the total addressable consumer market by 2020 and 12 per cent of the SME market ($11.4 billion).

The report points to a few potential flaws with the future expansion of P2P lending however, with a greater need for strategic alliances to more efficiently expand distribution, achieve scale and acquire customers.

Further, it warned that current platforms are largely untested; with questions regarding the regulatory environment and underwriting processes for P2P established loans.

Of course we have a very long way to go before everyday folk like you and I are no longer at the mercy of the big banks when it comes to our financial portfolios.

But developments like these do hold promise for change and importantly, alternative and potentially more flexible ways for Australians to assume greater control over our self-managed investment funds, with the secure diversity of bricks and mortar.