Mr John Lonsdale
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Financial System Inquiry
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1 September 2014

Dear Mr Lonsdale

Financial System Inquiry – Interim Report

Thank you for the further opportunity to comment on the Financial System Inquiry's Interim Report.

Creating a more efficient and flexible financial system will boost Australia's competitiveness and attract patient long term global capital that is critical for investment.

Our original submission dated 31 March identified that an optimal financial system has:

- 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.

The property industry strongly supports the previous submission's critical reform solutions that will boost the efficiency, competitiveness and flexibility of Australia's financial system.

While this submission focusses on the specific issues addressed in the Interim Report, the recommendations in our previous submission should be included in the final report.

Our members are keen to talk further about these issues with you:

- housing and household leverage;
- infrastructure financing;
- corporate bond market;
- disclosure;

- impact investment; and
- superannuation costs and fees.

We recommend:

- **continued prudential oversight of the finance sector to ensure the financial system remains stable and efficient, and retaining the existing negative gearing and capital gains tax laws**.

  Household leverage does not pose a systemic risk to Australia's financial system as banks have robust risk management processes.

  Households have paid down debt and the aggregate mortgage buffer has risen to almost 15 per cent of outstanding balances.

  Given only 1.25 per cent of Australian home loan customers are more than 30 days in arrears, household leverage is less of a risk than ever.

  Critically, negative gearing and the capital gains tax treatments have had a positive effect on the economy. They help bridge the housing supply shortfall and actually help keep rents low.

- **raising capital for infrastructure by:**
  - **packaging qualifying projects into asset-backed securities ('Urban Infrastructure Fund'); and**
  - **issuing long-dated Government bonds.**

  These recommendations support the development of a market for securities to boost public and private investment in infrastructure projects.

- **streamlining regulations for issuing corporate bonds,** including:
  - allowing renounceable rights issues for existing investors to enable companies to raise additional capital from their current investor base;
  - streamlining the investor notification requirements for issuers of vanilla bonds to reduce operating costs; and
  - promoting the use of credit ratings for sub-investment grade issuers to provide greater transparency for investors regarding the quality of the bonds.

  These initiatives will make bond markets more accessible to retail investors and reduce operating costs. Retail participation in corporate bonds is under-utilised and can provide Australia with a ready source of domestic capital.

- **developing shorter product disclosure statements for property funds.**

  This will provide simpler more meaningful capital raising documents for property investors and reduce fund operating costs. The current disclosure requirements are overly complex and skew investment away from property. This limits the ability of retail investors to achieve a diversified portfolio.

- **increasing private sector investment in not for profit organisations by:**
  - **providing guidance for superannuation funds on impact investment;**
  - **streamlining disclosure requirements for investment in social impact bonds; and**
  - **establishing social impact banks.**

  Impact investment (or socially responsible investment) aims to provide the not for profit sector with additional sources of private sector funding.

  Private sector investment in the not for profit sector is critical because this sector plays an important role in providing social and affordable housing for Australians.

- **reviewing the 'MySuper" reforms after three years** to determine whether the rules are operating as required.

  This will ensure that the 'MySuper' reforms are given sufficient lead time to deliver lower fund costs for members.

Our detailed comments on the proposals are contained in the attached submission.

We would welcome the opportunity to discuss our submission with you and will contact you shortly to arrange a meeting.

Please do not hesitate to contact Darren Davis on 0400 929 817 or myself if you have any queries.

Yours sincerely

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Financial System Inquiry – Interim Report

Property Council of Australia
September 2014

Comments on the Interim Report

We have set out below our comments on the following aspects of the Financial System Inquiry – Interim Report ("Interim Report"):

1. Housing and household leverage;
2. Infrastructure financing;
3. The corporate bond market;
4. Disclosure;
5. Impact investment; and
6. Superannuation costs and fees.

1. Housing and Household Leverage

The Interim Report seeks comments in the following area:

What measures should be taken to mitigate the effects of developments in the housing market on the financial system and the economy? How might the measures be implemented and what practical issues would need to be considered?

Industry supports continued prudential oversight of the banking sector to ensure the financial system remains stable and efficient.

However, industry does not support any proposal (for example, the removal of negative gearing) that would adversely impact the housing market and the financial wealth of all Australians.

As we have set out below, household leverage does not pose a systemic risk to Australia's financial system as banks have robust risk management processes.

The housing market underpins the strength of our economy, by providing jobs for the construction industry, and home ownership and rental opportunities for Australian families.

Unnecessary measures to artificially restrict the housing market supply will jeopardise the economic strength of Australia.

Financial instability from housing is a myth

Domestic housing finance lending in Australia has been managed prudently by the banking sector.

The Interim Report emphasises that "Australia has had a relatively stable financial system for most of the past two decades".

The Interim Report also indicates that the combination of a stable macroeconomic environment and prudent risk management by financial institutions has ensured balance in the system.

Household debt is being managed effectively

The Reserve Bank has indicated that many households have used lower interest rates to continue paying down their mortgages more quickly than required.

As a result, the aggregate mortgage buffer has risen to almost 15 per cent of outstanding balances, which is equivalent to around 24 months of total scheduled repayments at current interest rates.

This suggests that many households have considerable scope to continue to meet their debt obligations even in the event of a temporary spell of reduced income or unemployment.

Furthermore, a half-yearly study in December 2013 by Fitch Ratings of more than $200 billion worth of mortgage-backed securities shows only 1.25 per cent of Australian home loan customers were more than 30 days behind in repayments. This compares with a delinquency rate of 4.98 per cent in the United States, according to the US Federal Reserve.

House prices are fair

Real house prices have increased at an average annual rate of slightly less than 2.5 per cent since 1955 and are fairly valued at present, according to the Reserve Bank of Australia.

The Reserve Bank predicts that this rate of appreciation will continue and cites some external observers who have suggested that future house price growth may moderate to a level slightly below this historic average.

Taxation treatment of housing

Current negative gearing and capital gains tax treatment are essential if we want all Australians to have access to affordable housing.

The problem is that we face a nationwide shortage of approximately 220,000 homes and the national occupancy rate for private rental housing is at 97.8 percent.

With growing demand for homes and limited supply, a solution to Australia's rental crisis is to encourage investors to buy more homes for the purpose of renting these properties to fellow Australians.

Negative gearing and the capital gains tax treatment allows investors to bridge the housing supply shortfall by making the acquisition of rental property easier.

The advantage of negative gearing is its simplicity – as with any other business activity, the homeowner may deduct the cost of borrowing money if the property is rented to others Australians.

The cost of borrowing associated with acquiring rental housing is tax deductible, in the same way as other overheads (such as repairs and maintenance) are tax deductible.

Similarly, the capital gains tax treatment available to Australians applies to **all asset classes** and is not specific or limited to capital gains for investment housing.

The capital gains tax treatment is critical to ensure that investors are taxed on the "real" gain from their investment (by removing any inflationary effect). The current capital gains tax treatment is intended to simplify the previous 'indexation' rules which also sought to tax investors on "real" gains.

Combined, these tax measures make rental housing an attractive investment and increases the supply of housing to Australians.

If interest costs are not treated as overheads, rent will increase as a result of the tighter market and investors will simply seek alternative investment opportunities.

In effect, negative gearing and the capital gain tax concession subsidises rent which encourages Australians to invest in rental housing.

The last time we meddled with negative gearing, spending on new homes fell to its lowest level in 40 years.

This was a failed but instructive experiment. Since 1987, when full negative gearing was restored, spending on new homes easily outstripped the dire investment levels of the mid-80s.

We need to maintain negative gearing and the capital gains tax treatment to boost the supply of all housing.

How to make the financial system stronger

Given the strength of the Australian financial system, there is no basis for unnecessarily restricting the availability of debt to prospective home owners and investors.

The Property Council supports a continued role for the Government where it has oversight of lending institutions and ensures proper monitoring and compliance with lending standards.

We also recommend that:

- banks carry out regular mortgage book stress tests; and
- there should be oversight of mortgage brokers to ensure that loans are only offered to borrowers who have ongoing capacity to repay loans.

Continued attention to these prudential measures will ensure the housing market continues to play a positive role in underpinning the strength of the economy and the financial system.

Recommendations

The Property Council recommends:

- retaining the existing negative gearing and capital gains tax laws to safeguard affordable housing rental supply;
- banks undertake regular mortgage book stress tests; and
- prudential oversight of mortgage brokers to ensure that loans are only offered to borrowers who have ongoing capacity to repay loans.

2. Infrastructure Financing

The Interim Report seeks information on the impediments to the development of liquid securities market for infrastructure projects.

The Property Council supports the development of a market for infrastructure securities to boost public and private sector investment in infrastructure projects.

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.

Australia has been unable to develop a liquid market for infrastructure securities. There are two reasons for this:

- the lack of a standardised means for bringing infrastructure backed securities to market; and
- the absence of a long term (30+ year) private sector bond market.

Urban Infrastructure Fund

It is essential that Federal, State and Territory governments foster a new infrastructure asset class by establishing a government-backed 'Urban Infrastructure Fund'.

The Urban Infrastructure Fund would package qualifying projects into asset-backed securities for sale to the retail investment market.

By providing a government guarantee and a targeted tax concession, the Urban Infrastructure Fund could provide low risk, credit enhanced returns to both institutional and retail investors.

The Urban Infrastructure Fund would support investor confidence through:

- transparent regulatory controls and reporting that reduce the potential for default;
- standardised information requirements (eg. simple PDS) to increase comparability; and
- the development of a national database of projects (commenced and completed) with an assessment of the community dividends expected and delivered. This will provide a pipeline of projects so that investors are aware of new infrastructure investment opportunities.

The objective of the Urban Infrastructure Fund would be to embed long-term infrastructure bonds as an investment product with a view to creating a market for the private sector to tap in the medium term.

Long-dated Government Bond Market

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

This makes 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 long dated securities with a consortium of banks launching a well-supported 20-year 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. This type of issuance would improve the Government's ability to raise capital for infrastructure projects.

Recommendations

The Property Council recommends:

- Federal, State and Territory governments foster a new infrastructure asset class by establishing a government-backed 'Urban Infrastructure Fund'; and
- the Government bring long-dated bonds to market to improve the Government's ability to raise capital for infrastructure investment.

3. The Corporate Bond Market

The Interim Report observes that Australia has an established domestic bond market, but a range of regulatory factors have limited its development. As the Interim Report notes, a more developed and accessible corporate bond market would provide corporates with more funding options and allow investors to better diversify their portfolios.

As set out in our original submission, the Property Council supports measures to streamline regulations to increase retail participation in corporate bonds.

This will deliver a deeper and more liquid domestic bond market.

A liquid corporate bond market will:

- provide greater depth and diversification of the Australian financial system by increasing the sources of debt funding in Australia and reducing reliance on equity or offshore financing; and
- increase competition in the debt capital sector.

One significant regulatory hurdle in the current rules relates to investor notification requirements.

From time to time, issuers of bonds need to seek noteholder approval for changes in deeds, or to approve the sale of a property from a pool of assets that had been used as security for a bond.

This if often a time-consuming and uncertain process as it is extremely difficult to reliably contact, or receive instructions from, noteholders (overseas noteholders in particular), and custodians.

This is an unnecessary step if investors can agree in advance the circumstances in which changes are acceptable and do not require further written approval.

Issuers should be able to agree with the noteholders, in the terms and conditions of each vanilla bond issuance, the circumstances in which changes can be made to trust deeds, and assets can be sold, without direct prior notification.

We support the following reforms to reduce barriers to corporate bond issuance:

- allow renounceable rights issues for existing shareholders.

  This will allow both current and potential investors to equally participate in capital raisings, and increase the pool of funding available to the issuer company;
- allow listed issuers that are already subject to the continuous disclosure requirements to issue listed 'vanilla bonds'[1] directly to retail investors without the need for a prospectus.

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[1] Vanilla bonds are bonds which are straight forward and do not have complex or unusual terms and conditions. For example, features the bond must have include: that the bond be denominated in Australian dollars, have a maturity length of no more than 10 years, repay the principal to the investor at the bond's maturity, pay interest periodically, not be convertible to any other form of security and rank at least equally with amounts owed to unsecured creditors of the issuer -

This will remove unnecessary red tape because the relevant investment information is already publicly available;

- streamline the investor notification requirements for issuers of vanilla bonds.

  This will simplify administration and minimise operating costs by allowing issuers of vanilla bonds to agree with noteholders the circumstances in which changes can be made to the fund without prior notification; and

- promote the use of credit ratings for sub-investment grade issuers to provide greater transparency for investors regarding the quality of the bonds.

The Government should also consider issuing short-dated government bonds into the retail market to enable investors to compare the pricing of government bonds (with varying terms of maturity) to corporate bonds.

Recommendations

The Property Council recommends the following reforms to streamline corporate bond issuance:

- allow renounceable rights issues for existing investors to enable companies to raise additional capital from their current investor base;
- allow listed issuers already subject to the continuous disclosure requirements to issue listed 'vanilla bonds' directly to retail investors without the need for a prospectus. The continuous disclosure requirements satisfy prospectus disclosure requirements;
- streamline the investor notification requirements for issuers of vanilla bonds to reduce operating costs; and
- promote the use of credit ratings for sub-investment grade issuers to provide greater transparency for investors regarding the quality of the bonds.

Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2014, Explanatory Memorandum, paragraph 2.10.

4. Disclosure

The Interim Report observes that the current disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services and impose significant costs on industry.

The regulation impact statement to the Corporations Amendment Regulations 2010 (No. 5) which introduced the Shorter Product Disclosure Statement (SPDS) regime identified several persistent issues regarding the disclosure regime including:

- the effectiveness of disclosure has been compromised by a tendency for suppliers of financial products to provide excessive information;
- the language used in PDSs is difficult to understand and consumers do not see PDSs as providing easy access to the required relevant information; and
- industry feedback suggested significant uncertainty about the level of detail required in a PDS.

As set out in our original submission, a short form PDS for property funds should be developed 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.

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

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 volume from the PDS.

Recommendations

The Property Council recommends the development of short form product disclosure statements for property funds. Shorter product disclosure statements should include all critical information necessary to enable the consumer to make an investment decision.

5. Impact Investment

Impact investment (or socially responsible investment) is investing in organisations and funds that offer social and financial returns.

The Interim Report canvasses options to improve access to capital for these organisations who may not otherwise obtain funding from mainstream financial markets.

Private sector investment in the not for profit sector is critical because this sector plays an important role in providing social and affordable housing for Australians.

The not-for-profit sector is a significant part of the Australian economy:

- not-for-profits account for nearly 5 per cent of GDP and comprise 600,000 organisations (about 60,000 of which are charities). The sector is estimated to be growing at around 8 per cent each year, (exceeding the mining industry in relative growth terms)[2];

- the not-for-profit sector now contributes $55 billion to the Australian economy and employs more than eight percent of the Australian workforce[3]. (This does not include the large number of volunteers who offer their time, energy and talents to the sector); and

- governments are increasingly working with Australia's not-for-profits to deliver services to society.

For the property industry, the not-for-profit sector has most relevance in the area of housing. The provision of social and affordable housing makes an important contribution to the housing market.

Initiatives such as National Rental Affordability Scheme (NRAS) have helped to attract private sector funding on commercial terms.

Impact investment offers further opportunities to attract private sector funding.

The Australian impact investment market could attract annual investment of A$300 million with a total capital managed of around A$32 billion over 10 years[4].

This would stimulate economic activity and employment by directly boosting property and construction.

Impact investment and other social investment funding techniques are an essential aspect of the financial system for the not-for-profit sector. The sector has difficulty accessing bank debt and other funding on standard commercial terms due to the low capital reserves and fluctuating income of organisations in the sector.

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[2] Senate Economics Legislation Committee inquiry into the Australian Charities and Not-for-profits Commission (Repeal) (No. 1) Bill 2014, Submission 95, "ACNC Repeal: effects on the charitable sector", p iv

[3] The PwC-CSI Community Index 2013, http://www.pwc.com.au/media-centre/2013/pwc-csi-community-index-jun13.htm

[4] Based on UK and US comparisons - R Addis, J McLeod, A Raine, *Impact-Australia, investment for social and economic benefit, March 2013*, Department of Education, Employment and Workplace Relations & J B Were, p78.

This results in underfunding and heavy reliance on government funding.

The Australian financial system is not currently responsive to the needs of the not-for-profit sector and social investment. This is evident, for example, through the high cost and low volume of bank debt in the sector.

There are constraints that need to be addressed, including:

- lack of relevant investment options available to superannuation funds and other investors (ie. social infrastructure bonds);
- shortcomings in the risk and financial information management systems in the not-for-profit sector; and
- lack of training in, and awareness of, the opportunities.

The Property Council supports the policy options canvassed in the Interim Report to:

- provide guidance to superannuation funds and philanthropic trustees on impact investment.

  This will assist education of trustees about their fiduciary duties ie. that fiduciary duties do not prohibit impact investing;
- classify private ancillary funds as a sophisticated or professional investor for the purposes of the exemptions from the prospectus regime if the sponsor of the fund meets either of these thresholds.

  Exempting funds from preparing prospectus will reduce fund operating costs;
- simplify and streamline disclosure requirements associated with social impact bonds.

  This will reduce complexity and enhance consumer understanding of this product; and
- undertake a more active role in expanding impact investment, such as providing risk capital and establishing social investment banks.

  This initiative will provide specialised funding for the not for profit sector, including social housing.

The first three options involve minimal cost as they concern education and reducing red tape.

The fourth option involves capital investment. This can be done so that the benefits outweigh the costs.

For example, SROI analysis of investment in several affordable housing projects for low income women by Victorian Women's Housing Association (VWHA) indicated a return of $3.14 social value for every $1 invested[5].

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[5] B Kliger, J Marsh, A Martin, J Standish, "How an innovative housing investment scheme can increase social and economic outcomes for the disadvantaged", http://soac.fbe.unsw.edu.au/2011/papers/SOAC2011_0109_final%281%29.pdf, p 2

Detailed investigation of a social investment bank, similar to the UK's Big Society Capital, is required.

A landmark step is critical to generate the changes in attitude and awareness needed to support and promote innovation in the financial system in this area.

In a speech at the Social Impact Investment Forum in London on 6 June 2013 British Prime Minister, David Cameron, commented:

"*In just its first year, Big Society Capital has already committed £56 million to 20 different intermediaries, already supporting 23 frontline organisations and creating 13 new social investment intermediaries. That sounds quite technical. So let me put it simply. Big Society Capital matters because it is giving brilliant social entrepreneurs with dreams bigger than their budgets, the means to prove themselves, scale up and do more."*

This is the kind of innovation that Australia's financial system should support and promote as part of its mainstream business.

Recommendations

The Property Council recommends that Government:

- develop programs to provide guidance to superannuation funds and philanthropic trustees on impact investment;
- classify private ancillary funds as a sophisticated or professional investor for the purposes of the exemptions from the prospectus regime if the sponsor of the fund meets either of these thresholds;
- simplify and streamline disclosure requirements associated with social impact bonds; and
- undertake a more active role in expanding impact investment, such as providing risk capital and establishing social investment banks.

6. Superannuation Costs and Fees

The Interim Report queried the level of fee-based competition in the superannuation industry.

The superannuation system is performing well. A recent study by Deloitte Access Economics revealed that Australian superannuation funds have the third highest returns in the world against comparable countries.

Fee levels vary according to the portfolio of assets held by a superannuation fund and how intensively and actively the assets are traded.

It is important that the current spotlight on fees does not result in an increasing dependence on low growth investments (eg. bonds or cash which are passively managed), as opposed to higher growth investments (eg. shares and property which are actively managed), as this could result in lower overall net returns for members.

If Australian superannuation funds allow the level of fees to dictate their investment strategy, they will skew their portfolio towards lower return, lower fee structured investments.

This will mean they will miss out on opportunities to invest in high quality assets such as direct real estate.

The cost of investing should be considered separately to the overall cost of operating a superannuation fund. In this way, funds will investigate investments on their merits rather than focus on overall operating costs.

Importantly, the superannuation system in Australia has a number of aspects which impact operating costs and consequently the fees charged to fund members.

The factors that increase operating costs include:

- a very high proportion of fund contributions invested in equities (51% by APRA-regulated funds and 32% for self-managed super funds) which usually need active management;
- the provision of life insurance (ie. income protection and temporary and permanent disability) as part of superannuation which is an additional member service;
- the superannuation industry is fragmented which adversely impacts economies of scale;
- the provision of fund investment choice for members (eg. conservative, balanced and growth options) which is an additional service; and
- the competition between funds as funds compete for new and existing members.

Continued consolidation of APRA regulated funds will enable superannuation funds to take advantage of economies of scale which should drive down operating costs.

In addition, 'MySuper' reforms (introduced in July 2013) are aimed at providing cost effective superannuation for members who have limited engagement with their retirement income arrangements.

As MySuper has only been operating for a little over a year, and the industry has invested significant resources to put the new arrangements in place, MySuper should be given more time to deliver lower fund costs for members.

Recommendations

The Property Council recommends that the MySuper reforms are reviewed after three years to determine whether the rules are operating as required.