THE VOICE OF **LEADERSHIP**

Financial System Inquiry
2014

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Executive Summary

- This submission outlines solutions to improve the efficiency, competitiveness and flexibility of Australia's financial system.

- Our solutions will increase the velocity of capital, boost productivity, enhance community prosperity and improve living standards.

- The financial system encompasses debt and equity capital across the public and private markets. The Property Council represents members operating in all investment markets.

- The current financial system is stymied by complex and costly regulation and inefficient taxes. Creating a more efficient financial system will boost Australia's economic resilience and attract patient long term global capital that is critical for investment.

- The hallmarks of an optimal financial system are:

  - a **competitive and stable regulatory framework** that boosts productivity, transparency and the efficient allocation of capital;

  - a **diverse range of financial products and services** that provides greater choice for borrowers and consumers; and

  - **clear and cost efficient financial market rules** that promote innovation and international competitiveness.

- Our game changing solutions are:

Competitive and stable regulatory framework that boosts productivity, transparency and the efficient allocation of capital

- Adopt a partnerships for economic growth model
- Establish a long-dated government bond market
- Modernise the federal and state tax frameworks
- Increase national savings
- Ensure availability of debt finance during periods of economic volatility

Diverse range of financial products and services that provides greater choice for borrowers and consumers

- Diversify sources of domestic debt capital
- Simplify regulations for issuing corporate bonds
- Clarify the tax treatment of Islamic finance
- Develop shorter product disclosure statements for property funds
- Bolster objectivity and transparency of loan approvals
- Expand the ASX Managed Fund Service
- Create a "clearing house" for unlisted property funds

Clear and cost efficient financial market rules that promote innovation and international competitiveness

- Streamline Foreign Investment Review Board rules
- Fast track implementation of the Asian Region Funds Passport policy
- Expedite mutual recognition of overseas regulatory regimes
- Strike a competitive MIT withholding tax rate
- Modernise the taxation of MITs
- Align collective investment vehicle rules with MIT rules
- Maintain thin capitalisation rules for property trusts and companies

About the Property Council

The Property Council represents the $680 billion property investment industry in Australia.

The Property Council's 2,000 member firms and 55,000 active industry professionals span the entire spectrum of the property and construction industry.

Our members operate across all property asset classes - including office, shopping centres, residential development, industrial, tourism, leisure, aged care, retirement villages and infrastructure.

The property industry by numbers

- $34 billion p.a. in property-specific taxes.
- $340 billion in investment grade assets under management.
- 1.3 million jobs (12.8 percent of the total workforce).
- $148 billion in direct economic activity.
- 11.5 percent of Australia's GDP.

1. Competitive and Stable Regulatory Framework

A well-functioning financial system is underpinned by a competitive and stable regulatory framework that boots productivity, transparency and the efficient allocation of capital.

Without reform, our current regulatory framework:

- cannot support Australia's growing infrastructure needs;
- imposes dozens of outmoded, inefficient taxes on businesses; and
- will not provide financial self-sufficiency for Australian retirees.

Our game changing solutions to address these problems and boost Australia's productivity are:

☑ adopt a Partnerships for Economic Growth model;

☑ establish a long-dated government bond market;

☑ modernise the federal and state tax frameworks;

☑ increase national savings; and

☑ ensure availability of debt finance during periods of economic volatility.

1.1 Adopt a Partnerships for Economic Growth Model

Why is this important?

Australia will face a significant infrastructure backlog in the coming decade in the order of $450 - 770 billion. Public infrastructure spending has been falling as a proportion of GDP since the 1980s – placing future productivity and prosperity at risk.

The UK approach to urban and regional growth provides the world's best model for smart planning and infrastructure investment.

The Property Council is working with several organisations to adapt the UK model to suit Australian circumstances – we call this approach Partnerships for Economic Growth (PEG).

The Issue

In Australian public policy terms, the UK City Deal prototype represents a National Competition Policy-style approach applied to the urban and regional realm.

The core goal of the UK City Deal model is to direct infrastructure spending to projects that boost productivity, employment and economic growth.

The UK model represents a radically new approach to infrastructure funding and financing.

The UK approach determines an economic growth budget for a designated region. Regions are rewarded for achieving and exceeding these growth budgets.

The Property Council has worked with the South East Queensland Council of Mayors (CoMSEQ) and the Queensland Government to adapt the City Deal approach to Australian circumstances (to be known as Partnerships for Economic Growth).

See Annexure A for more detail on the merits of customising a UK City Deal approach to Australia.

The Solution

☑ The Federal Government should facilitate a COAG-level group (working with the private sector) to develop an urban and regional growth framework for Australia, adapted from the UK experience and the joint SEQ pilot study.

1.2 Establish a Long-Dated Government Bond Market

Why this is important?

Australia faces considerable challenges to meet the transport, energy, communications and water needs of a growing population.

Without a significant increase in public and private investment, our future economic and social prosperity is at risk.

The Issue

Payback periods for major infrastructure investments often exceed the term of standard Commonwealth Government bonds.

This can make it difficult for the Government to raise capital for new investments without relying on consolidated revenue, asset sales or debt financing.

The market has already demonstrated an appetite for this type of issuance, with a consortium of banks launching a well-supported 20-year nominal treasury bond in November 2013.

During the 2013 Election Campaign, now Treasurer Joe Hockey indicated that he would like to see the Australian Office of Financial Management issuing bonds with 40-50 year maturity dates.

Section 2.2 addresses a growing issue in relation to the private market, where long-dated bond markets need to be encouraged.

The Solution

☑ The Property Council strongly supports moves by the Abbott Government to bring long-dated bonds to market. This will improve the Government’s ability to raise capital for infrastructure investment.

1.3 Modernise the Federal and State Tax Frameworks

Why this is important?

A competitive and stable tax environment is essential to attract global capital from pension/sovereign wealth funds, and encourage domestic investment in property.

Modernising international, national, state/territory and local government taxes will boost Australia's competitiveness.

Improved tax efficiency provides a stable source of revenue for federal and state governments, which helps pay for the public services demanded by the community.

The Issue

The Henry Tax Review formula is simple: trade in dozens of outmoded, inefficient taxes for those that are broad-based, low rate and efficient.

To succeed, this process requires an ironclad, up-front, long-term commitment from all states and territories.

As the largest collector of taxation revenue and the central manager of the nation's public finances, the Australian Government must facilitate the modernisation of the federation's tax framework.

Many state taxes, such as commercial conveyancing duty, are inefficient jurisdictional taxes. Yet, they are a key feature of most state and territory budgets.

Business Coalition for Tax Reform research shows that economic activity can be boosted by billions of dollars without spending a cent, by replacing inefficient state taxes with a suite of efficient broad based taxes.

The Solution

☑ COAG should commit to an intergovernmental agreement (IGA) that progressively replaces inefficient state and territory taxes with broad-based efficient taxes that meet Australia's strategic public finance goals.

☑ Establish a Tax Modernisation Commission, with an independent chairperson from the business community, to oversee the IGA and develop a 10 year state tax blueprint that:

- abolishes inefficient state taxes including conveyancing duty and developer charges;
- replaces them with a suite of efficient broad-based, flat-rate taxes;
- consults the community and business on a model package of reforms; and
- develops a multi-year timetable for Modernising Australia's federal and state tax frameworks tied to an IGA with short, medium and long term performance milestones.

1.4 Increase National Savings

Why this is important?

Increasing national savings will reduce the burden on taxpayers and ensure Australian retirees are financially self-sufficient.

The Issue

Superannuation is a domestic source of savings that helps Australians achieve a self-sufficient retirement lifestyle.

There are three critical issues with national savings:

1. Australia has a "savings gap" estimated by Rice Warner Actuaries at over $1 trillion, based on a superannuation guarantee charge of 12%.

   The gap is the difference between the amount required to be saved by Australians to ensure adequacy in retirement and the amount that will be saved in the super system by the current workforce.

2. Baby boomers are now retiring and a smaller workforce is supporting a larger number of retirees.

   By 2050, there will be 2.7 taxpayers for each retiree, according to the Federal Treasury's Intergenerational report (IGR). The imbalance in the dependency ratio will be exacerbated if Australia follows a business as usual approach.

   Inevitably, the tax burdens of a smaller percentage of working Australians will rise. Based on the IGR, per capita tax revenue will need to increase from $15,000 pa in 2010 to $27,000 pa by 2050 (in real terms).

3. Constant changes to superannuation rules undermines the ability of superannuants to plan and invest for their future.

The Solution

☑ Increase the superannuation guarantee charge to a level that:
- allows individuals to enjoy a self-sufficient independent lifestyle; and
- reduces the burden on Government (except for society's most disadvantaged) by minimising the reliance on the age pension safety net.

☑ Boost savings by phasing in an increase to the preservation age to 62 years (from 60 now) to restore a five year gap between the preservation age and Age Pension eligibility age (which will increase to 67 from 2023).

☑ Provide incentives to remain in the workforce (full and part time) after the statutory retirement age including:
- job skills training and re-training programs for older workers;
- payroll tax and other incentives for organisations that hire and retain older workers;
- business incentives to customise workspaces for older workers;
- government job referral programs and career counselling for older workers; and
- relax government regulations that enforce a statutory age of retirement.

☑ Bolster confidence in the superannuation regime and improve retirement planning by applying a moratorium on changes to superannuation rules for superannuants.

1.5 Ensure Availability of Debt Finance During Periods of Economic Volatility

Why is this important?

In a financial crisis, it is critical that banks continue to provide capital to businesses. This will stimulate investment, growth and employment.

The Issue

During the 2008 Global Financial Crisis (GFC), the Government protected Australian banks by guaranteeing their funding in return for a nominal fee.

There was no obligation for banks to on-lend the guaranteed funds to Australian businesses.

This made it difficult for companies to obtain funding for critical projects and forced many groups to raise equity to meet the funding gap.

Companies that could not raise new equity faced financial collapse, job losses and lower economic activity. Investor confidence was also damaged.

The Solution

☑ Ensure that a government guarantee for bank funding is combined with an obligation for banks to continue lending to businesses, including property funds.

2. Diverse Range of Financial Products and Services

A leading financial system should provide a wide menu of capital options for businesses and consumers.

Diversifying sources of debt and equity capital will improve supply and promote competition to drive down funding costs.

The global financial crisis resulted in consolidation of Australian financial institutions and exodus of foreign capital.

This has adversely impacted the ability of property groups to adopt optimal capital management strategies domestically.

In addition, Australia's property fund investment rules are overly complex and restrictive.

This distorts the market by skewing investment away from property and limits the ability of retail investors to achieve a diversified investment portfolio.

Our game changing solutions to widen capital options for businesses and consumers are:

- ☑ diversify sources of domestic debt capital;
- ☑ simplify regulations for issuing corporate bonds;
- ☑ clarify the tax treatment of Islamic finance;
- ☑ develop shorter Product Disclosure Statements for property funds;
- ☑ bolster objectivity and transparency of loan approvals;
- ☑ expand the ASX Managed Fund Service;
- ☑ create a 'clearing house' for unlisted property funds; and

2.1 Diversify Sources of Domestic Debt Capital

Why this is important?

Australia needs deeper and more diverse sources of domestic debt capital to reliably fund major investments including social infrastructure projects.

This will also ensure the property industry can supply vital services for the residential, commercial and industrial sectors.

The Issue

Property companies have not been able to adopt optimal capital management strategies domestically due to the lack of longer-dated debt capital in Australia.

This is a systemic weakness in our financial system that will expose Australia to increased refinancing risk in market downturns.

Gaps in domestic debt funding have forced the property industry to:

- access capital through the domestic equity markets;
- finance long-term investments using short-term debt; or
- seek funding from global debt markets.

However, these options do not provide an optimal capital management solution because:

- financing through equity is more expensive than debt as it dilutes returns for existing investors;
- financing with short-term debt increases refinancing and liquidity risk due to the long-term nature of underlying real estate assets; and
- financing through global debt markets forces property groups to expose their balance sheet to foreign currency risk, or bear steep hedging costs.

Box 1 details the significant refinancing and liquidity issues for real estate groups in the aftermath of the global financial crisis (GFC).

The Solution

☑ Incentivise superannuation funds and life insurers to invest in longer-term debt capital by providing a discounted tax rate on interest earnings (see Box 2).

☑ Establish a long-dated government bond market (refer section 1.2).

☑ Streamline regulations for issuing corporate bonds (refer section 2.2).

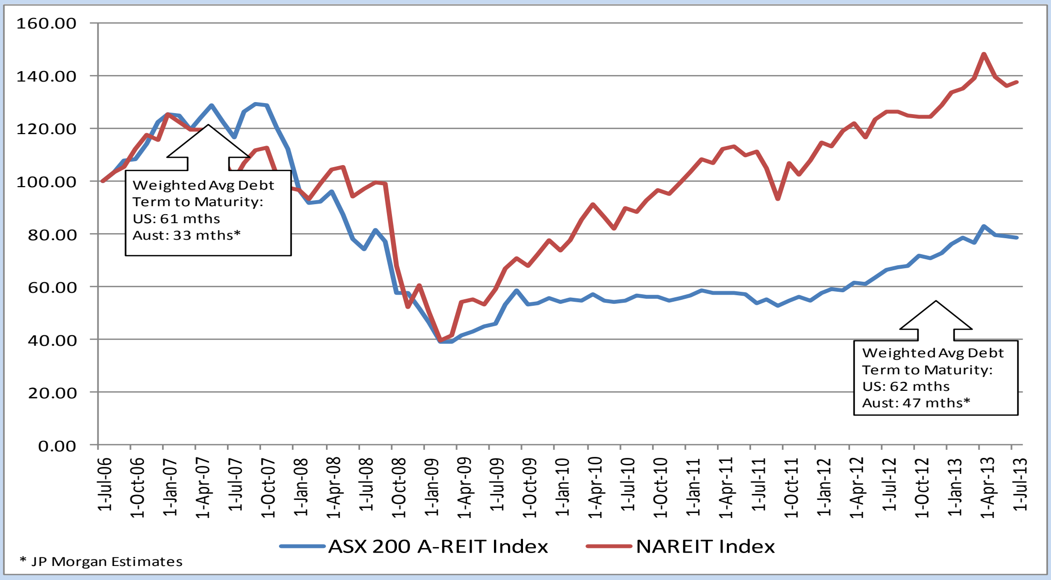
Box 1: Impact of the global financial crisis (GFC) on property groups

Each year, on average, one third of the total outstanding commercial loans to property groups need to be recapitalised.

This is manageable providing debt capital is available at the right price and terms.

However, during the GFC, several companies could not refinance their loans and went into receivership.

The chart shows the relative performance of the Australia listed real estate market (AREIT Index) versus its US counterpart (NAREIT).



Source: Quadrant Real Estate Advisors LLC

While the US publicly traded REIT sector has much higher leverage (60% in US vs. 40% in Australia), the US market rebounded faster and has continued to outperform its Australian counterpart.

One reason for the divergence in comparative performance is the **stronger debt market in the US.**

This outperformance underpins confidence in investment and financial services products.

The **shorter duration of Australian lending** meant that we had a relatively greater proportion of loans maturing during the GFC compared to the US.

Australia's financial institutions were unable to satisfy these refinancing demands.

This forced Australian REITs to raise equity capital to bridge the funding gap and undermined the performance of their share price.

Box 2: Debt as an asset class for superannuation funds and life companies

Australia needs to encourage lenders into the market who are able to match their debt capital to long-term assets.

There is an opportunity for Australian institutional investors, particularly superannuation funds and life insurance companies, to meet the demand for longer-term debt capital.

Institutional investors represent a completely domestic source of capital that will not repatriate funds to a different country in the event of another downturn.

The investment profile of superannuation funds and life companies in particular matches long term asset returns.

Debt investment by institutional investors can provide a relatively high income return, capital preservation/growth and low volatility.

Superannuation funds are necessarily conservative investment vehicles that have not traditionally invested in debt. The investment allocation has traditionally been 14% in Australia where overseas pension funds hold 40% of their investment in debt products.

Overseas pension funds which lend money to Australian companies are exempt from paying withholding tax on their interest earnings.

Examples of where super funds are tax exempt include Canada, US, UK and Japan.

Australian based superannuation funds do not receive the same exemption and are required to pay 15% tax on their interest earnings from money lent to companies.

Government can kick start further investment by superannuation funds and life companies by providing a discounted tax rate on interest earnings.

2.2 Simplify Regulations for Issuing Corporate Bonds

Why this is important?

Simple changes to corporate regulations will boost domestic investment in debt products.

The Issue

Retail participation in corporate bonds is under-utilised and can provide Australia with a ready source of domestic capital.

It is currently more difficult for mum and dad investors to invest in bonds compared to shares due to the lengthy and complex documentation requirements.

The Solution

☑ Streamline regulations for issuing corporate bonds including:

- allow renounceable rights issues for existing shareholders to make issuance easier;
- streamline prospectus documentation requirements to simplify information provided to investors; and
- utilise continuous disclosure for retail corporate bond issuance to ensure the latest information is available to investors.

2.3 Clarify the Tax Treatment of Islamic Finance

Why this is important?

Islamic finance is an increasingly important and growing segment of international capital markets.

The global market for Islamic finance is currently estimated to be worth $1.3 trillion and Muslims comprise about one quarter of the world's population.

Amending the tax system to accommodate Sharia financing will unlock billions of dollars of potential funding for Australian organisations.

The Issue

Australia has an opportunity to attract patient long term capital using Islamic finance to fund property investment.

However, the Australian tax system does not have rules to appropriately identify the true nature of many Islamic financial transactions and unfairly imposes taxes on these transactions (see Box 3 for examples).

In particular, under the current tax rules:

- the return is not typically characterised as interest for tax purposes which would allow for deductions;
- the return is more typically characterised as lease income, profits on disposals of assets and profit share and acquiring interests giving rise to these returns may attract additional stamp duty;
- there are differing withholding tax outcomes depending on the classification of Islamic finance product as debt/equity (for example, sukuk (Islamic bonds) may be characterised as equity for tax purposes);
- the timing of assessability and deductibility is altered (for example, a murabaha transaction can result in upfront taxation, rather than progressively); and
- the transactions can result in double stamp duty.

This has discouraged Australian financial institutions and companies from participating in Islamic finance transactions.

Islamic finance products require "parity of tax treatment" with conventional finance products.

The Solution

☑ Release the Board of Taxation's Report on Islamic Finance for industry consultation.

☑ Amend the current income tax rules to align them with Islamic concepts of finance, in particular:

- recast Islamic finance transactions as 'loan' arrangements for Australian tax purposes by ignoring any asset sale element; and
- treat sukuk bonds as a debt interest for the issuer and deem returns on that instrument to be classified as interest income for the lender.

- ☑ Islamic finance products should be viewed as a single financial supply i.e. interim transactions should be ignored (to achieve parity with western financial products).

- ☑ Introduce laws in each State that remove double stamp duty in relation to Islamic finance products (to create a level playing field with traditional debt finance products).

Box 3: Barriers to Australia Participating in Islamic Finance

A mortgage using Islamic finance could involve the lender buying a property, and immediately on-selling the property to the borrower for a premium. The borrower usually pays the purchase price to the lender in instalments over time. This is known as ***murabaha*** financing.

Under the existing Australian tax laws, this method of financing will attract stamp duty on each 'sale' transaction, resulting in double duty. The lender could also be required to pay tax on the premium upfront, rather than when the instalments are paid.

In addition, some Islamic finance products involve a "borrower" undertaking transactions that could be construed as trading. This is a problem for Australian property trusts that cannot undertake these activities (even though the trust would merely be borrowing to finance its permissible investment activities).

2.4 Bolster Objectivity and Transparency of Loan Approvals

Why this is important?

A clear and uniform set of rules for commercial loan approvals will provide transparency for all property company borrowers and speed up access to finance.

The Issue

Industry does not have a clear understanding of how aggregation policies are applied by banks (refer Box 4).

Bank aggregation policies also vary between financial institutions.

This creates unnecessary delays and makes it harder for industry to comply with bank policies.

For instance, it is not always clear when banks will treat the non-recourse debt of a group subsidiary as debt of the head corporation.

Clear and transparent rules will provide more efficient access to finance for property groups.

The Solution

☑ Require banks to:

- develop clear and transparent policies for assessing commercial loan applications by industry eg. aggregation policies.

- publicly disclose any material changes to loan approval policies which impact an industry ie. similar to the continuous disclosure requirements under ASX listing rules.

☑ Ensure borrowers have access to an independent "umpire" (eg. APRA or ASIC) where a bank has not applied its loan approval policies fairly and consistently.

Box 4: What are aggregation policies?

When deciding whether to lend to a property group, a bank may look only at the debt of the particular borrowing company, or choose to group together the debts of the whole organisation. This grouping, or 'aggregation' is used to identify the banks' exposure to default risk from the group as a whole.

2.5 Expand the ASX Managed Fund Service

Why this is important?

The ASX Managed Fund Service (AMFS) enables investors to electronically apply for and redeem units in most unlisted registered managed investment schemes.

Access to the AMFS platform will increase liquidity for property funds and assist these funds raise capital more efficiently.

The Issue

The AMFS:

- streamlines the process of applying for and redeeming units in unlisted funds;
- allows fund entry and exit prices to be displayed in one place;
- enables investors to amalgamate their listed and unlisted investments in the one electronic system using a single Holder Identification Number; and
- provides more asset allocation options for investors via the ASX regardless of the structure of the investment, ie. listed or unlisted.

However, AMFS is only open to simple managed investment schemes that can use a short form PDS. This bars unlisted property funds which are required to use a long form PDS.

Property is an important asset class in a diversified portfolio for investors (both in the accumulation/growth phase and draw down/retirement phase).

There are two main structures for property: listed and unlisted.

Listed property provides excellent liquidity and is highly correlated to equities.

Unlisted property provides regular or structured liquidity for investors, a stable capital base and consistent distributions from rental income.

Both property structures are crucial to a diversified portfolio.

Currently, the AMFS platform:

- makes it more difficult for unlisted property funds to raise capital efficiently;
- distorts the market by skewing investment way from property; and
- limits the ability for investors to achieve a diversified investment portfolio.

The Solution

☑ Include unlisted property funds as an asset allocation option in the AMFS platform.

2.6 Develop Shorter Product Disclosure Statements for Property Funds

Why this is important?

A short form Product Disclosure Statement (PDS) will provide simpler, more meaningful capital raising documentation for property investors.

The Issue

It is unrealistic to expect retail investors to read past the first several pages of a PDS.

Issuers need simpler compliance and targeted liability rules.

Unlisted property funds are excluded from the shorter PDS regime and instead have to disclose under ASIC's Regulatory Guide 46.

This means that unlisted funds can only raise capital using a long form PDS.

Fund managers are reluctant to cut down the number of pages within a PDS due to liability requirements. These requirements place the onus on the product provider to disclose all relevant information to potential investors.

Critical information should be set out in the first few pages of a PDS and non-critical information can be incorporated by reference.

There is substantial content within a PDS that is "boilerplate" (standard form information) provided in every PDS.

This can be provided on a website with a suitable reference in the PDS which would remove a significant amount of paper from the PDS.

The Solution

☑ Agree to develop a short form PDS for property funds that will:

- disclose the generic investment advice and risk prescribed content in a separate single page educational tool that accompanies the PDS (rather than be embedded and repeated in every PDS);
- allow a 12 page limit to enable adequate space for product specific disclosure (or set the limit in multiples of 4 to ensure it can be easily published);
- promote the use of charts, tables, images, and navigation aids to maximise retail investor engagement and communication;
- provide clear and effective liability rules that treats material that is "incorporated by reference" in the same way as information actually set out in the PDS;
- give equal prominence to information on withdrawal and application (ie investment liquidity); and
- ensure meaningful fee disclosure including actual and maximum fees.

2.7 Create a "Clearing House" for Unlisted Property Funds

Why this is important?

A "clearing house" for unlisted property funds will bring together retail investors seeking to buy and sell units/securities.

This will improve liquidity for existing investors and provide opportunities for new investors to access unlisted property funds.

The Issue

Changing circumstances may force investors to sell their unlisted investment in a fund.

Fund managers can bring together wholesale investors seeking to buy and sell units in unlisted property funds (a "clearing house").

However, fund managers are prevented from making introductions for retail investors under the financial services licensing regime.

This disadvantages retail investors in unlisted funds as they do not have the same access to liquidity as wholesale investors.

Retail investors in unlisted property funds need an introductory service or "clearing house" for their securities to provide a forum to buy and sell their securities at the best price.

The Solution

☑ Ensure Australian Financial Services Licensing rules permit managers of unlisted property funds to offer retail investors a "clearing house" (see Box 5).

Box 5: "Clearing House" for Retail Investors in Unlisted Property Funds

What is it?

A platform that brings together retail investors seeking to buy or sell units in unlisted property funds.

This can be modelled on the clearing house service that currently exists for wholesale investors in unlisted property funds.

How does it operate?

- An unlisted fund manager (or an independent third party) seeks out and accepts bids and offers from existing and new retail investors.
- Buyers and sellers are matched and negotiate with each other directly to determine the price, volume and terms of the transaction.
- Once a trade is agreed, the exact unit price and volume will be confirmed and sent to both parties.
- The fund manager ensures that settlement occurs through its registry.

How are investors protected?

- Fund managers are required to act efficiently, honestly and fairly in accordance with their obligations under their Australian Financial Services Licence.
- Participating funds will need to disclose up to date information to assist investors understand, compare and assess a fund's performance.
- Funds are already required to meet ASIC disclosure principles (as required by Regulatory Guide 46) as well as comply with continuous disclosure requirements.

3. Clear and Cost Efficient Financial Market Rules

An optimal financial system is underpinned by clear and cost efficient rules that encourage innovation and promotes international competitiveness.

Our current regulatory framework imposes unnecessary barriers which delays investment decisions, stymies cross border financial transactions and places Australia at a competitive disadvantage.

Slashing red tape and removing artificial regulatory barriers will unlock access to finance for businesses and consumers.

Our game changing solutions to restore Australia's international competitiveness are:

- ☑ streamline Foreign Investment Review Board rules;
- ☑ fast track implementation of the Asian Region Funds Passport policy;
- ☑ expedite mutual recognition of overseas regulatory regimes;
- ☑ strike a competitive managed investment trust withholding tax rate;
- ☑ modernise the taxation of managed investment trusts;
- ☑ align collective investment vehicle rules with managed investment trust rules; and
- ☑ maintain thin capitalisation rules for property trusts and companies.

3.1 Streamline Foreign Investment Review Board Rules

Why this is important?

Streamlining Foreign Investment Review Board (FIRB) processes will help Government slash red tape and reduce artificial barriers to investment.

The Issue

The FIRB is currently forced to review all commercial investments even when the property has no "national interest" element.

This delays investment decisions, increases administrative costs for government and impacts industry's ability to finance and deliver projects.

Importantly, in coming years, the burden will only increase as investor applications for Significant Investment Visas (SIV) ramp up.

Although the FIRB has made considerable inroads to reduce approval times, the system can be streamlined further.

Any reforms that strip out unnecessary red tape will shorten delays and help investors make timely investment decisions.

For instance currently, the SIV regime requires Government approval for each investment application and then a separate, additional FIRB approval.

This is an inefficient and unnecessary second step given the SIV approval already specifies the accepted complying investment.

In the majority of other cases, the FIRB already approves the foreign investment and significant resources are used to review applications that are of little concern to Government.

There is an opportunity to significantly cut red tape through better targeted FIRB rules that strip out unnecessary processes.

The Solution

- ☑ Implement an automatic approval process for commercial investment applications that have no "national interest" issues.

- ☑ Codify the type of investments that are contrary to the "national interest".

- ☑ In addition to existing annual approval limits, implement a streamlined "VIP" process for regular FIRB applicants that expedites approvals.

- ☑ Combine FIRB and Significant Investment Visa (SIV) approvals into one process to cut compliance in half.

3.2 Fast Track Implementation of the Asian Region Funds Passport Policy

Why this is important?

Currently, Australian property funds must prepare tailored Product Disclosure Statements (PDS) for each market in which they are seeking to raise capital.

An Asian Region Funds Passport will allow managed funds to market their products quickly and efficiently, boosting international investment in Australia and reducing red tape.

The Issue

The program will commence in 2016 and will initially be restricted to a small pilot group of Australia, New Zealand, Korea and Singapore.

It is essential that a funds passport is established as quickly as possible to:

- simplify marketing of managed funds (including property funds) overseas;
- provide investors with a more diverse range of investments; and
- attract finance in order to ignite growth in the region.

Reducing barriers to cross border financial transactions will lead to deeper and more efficient financial markets and boost regional economic growth.

The Solution

☑ Bring forward the start date for the Asian Region Funds Passport and commit to expanding eligible countries after the pilot program.

☑ Government should confirm that property funds will have access to the Asian Region Funds Passport.

3.3 Expedite Mutual Recognition of Overseas Regulatory Regimes

Why this is important?

Streamlining and simplifying the marketing of investments across jurisdictions will help Australia become a leading financial services hub.

The Issue

Australian property funds must prepare tailored prospectuses for each market in which they are seeking to raise capital.

This increases compliances costs and impedes timely access to funding.

Mutual recognition of regulatory documents between favoured jurisdictions will reduce costs, red tape and time to market.

This will improve Australia's ability to attract overseas capital and open up access to global debt markets.

The Solution

☑ Fast track the mutual recognition of regulatory documents between Australia and major global financial centres.

3.4 Strike a Competitive Managed Investment Trust Withholding Tax Rate

Why this is important?

A managed investment trust (MIT) withholding tax rate of 10% will attract more patient, long-term capital for major property and infrastructure projects.

The Issue

The Australian property industry relies heavily on patient, long term global capital to capitalise major investments including social infrastructure projects.

Australia competes with more than 24 REIT markets worldwide for international capital.

Many of these markets have lower withholding tax rates including Japan (7%), Singapore (10%), USA (0%), France (0%) and Hong Kong (0%).

Doubling the MIT withholding tax to 15% has made it harder for Australia to compete for pension fund investors.

A lower withholding tax rate will help Australia reclaim its competitive advantage.

The Solution

☑ Reduce the MIT withholding tax rate to 10% for all investment classes and qualifying projects.

3.5 Modernise the Taxation of Managed Investment Trusts

Why this is important?

Ordinary Australians who invest in property managed investment trusts (MITs) deserve the same treatment and opportunities as direct property investors.

The Issue

Unlike direct investors, MITs are currently subject to restrictions that impede their ability to earn income from property investment.

Many of today's common property investment opportunities simply did not exist when the Australian trust tax rules were developed.

Inconsistent and uncertain tax treatments for property trusts create confusion for local and international investors.

Australia's MIT tax rules must evolve with the market and provide the flexibility needed to support new forms of property investment.

The Solution

☑ Establish a simple modern MIT tax regime that:

- allows trusts to undertake new forms of property investment with tax flow-through status;
- clearly defines ineligible investment activities and scraps outmoded 'active/passive' rules;
- encourages widely held collective investment vehicles to invest in Australian MITs, for example, by treating foreign life companies as a qualifying investor;
- confirms that all widely held MITs and MITs with no material discretionary powers are fixed trusts to ensure property trusts can access tax rules they need to operate effectively (eg: trust loss rules); and
- ensures the Division 6 trust income rules allow unit trusts to distribute income to investors in line with the trust deed.

3.6 Align Collective Investment Vehicle Rules with MIT Rules

Why this is important?

Australia's attractiveness as a funds management hub relies on a simple, functional collective investment vehicle (CIV) regime that encourages risk-averse international investors to invest in or through Australia.

Australia's financial system is an outlier in the global funds management world in its reliance on trusts rather than corporate or limited partnership structures.

This provides a competitive advantage to other financial centres competing with Australia for financial business in the Asia Pacific region.

The Issue

Australia does not have a specific tax regime for CIVs.

The focus of a CIV regime should not be on the type of entity, but rather the nature of the activity and income arising from that activity.

While trusts are reasonably well understood in Australia, they are not the CIV of choice in other countries. Corporate and limited partnership CIVs are common internationally.

Which legal entity a CIV uses will depend on a number of considerations, including the type of investors and where they are based. This choice should be tax neutral in line with revenue principles.

The Board of Taxation report on CIVs was given to Government in December 2011, but has not yet been released. This results in confusion and costly delay for international investors.

The Solution

☑ Release the Board of Taxation's Report on Collective Investment Vehicles for industry consultation.

☑ Ensure the CIV rules are harmonised and in line with the MIT rules.

☑ Reform the tax treatment of CIVs so that it is driven by function (an activity-based test) rather than an entity-based assessment which distorts business transactions.

3.7 Maintain Thin Capitalisation Rules for Property Trusts and Companies

Why this is important?

Tighter thin capitalisation rules will restrict Australia's ability to attract the international capital needed to finance key infrastructure and development.

The Issue

Thin capitalisation rules limit debt interest deductions for global organisations to prevent allocation of excessive debt to Australian entities.

The rules use simple safe harbour thresholds to limit debt levels.

With the proposed reduction in the safe harbour thresholds, it is even more critical that an arm's length test is preserved as a practical safeguard.

The thin capitalisation arm's length test was introduced to protect legitimate transactions that are geared with commercial arm's length debt in excess of the safe harbour limits.

For example, critical projects may have arm's length debt in excess of the safe harbour limit during the construction phase, but once they are completed, the increased property value brings the debt levels within safe harbour limits.

Without the arm's length test, the viability of these projects is at risk, even though investors are willing to lend above the safe harbour threshold.

Limiting access to the arms-length test will impose an artificial barrier on the amount of debt capital that would otherwise be available for property investments.

The Solution

☑ Maintain existing arm's length eligibility rules.

☑ Implement measures to simplify the administration of the arm's length test, including moving from an annual test to a once-off test at the time the loan is entered into, in line with commercial borrowing practices.

PROPERTY COUNCIL of Australia

UK *City Deals* in a nutshell…

Why the UK approach to urban and regional growth provides a model for Australia

Introduction to City Deals

UK City Deals are the Cameron Government's innovative strategy for building stronger urban and regional growth via smarter planning, infrastructure investment and local governance.

This paper summarises the City Deal model and its relevance to Australia.

City Deals will soon extend to 28 major UK towns and regions.

The Greater Manchester deal signed in 2012 provides a template for other cities.

In Australian public policy terms, the UK City Deal prototype represents a National Competition Policy-style approach applied to the urban and regional realm.

The core goal of the UK City Deal model is to direct infrastructure spending to projects that boost productivity, employment and economic growth.

The model also seeks to deliver complementary economic and social dividends that meet the specific needs of individual regions.

The UK model represents a **radically new approach to infrastructure priority-setting, funding and financing**.

The UK approach determines an economic growth budget for a designated region. Regions are rewarded for achieving and exceeding these growth budgets.

The Property Council is currently working with the South East Queensland Council of Mayors (CoMSEQ) and the Queensland Government to adapt the City Deal approach to Australian circumstances.

An Australian model will be available in March 2014.

At its most basic, there are five dimensions to the UK City Deal template.

1

A City Deal is a contract – the deal is a deal!

Each City Deal is codified as a contract between an economic region and the central government.

In Scotland, with its triple tier governance arrangements, there are three parties to the contract – a model that may better suit Australian circumstances.

A City Deal generally runs for 10 years or longer. Each deal identifies a list of priority infrastructure projects to be delivered along with benchmarks of regional economic and productivity growth to be achieved.

2

Local leadership

The UK approach revolves around City Deal partners.

In Manchester, the 10 existing local government authorities combined to form the Greater Manchester Combined Authority (GMCA) in 2011.

In addition, Local Enterprise Partnerships link key stakeholders – government, business, community groups – based on logical economic regions.

A Local Enterprise Partnership (LEP) is incorporated into the GMCA governance arrangements (please see break-out box).

These LEPs evolve US-style Business Improvement Districts (BIDs) into far more strategic priority-setting and delivery vehicles.

Greater Manchester City Deal Governance

Greater Manchester is leading the way amongst the core cities, with strong, stable and effective governance across its economic area following the establishment of the Greater Manchester Combined Authority in April 20111

This strategic, corporate body has powers in its own right, so is not dependent on delegations from its constituent authorities, and decisions to pursue a particular policy are binding, providing long-term stability. This provides a stable and accountable platform for Government to devolve powers and functions as part of the City Deal process.

The Local Enterprise Partnership (LEP) is a key component of Greater Manchester's governance arrangements. Building on existing public and private partnerships, it provides a forum to have a single conversation with business leaders, enabling them to play an even more active role in securing economic growth. Political leadership is secured through the Combined Authority and decisions are cleared by the LEP.

The Combined Authority is the accountable body for LEP funding, as opposed to having to nominate a local authority to take on this role, as is the case in other LEP areas. This provides coherence and a truly joined-up approach across all ten local authorities.

A key advantage of the Combined Authority model is its joint governance arrangements for transport, economic development and regeneration, which allow for strategic prioritisation across the functional economic area. Sub-groups lead on different work-strands, with relevant partners represented on the Boards. Furthermore, the establishment of Transport for Greater Manchester facilitated much greater integration and closer working relationships with the Highways Agency and the ten local authorities on the operation and development of the road network.

Not only does the Greater Manchester Combined Authority provides a stable and strong governance structure enabling it to take on new powers and functions, it also has the gravitas to engage with central government and national agencies successfully. This will enable Greater Manchester to secure future devolution and resource prioritisation.

Source: Greater Manchester Combined Authority, Greater Manchester City Deal, 2012, page six

3 Incentives – TIF, "Earn Back" and the "self-help" model…

The UK City Deal model provides City Deal partners with a menu of financing options.

First, these partners receive baseline funding – that is, long-term certainty around core revenue streams.

Second, City Deal partners are encouraged to explore innovative forms of capital formation with the private sector.

PPPs are on this menu, as are Local Asset Backed Vehicles and Tax Increment Financing.

These models complement traditional forms of capital raising.

In Birmingham and Solihull, City Deal partners propose to raise 25 billion pounds of private capital on the back of special purpose fund – GBS Capital.

Third, the UK system rewards City deal partners that ***exceed*** their growth benchmarks.

This approach is called "earn back".

In an Australian context, "earn back" is analogous to competition payments under the National Competition Policy (NCP) model.

In short, where a City deal partner exceeds agreed growth KPIs, the central government provides a reward payment.

This payment can be used to amortise debt obligations or to capitalise new priority infrastructure projects.

What is the philosophy behind 'Earn Back'?

The UK City Deal program focuses on growth.

Smarter infrastructure investment grows productivity, jobs and economic output.

The City Deal methodology aims to generate higher (measurable) Gross Value Added (local GDP) for a region on the back of optimised infrastructure investment choices.

In theory, faster economic growth then translates into higher taxation revenue.

The chief beneficiary of this taxation premium is the UK central government.

A "payment by results" model allows City Deal partners to "earn back" a designated portion of this growth premium from the central government. The `earn back' payments supplement baseline funding.

`Earn back' acknowledges that City Partners are:

- making hard decisions about the allocation of scarce resources; and,
- delivering on agreed performance targets within the real economy.

The goal is not simply to complete an infrastructure project on time and to budget, it is to secure the tangible benefits of productivity, jobs and growth within the real economy.

In time, incremental increases in taxation receipts arising from initial infrastructure spending are reinvested on a rolling basis into further high value infrastructure projects.

4

Tools and Benchmarks

The UK City Deal methodologies employed to assess infrastructure project priorities are the same tools utilised to assess the performance of the deal.

The methodologies were developed by the UK Treasury, which also independently assesses performance against targets outlined in City Deal contracts – the "single assessment framework".

What is the Single Assessment Framework?

Traditional cost-benefit ratios (BCR):

- focus on a single asset or project;
- operate on the basis of rigid assumptions about growth and productivity arising from an investment – that is, BCR methodologies generally assume the real economy is fixed for the purposes of modelling; and,
- quantify dividends in terms of a narrow set of metrics, such as travel time savings, or limited "economic multipliers".

The UK City Deal program represents a major paradigm shift, where:

- the focus is on wider impacts within a defined region;
- project priorities and program success are assessed in terms of **growth in jobs and productivity** (along with attendant increases in tax revenue); and,
- the goal is to quantify changes in Gross Value Added (local GDP) for an economic region.

The UK Treasury has developed methodologies to drive the "single assessment framework".

In other words, the "single assessment framework" is a tool to:

- allocate capital budgets to promote growth; and,
- provide performance benchmarks for City Deal contracts.

The UK City Deal approach promotes a move away from budget silos – a "housing budget", a "transport budget" etc – to an **"economic growth budget" for a region**.

The lens provided by the single assessment framework shifts the fiscal focus away from isolated project evaluations to metrics that capture broader benefits – this includes welfare, housing and regeneration dividends.

5

Invigilation – Keeping the Process Honest

The UK City Deal program is overseen by a Minister, currently Greg Clarke.

Clarke is Secretary to the Treasury and Minister for Cities.

This approach recognises that cities are economic assets which drive productivity and growth.

There is a unit within Treasury that helps City Deal partners assess infrastructure priorities and set GVA growth benchmarks.

These benchmarks are written into each City Deal.

Treasury also acts as an independent assessor of progress against targets.

What Makes the UK City Deal Model so Instructive?

The UK City Deal approach represents a radical rethink of infrastructure and growth policies.

It rejects the traditional approach to policy silos.

It seeks to join-up policy programs by setting **productivity and growth targets**. It hardwires these targets into contracts - "deals" – with the partners best placed to deliver growth over a generation.

The UK City Deal model recognises the direct link between smart infrastructure investment and urban/regional policy.

That is, productivity gains are best achieved in terms of logical economic and community catchments, not artificial political boundaries.

Australia lacks a coherent urban and regional policy framework. The UK City Deal model provides a policy philosophy that can be adapted to Australian circumstances.

In many ways, the UK City Deal approach takes the critical elements of Australia's successful National Competition Policy model and applies them to cities and regions.

This section outlines why we should adopt the UK City Deal approach and customise it to Australian circumstances.

1

The focus is on productivity and growth

Wise choices about infrastructure investment can boost productivity.

The UK City Deal model explicitly targets a package of infrastructure projects that boost a region's economic capacity over a long-term timeframe.

This helps focus competing priorities into a coherent set of goals that can be communicated to voters.

2

City Deals encourage local leadership

City Deals promote collaboration.

City Deal stakeholders – government, community, business – are partners to a contract.

This encourages a more enterprising, strategic approach to growth and self-reliance.

In doing so, it fosters the growth of social capital and local resilience as everyone is in the same boat.

3

Smarter tools for determining infrastructure priorities

The City Deal approach moves from narrow benefit-cost analysis to an agreed measure of Gross Value Added for a region (a local "GDP").

It aligns the methodologies for selecting infrastructure investment priorities to the methodology for rewarding the performance of City Deal Partners.

It also does so within an independent assessment process controlled by Treasury.

4

Performance is rewarded

Financial incentives motivate and reward smart thinking.

The UK City Deal model allows deal partners to "earn back" a share of the additional taxation dividend generated by faster economic growth.

This financial reward motivates strategic thinking, collaboration and public policy innovation.

It also provides a clear ongoing incentive to deliver on long-term infrastructure investment programs.

5

City Deals help joins up economic and social goals

A feature of UK City Deal contracts is the inclusion of complementary programs relevant to a region.

For instance, the Manchester City Deal includes:

- a Growth Hub program;
- a Skills Hub – a plan to employ 6,000 apprentices;
- a Low Carbon Demonstrator initiative – an innovative funding model to reduce emissions;
- an Inward Investment Beacon – a program for attracting international and patient capital to local projects; and,
- a housing program that aims to deliver 7,000 homes by 2017.

The Birmingham and Solihull Deal includes:

- a plan for 100,000 extra private sector jobs (generating an additional $23 billion of GVA by 2020);
- a Life Science Accelerator program;
- a Skills for Growth program; and,
- Green Deal initiatives.

In other words, City Deals foster a **mutually reinforcing set of public policy programs.**

6

City Deals promote financial literacy and skills at a local level

The Birmingham and Solihull City Deal partners have established GBS Capital which proposes to leverage $2.5 billion of seed funding into $25 billion of private capital.

The Greater Manchester Combined Authority has established a $2.5 billion "revolving infrastructure fund".

These special purpose capital formation entities are monitored and advised by the UK Treasury and operate under strict governance arrangements.

Deeper involvement by local stakeholders, who are accountable for their actions, fosters financial savvy.

7

There's less need to rely on inefficient taxes when efficient alternatives are available

Australia's panoply of inefficient taxes exist because of cost-shifting to local government, poor access to capital and policy conservatism.

A secure stream of capital for infrastructure projects (within a disciplined framework) will not only reduce reliance on inefficient taxes, it can provide the basis for phasing them out.

Conclusion

The Property Council is working with partners, such as the Urban Coalition, the Australian Sustainable Built Environment Council (ASBEC), the Queensland Government and South East Queensland Mayors to review the critical elements of the UK approach.

The goal is to adopt the UK approach to Australian circumstances.

There is no Australian equivalent to the UK's joined-up approach to stimulating urban and regional growth. We are confident of building a locally relevant model to fill this gap.

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