Master Builders Australia

Submission to

The Financial System Inquiry

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1 Introduction

1.1 Master Builders Australia is the peak national association for the building and construction industry in Australia. Its primary role is to champion the interests of the building and construction industry, representing residential and commercial building, and engineering construction.

1.2 Master Builders Australia has more than 32,000 member-companies with representation in every state and territory from all parts of the building and construction industry. Our members are large national, international, residential and commercial builders and civil contractors through to smaller local subcontracting firms, as well as suppliers and professional advisers.

1.3 The building and construction sector accounts for close to 8 per cent of gross domestic product and 9 per cent of employment in Australia. It makes an essential contribution to the generation of wealth and welfare of the community. At the same time, the wellbeing of the building and construction industry is closely linked to the prosperity of the domestic economy.

1.4 The cumulative building and construction task over the next decade will require work done to the value of $2.8 trillion and for the number of people employed in the industry to rise to 1.3 million.

1.5 The building and construction industry is heavily reliant on the ready availability of finance as well as a robust prudential system of regulation.

2 Background/Terms of reference

2.1 The Financial System Inquiry will report on the consequences of developments in Australia since the 1997 Inquiry and the global financial crisis (GFC), including implications for: how Australia funds its growth; domestic competition and international competitiveness; and the current cost, quality, safety and availability of financial services, products and capital for users.

2.2 It will refresh the philosophy, principles and objectives underpinning the development of a well-functioning financial system, including: balancing competition, innovation, efficiency, stability and consumer protection; how financial risk is allocated and systemic risk is managed; assessing the effectiveness and need for financial regulation, including its impact on costs, flexibility, innovation, industry and among users; the role of Government; and the role, objectives, funding and performance of financial regulators including an international comparison.

2.3 The Inquiry will identify and consider the emerging opportunities and challenges that are likely to drive further change in the global and domestic financial system, including: the role and impact of new technologies, market innovations and changing consumer preferences and demography; international integration, including international financial regulation; changes in the way Australia sources and distributes capital, including the intermediation of savings through banks, non-bank financial institutions, insurance companies, superannuation funds and capital markets; changing organisational structures in the financial sector; corporate governance structures across the financial system and how they affect stakeholder interests; and developments in the payment system.

2.4 It will recommend policy options that: promote a competitive and stable financial system that contributes to Australia's productivity growth; promote the efficient allocation of capital and cost efficient access and services for users; meet the needs of users with appropriate financial products and services; create an environment conducive to dynamic and innovative financial service providers; and relate to other matters that fall within this terms of reference.

2.5 The Inquiry will take account of the regulation of the general operation of companies and trusts to the extent this impinges on the efficiency and effective allocation of capital within the financial system. The Inquiry will examine the taxation of financial arrangements, products or institutions to the extent these impinge on the efficient and effective allocation of capital by the financial system, and provide observations that could inform the Tax White Paper. In reaching its conclusions, the Inquiry will take account of, but not make recommendations on the objectives and procedures of the Reserve Bank in its conduct of monetary policy.

2.6 The Financial System Inquiry aims to establish a direction for the future of Australia's financial system by laying out a 'blueprint' for the financial system over the next decade. The Inquiry will consult extensively both domestically and globally. It will publish an interim report in mid-2014 setting out initial findings with a final report to be provided to the Treasurer by November 2014.

2.7 Previous financial system inquiries, including the Campbell Report in 1981 and Wallis Report in 1997, were the catalysts for major economic reforms in Australia. The Campbell Report led to the floating of the Australian dollar and the deregulation of the financial sector whilst the Wallis Inquiry led to streamlined financial services regulation, the creation of the Australian Prudential Regulation Authority (APRA), and the current form of the Australian Securities and Investments Commission (ASIC).

2.8 These reforms underpinned Australia's economic stability and growth over the past thirty years. Deregulation of the financial sector has meant the volume and quality of financial services in Australia has dramatically improved, while the restructure of financial regulators is considered to be one of the main reasons Australia weathered the GFC well relative to international peers.

2.9 It has been sixteen years since the last financial system inquiry. While the financial sector has served Australia well in this time, it has been transformed by forces such as domestic and international economic and financial crises, a substantial regulatory reform agenda, the growth in superannuation, changes in industry structure, new competitive dynamics, technology, innovation and broader macroeconomic trends.

3 Master Builders' observations on the financial system

3.1 Notwithstanding the sound, high level performance of Australia's financial system, it caused serious disruption for business enterprises operating in the building and construction industry. This is explored in detail in the submission.

3.2 But first, at the high level, there is little doubt that Australia has a quality financial system and world-class banks. Australia suffered a financial system 'meltdown' 20 years ago and improvements since have served us well, most recently during the GFC when the system survived an extreme "stress test".

3.3 In its detailed assessment of Australia's financial sector released in October 2012, the IMF deemed that Australia's financial sector was "sound, resilient and well-managed". It judged that the country's major banks were "conservatively run, well capitalised and profitable and likely to withstand severe shocks", although it noted that there were some potential risks arising as a result of high household debt levels, the reliance on offshore funding and interconnected banking systems. The IMF commended the country's regulatory and financial framework, saying it showed "a high degree of compliance with international standards", and said that commendable steps had been taken to strengthen crisis management.

3.4 Given recent events on the world stage, it is understandable that many countries are looking to rebuild financial systems but Australia must resist the temptation to "re-regulate" for the sake of it, despite the high priority that the G20 has put into the world financial system's regulatory framework and in the year that Australia has the G20 presidency.

3.5 As noted, the GFC caused serious disruption for the building and construction industry. Builders, particularly small businesses in the sector, have had ongoing issues with limited access to finance since the global financial crisis.

3.6 *"We didn't change how we did projects, the world changed how they financed them."* (Newcastle builder).

3.7 The four major banks hold a uniquely dominant position in Australia. After BHP, the big four banks are the second, third, fourth and fifth largest companies in Australia in terms of capitalisation. The big four banks dominate the lending market with the other (more than 50) banks fighting for the remaining 10 to 20 per cent of the market.

3.8 In respect of the intensity of competition issue, the Reserve Bank of Australia has avoided direct comments. But it has highlighted the long-term slide in net interest margins – the difference between what banks pay for money and the price at which they lend it out, and a gauge of competition. Since the wave of deregulation in the 1980s, margins have fallen from more than 5 per cent to about 2.5 per cent today, a trend reflecting more competition.

3.9 Nonetheless, oligopoly can lead to market failure and the Inquiry must look to introduce more reforms and a further opening up of competition. There is a need to ensure that the home lending market remains competitive.

3.10 Master Builders Australia was pleased that in a keynote address by David Murray, Chairman of the Committee of Inquiry into the Financial System at a

Committee of Economic Development of Australia function on 14 February 2014, he pointed to the committee's interest in the "allocative efficiency" of the financial system's funding of the economy, or how well it funds businesses.

3.11 The ABS has found that access to finance is the most common barrier to innovation, with concerns reported by 20 per cent of businesses (around 400,000), and the third largest barrier to general business activity. A survey conducted by Deloitte Access Economics for a November 2013 report by the NSW Business Chamber on small business access to finance, estimated that about 10 per cent of Australian SMEs or around 200,000 businesses have problems accessing finance. These findings are consistent with the experience of builders and building contractors.

3.12 Before the GFC an active securitisation market allowed all lenders to obtain funds based on the quality of their assets. The collapse of the market for residential mortgage-backed securities meant the ability of many small lenders to compete also collapsed. The Government attempted to inject competition into the mortgage market by investing close to $20 billion in triple-rated RMBS, but support in favour of the banks at the expense of the securities market meant that competition suffered. Means to improve access to finance should be a central concern of the Inquiry.

4 Impact of the financial system on building & construction

4.1 In the building and construction industry, credit flows have yet to normalise and restrictions on finance brought about by the GFC continue to affect many parts of the industry. During the GFC banks restricted their loan to value ratio to around 50 per cent for land purchase and 60-65 per cent for developments, forcing builders and developers to increase levels of upfront equity required.

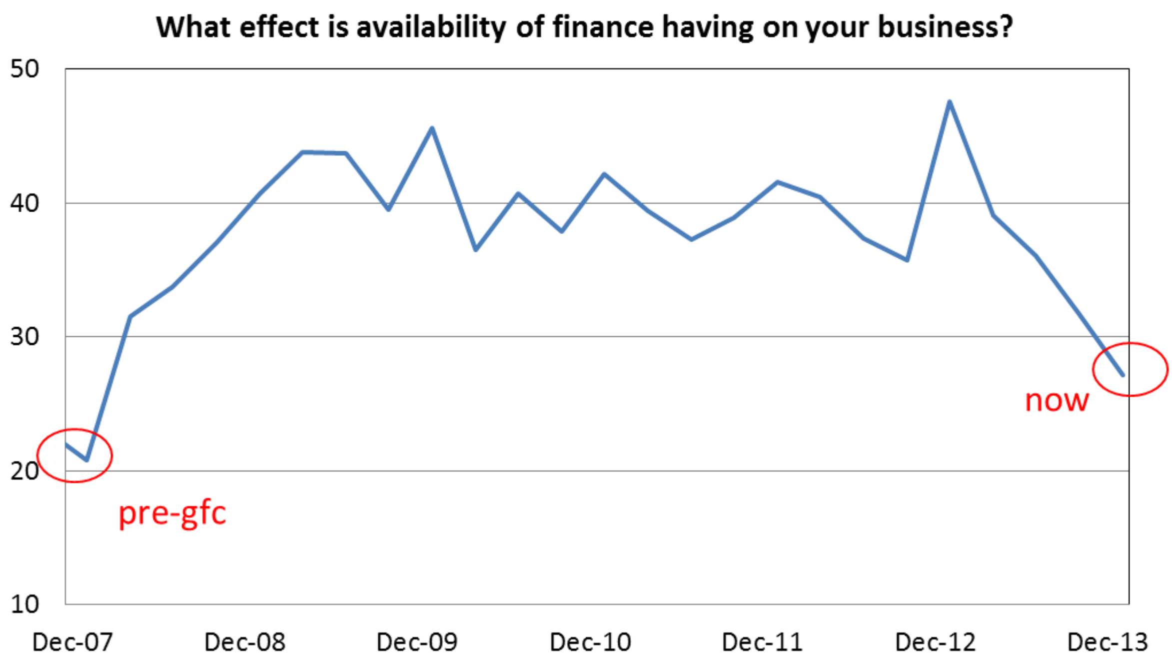
4.2 Commercial building and the industrial sectors were the worst hit by the GFC and economic downturn. Difficulties with cash flow and accessing credit from banks and other lending institutions remain as key issues today as tough lending criteria continue to be imposed on builders and developers. Problems relating to debt and asset valuation have been limiting the capacity to obtain credit and the economic downturn caused delays of some projects and forced tenants and building owners to commission less refurbishment and building works.

4.3 Loan to valuation ratios have been relaxed slightly but a lack of credit continues to act as an impediment working against the ability of clients and contractors to kick start new private sector projects. Small businesses in the building and construction industry have been particularly affected.

4.4 As the table below shows, more than 60 per cent of builders surveyed in Master Builders Australia's latest national quarterly survey believe the availability of finance is having some detrimental effect on their business. Around 10 per cent of respondents surveyed were concerned that availability of finance was having a large or major constraining effect on their business. Although down from recent highs, the proportion of respondents reporting a moderate effect is still well up on survey results prior to the global financial crisis.

4.5 Table: Master Builders Australia National Quarterly Survey – Detailed Results in Response to Question: "What effect is availability of finance having on your business?

	Dec Q 2007	Dec Q 2008	Dec Q 2009	Dec Q 2010	Dec Q 2011	Dec Q 2012	Dec Q 2013
major effect	2.2	4.8	16.5	8.3	8.3	15.0	2.6
large effect	7.5	25.0	19.3	25.3	18.9	24.4	7.2
moderate effect	15.0	23.9	20.0	19.4	28.3	22.8	25.6
slight effect	21.8	20.7	18.4	20.4	19.8	11.7	25.5
No effect	53.5	25.6	25.8	26.5	24.8	26.2	39.2
Index	**20.8**	**40.7**	**45.6**	**42.1**	**41.5**	**47.6**	**27.1**



4.6 Although banks and other lending institutions have to assess the level of risk associated with a lending request, there is a need for greater transparency in the process. There have been concerns in all jurisdictions. Queensland Master Builders Association reports that the impact of mortgage valuations on new housing activity is a major issue affecting a number of businesses in that State. Transparency is an issue and banks (and associated professionals in the valuation business) need to better explain the mechanisms and processes by which they base their lending decisions.

4.7 Master Builders notes that the current law surrounding the registration of security interests in personal property governed by the *Personal Property Securities Act 2009* (Cth) (PPSA) has increased the costs of obtaining finance for participants in the building and construction industry and for small business generally.

4.8 It appears to be standard practice for financiers to undertake searches of borrower and guarantor entities by using the old ASIC register and the Personal Property Securities Register (PPSR) before providing financial accommodation. In essence, members do not like additional administration as it is unpaid work; builders want to get on and build. PPSA has made pre-lending due diligence very challenging and time consuming for all parties especially in the event that, for example, a lender calls upon the builder to provide details of the collateral to which each security interest attaches and there exist multiple registrations. Often a builder is unaware of the interest that a secured party seeks to protect (this arises in many instances under building contracts where a security interest may be registered of which the contractor/subcontractor is unaware). In some instances banks have asked for members to issue a financing change statement under s178 PPSA which permits the person with an interest in collateral described in the registration to give a demand in writing to the secured party for a financing change statement to be registered. In practice these are often ignored and members have found it necessary to engage lawyers to assist them, adding to the cost of lending. Essentially, this is where the collateral no longer secures an obligation owed by the debtor to the secured party or where the particular collateral does not secure any such obligation. These and other systemic problems will be more fulsomely communicated in our submission to the separate review of the PPSA announced recently by the Government.

5 Master Builders' comments and recommendations

5.1 In the year that it has the G20 presidency, Australia must consider whether some of the rules designed for post-GFC Europe and the United States in the world financial system's regulatory framework are suitable for the Australian financial system.

5.2 Builders, particularly small businesses, have had ongoing issues with access to finance since the global financial crisis.

5.3 *"We didn't change how we did projects, the world changed how they financed them."* (Newcastle builder).

5.4 In the building and construction industry, credit flows have yet to normalise. Loan to valuation ratios have been relaxed slightly but a lack of credit continues to act as an impediment working against the ability of clients and contractors to kick start new private sector projects.

5.5 The four major banks hold a uniquely dominant position in Australia; oligopoly can lead to market failure and the Inquiry must look to introduce more reforms and a further opening up of competition.

5.6 There is a need to ensure that the home lending market remains competitive.

5.7 Master Builders Australia recommends that the Inquiry examine whether there are initiatives that might remove impediments to competition and encourage greater participation in the market by lenders outside the four major banks, especially foreign banks, regional banks and non-bank lenders, provided any measures adopted are market-based with limited extra regulation.

5.8 Master Builders Australia would like the Inquiry to focus on the market for small-business loans that remains subject to structural impediments to competition, a point noted by the Reserve Bank in a recent statement.

5.9 Banks (and valuers) need to better explain the mechanisms and processes on which they base their lending decisions.

5.10 Master Builders Australia believes that the Inquiry should investigate ways to further improve the liquidity of the residential and commercial mortgage backed securities.

5.11 Master Builders Australia recommends that the Inquiry should explore whether the risk-weightings on business loans secured by residential properties are unduly punitive. Currently, the Australian Prudential Regulation Authority requires the banks to apply a risk weighting of 50-70 per cent for small business whereas regional banks have to apply a risk weighting of 100 per cent for small business.

5.12 Master Builders Australia proposes that the Government should examine whether there are other incentives that might reasonably encourage competition in Australia's financial system, for example, whether the Reserve Bank of Australia should further broaden and enhance the scope of regular reports on bank net interest margins, return on equity and profitability, and small business lending conditions.

5.13 The importance of an informed "market" should not be underestimated. Lenders should improve information flows and transparency whereas small businesses, including building industry participants, would benefit from enhanced financial literacy education programs. Master Builders Australia believes there is a case to strengthen the banking ombudsman.

5.14 Master Builders Australia notes that the current law surrounding the registration of security interests in personal property governed by the Personal Property Securities Act 2009 (Cth) (PPSA) has increased the costs of obtaining finance for participants in the building and construction industry and for small business generally. Master Builders Australia will respond more fully to a comprehensive, separate review of the PPSA announced recently by the Government.

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