REIA RESPONSE TO THE INTERIM REPORT OF THE FINANCIAL SYSTEM INQUIRY

AUGUST 2014

PREPARED BY

Real Estate Institute of Australia (REIA)
PO Box 234
Deakin West ACT 2600
Amanda Lynch
Chief Executive Officer
amanda.lynch@reia.com.au
Ph: 02 6282 4277
@REIANational
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The Real Estate Institute of Australia (REIA) is the peak national association for the real estate profession in Australia.

The REIA's members are the State and Territory Real Estate Institutes, through which around 75 per cent of real estate agencies are collectively represented. The 2011 Census records the Rental, Hiring and Real Estate Services Industry employment sitting at a total of 117,880. By occupation the key data recorded by ABS Census were 64,699 business brokers, property managers, principals, real estate agents and representatives.

The REIA represents an important element of the broader property and construction sector which together makes a significant contribution to Australia's social climate and economic development. Property contributes $300 billion annually in economic activity.

Importantly, REIA represents an integral element of the small business sector. Some 99 per cent of real estate agencies are small businesses and 11 per cent of all small businesses in Australia are involved in real estate. Only 0.6 per cent of businesses employ 50 or more persons.

REIA is committed to providing and assisting research and well-informed advice to the Federal Government, Opposition, professional members of the real estate sector, media and the public on a range of issues affecting the property market.

The REIA welcomes the opportunity to provide a response to The Interim Report Of The Financial System Inquiry.

Introduction

The Interim Report (The Report) of The Financial Systems Inquiry (FSI) considers a range of issues where regulatory reform could have an impact on business. The Report makes a number of observations and seeks the views on a range of policy options.

The REIA responds to a number of these observations. Where it has, the page and section number of the Report are identified.

Lenders' Mortgage Insurance (Page 2-23)

The Report raises the question as to whether the risk weights for insured loans should be decreased as this could improve the competitive position of authorised deposit–taking institutions (ADIs) and non-bank lenders, maintain broad access to mortgage loans and provide more capital in the system.

Overall, more than one-quarter of Australian housing loans are covered by mortgage insurance with the incidence being nearly three times this for first home buyers. According to Genworth nearly three-quarters of first home buyers in the 6 month period to March 2014 had less than 20 percent deposit. Lenders generally use mortgage insurance for loans with a Loan to Valuation Ratio (LVR) of 80 per cent or greater, given the higher risk profile of these loans.

The additional mortgage repayments resulting from mortgage insurance are around $16k for a 30 year mortgage of $500k with a LVR of 90 per cent.

With first home buyers finding it increasingly difficult to enter the housing market and home ownership in Australia declining after four decades of stable levels, any measure that improves housing affordability is fully supported by the REIA. To the extent that reducing the risk weights for insured loans achieves this is supported by the REIA.

The REIA recommends that the risk weights for insured loans be reduced.

Negative Gearing (Page 2-50)

The Report notes that the asymmetric treatment of interest costs and other expenses – which are fully tax deductable – and capital gains tax – which is taxed concessionally – encourages leveraged investment, particularly in housing. This has implications for lender risk which in turn creates a systemic risk for the financial system which should be considered. The Report then seeks a response as to how the potential risk can be mitigated.

Whilst it is acknowledged that the Report has a focus on the financial system, the REIA finds it disappointing that this focus prevents it taking a broader perspective on the benefits of negative gearing and that the arrangements are equitable across all asset classes.

Negative gearing increases increase the supply of rental accommodation with almost 1.9 million of Australians investing in the residential property and, as pointed out in the Henry Review, these arrangements place downward pressure on rents.

As such negative gearing in its current form for the purpose of property investment is complementary to the goals of Government in addressing the supply of rental accommodation. The removal of negative gearing would increase demand on social housing – an area that governments have been struggling to address.

Importantly in the context of the FSI, the majority of investors in property are ordinary ‘mums and dads’ who have only one investment property which is often part of a retirement plan and is complementary to superannuation.

It should also be noted that any changes to negative gearing arrangements will not make housing more affordable to prospective owner occupiers as there will be a supply side response. This would exacerbate the current imbalance between the supply and the demand for housing.

The REIA believes that the benefits of negative gearing far outweigh the negligible risk to the financial system.

The REIA recommends that the current arrangements regarding negative gearing remain unchanged.

Financing for Small and Medium Enterprises (Page 2- 61)

The Report observes that there are structural impediments for small and medium sized enterprises to access finance and that the cost of that finance is higher than for larger enterprises. The most significant impediment is identified as being information asymmetries where lenders have only a limited knowledge about a new borrower's financial position, the financial performance of the business and the financial behaviour of the business owner.

REIA concurs with that finding and would add that a further information asymmetry is that lenders have limited knowledge about the industry sector that a particular small business operates in and further that there are quite large geographic differences. The lack of this understanding was most noticeable in the finance sectors response to the GFC.

Despite this, many respondents to the March 2010 REIA survey in their comments felt that the financial sector did not understand the small business sector and furthermore tended to group all small businesses in the one basket without any differentiation, neither of the factors affecting a particular segment nor of the outlook for that segment.

An example of this is the treatment of rent rolls as security against borrowings. A large number of respondents to a survey REIA conducted in March 2010 to gauge the impact on finance accessibility post GFC indicated that financial institutions did not recognise rent rolls as an asset despite low vacancy ratios in the rental market and the cash flow stability offered by the rent rolls. When rent rolls are considered as an asset the LVR had changed markedly since the GFC despite the risk associated with the rent roll remaining unchanged – from 90% down to 65% of the value. This downgrading occurred despite the fact that two-thirds of respondents felt that their financial position was either the same or better than 12 months earlier.

The Report's suggestion that a data base be developed to reduce information asymmetries between lenders and borrowers would go some way towards alleviating the problem that has been identified.

The REIA recommends that a data base be developed to reduce information asymmetries between lenders and borrowers.

Superannuation (Page 2-117)

The Report seeks views on restoring a prohibition on direct leverage of superannuation funds on a prospective basis.

The REIA notes that the task of the FSI was to report on the integrity and risks to the financial system yet the arguments provided for the proposal to prohibit Self Managed Superannuation Funds (SMSFs) from engaging in leveraging could be seen as passing an assessment on what are suitable investments for individuals.

Further, it ignores the fact that lending to SMSFs is such a very small part of the financial system that it is inconceivable that it presents a risk to it, even with further growth.

There are tight controls affecting the borrower. These include the use of the property and the requirement that tenancies are at arm's length to unrelated parties. In addition there is the annual scrutiny by auditors to ensure compliance with the regulations.

To impose a prohibition on borrowing by SMSFs would put a constraint on the maximising of the profits of those funds and thus limit retirement savings.

The REIA recommends that the current arrangements regarding leveraging by superannuation funds remain unchanged.

Recommendations

REIA makes the following recommendations:

- ***That the risk weights for insured loans be reduced.***
- ***That the current arrangements regarding negative gearing remain unchanged***
- ***That a data base be developed to reduce information asymmetries between lenders and borrowers.***
- ***That the current arrangements regarding leveraging by superannuation funds remain unchanged.***