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Ms Kathleen Dermody
Committee Secretary
Senate Economics References Committee
PO Box 6100
Parliament House
Canberra ACT 2600

Email: economics.sen@aph.gov.au

Dear Ms Dermody,

INQUIRY INTO AFFORDABLE HOUSING IN AUSTRALIA

The Association of Superannuation Funds of Australia (ASFA) would like to provide this submission in relation to the Committee's inquiry into affordable housing in Australia.

About ASFA

ASFA is a non-profit, non-politically aligned national organisation. We are the peak policy and research body for the superannuation sector. Our mandate is to develop and advocate policy in the best long-term interest of fund members. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider membership, represent over 90% of the 12 million Australians with superannuation.

Terms of Reference

We have comments with respect to those terms of reference which relate directly or indirectly to superannuation.

(a) the role of all levels of government in facilitating affordable home ownership and affordable private rental, including:

> **(ii) the taxes and levies imposed by the Commonwealth, state, territory and local governments**

Determining and analysing the behavioural and market effects of the various taxes and levies which are imposed – or not imposed - by all levels of government is difficult, if not impossible.

At the Commonwealth level the main taxes which influence taxpayer behaviour and potentially affect the housing, and other, markets are negative gearing and the Capital Gains Tax (CGT).

Negative Gearing

The policy rationale underpinning the availability of negative gearing, which allows losses with respect to investments such as property/housing and equities, to be claimed as a deduction against other taxable income, is to encourage investment in those assets. With respect to residential property, a deduction is only available to the extent that the property is made available for rent, reflecting the policy rationale to increase the stock of available rental property.

In 2004 the Productivity Commission observed that: -

> *"Negative gearing facilitates risk-spreading among investments. In principle —and leaving aside tax avoidance issues — it would seemingly be both inefficient and inequitable to tax the returns from an investment in the year of gain, but not allow deductions that reduce an individual's income in the year of loss. Negative gearing also provides neutrality between investors who borrow and those who use their own equity.*
>
> *Were negative gearing more confined in its application, tax arrangements would then favour investment in income-producing assets at the expense of riskier growth assets without the income yield to cover immediate expenses".*[1]

Capital Gains Tax

Capital gains tax is applied to capital gains made on the disposal an asset other than, in the context of housing, the primary place of residence and housing acquired prior to 20 September 1983. It could be argued that the exemption for the primary residence could, in some circumstances, lead to behaviour whereby an individual consciously ties up a significant proportion of their wealth in their home, as opposed to investing in alternative assets which would produce a capital growth which would be subject to taxation.

Of course there a number of personal and lifestyle reasons which lie behind decisions as to the primary residence and it would be near impossible to determine the extent to which tax considerations play a part. The time when this is most likely to be pertinent is when it comes to any decision as to whether or not to "down-size" at some time after children have left home.

Tax within superannuation

With respect to housing held within superannuation, the applicable rate of tax depends on whether the housing asset is supporting members' interests which are: -

- still in the accumulation phase – in which case the gain is discounted by 33% and then taxed that the applicable rate of tax on superannuation fund income (15%); or
- in the pension phase – in which case the capital gain is tax free.

[1] Productivity Commission Inquiry Report into First Home Ownership, No. 28, 31 March 2004, Page 117 http://www.pc.gov.au/__data/assets/pdf_file/0016/56302/housing.pdf

Use of Limited Recourse Borrowing

For a variety of reasons, including the fact that capital gains realised in the pension phase within superannuation are tax free, a number of Self Managed Superannuation Funds (SMSFs) have invested in housing, including accessing limited recourse borrowing to be able to do so. Indeed it has been suggested that this may even be a driving force behind some people acquiring an SMSF in the first place and may even have been partially responsible for the recent increases in house prices.

The exposure to assets financed by limited recourse borrowings as at June 2012 (the latest available data) was not large at $2.26 billion relative to overall SMSF assets of $438 billion at that date. However, this amount has been growing rapidly, from only $665 million as at June 2010.

Limited recourse borrowings have only been possible in recent years. In September 2007 a new exception to the borrowing restrictions applying to superannuation funds was created. The exception allowed instalment warrants to be used to purchase any permitted asset.

In 2010 the conditions imposed on the permitted arrangement were refined and are:

1. the money borrowed is applied to purchase a single asset;
2. the asset that is purchased is held in trust for the superannuation fund and the fund has a beneficial interest in the asset;
3. the asset is one that the superannuation fund is permitted to purchase under the *Superannuation Industry (Supervision) Act 1993* (SIS) and regulations;
4. the superannuation fund has a right, but not an obligation, to acquire the asset after making one or more instalment payments; and
5. the loan style is of limited recourse, where the rights of the lender to recover the loan in the event of a default are limited to the asset purchased.

The loan to the fund is not required to be from an approved lender or an issuer of instalment warrants such as a bank. However, most major banks and lenders have become active in this market, offering limited recourse loans of up to 80% of the value of a residential property.

There has been some public commentary on the impact on residential property prices of purchases by SMSFs making use of borrowings. This includes comments in the September 2013 Financial Stability Review published by the Reserve Bank of Australia that: -.

> *"One risk of the increase in property investment by SMSFs is that at least some of it is a new source of demand that could potentially exacerbate property price cycles".*[2]

In terms of the relative magnitude of property investments by SMSFs, these are likely to represent only a relatively small proportion of overall property sales.

Each year in Australia there are between 360,000 and 450,000 residential property sales. Around 20% of these are first home buyers, 60% are repeat purchases by owner occupiers and around 20% are by investors. The total number of investment property purchases are

[2] Reserve Bank of Australia, Financial Stability Review, September 2013, Page 49
http://www.rba.gov.au/publications/fsr/

likely to be around 70,000 to 90,000 a year. Based on the ATO figures and assuming an average purchase price of approximately $500,000, which is around the median for residential property purchases, the number of residential property purchases by SMSFs supported by borrowings might have been a low as 3,000 in 2011-12 if allowance is made for other investments, such as shares, purchased through limited recourse arrangements.

However, it is difficult to be definitive given the lack of hard data. The latest ATO data relates to the position of SMSFs as at June 2012 and since then there appears to have been an increase in the activity of “property spruikers” strongly pushing residential real estate purchases by SMSFs.

It also is possible that some SMSFs may not have been filling in their returns to ATO correctly. Borrowings reached $6.3 billion in June 2012 but the value of assets supposedly related to limited recourse borrowings was only $2.3 billion. Funds are not permitted to borrow for other purposes (other than short term to pay benefits or settle a securities transaction). It seems plausible that many SMSFs listed the assets associated with borrowings under the “residential real property” label rather than the residential real property sub-category underneath “limited recourse borrowings”.

Around 3.7% of SMSFs have borrowings, around 18,500 funds in total. Many of these funds have borrowings to support a residential property purchase. The average borrowings of those funds with borrowings was around $340,000, which suggests borrowings were used for a significant asset such as a residential property rather than for any short term purpose.

A plausible figure might be that there were around 8,000 or 9,000 residential property purchases by SMSFs in 2011-12 that were supported by borrowings. This is not a large proportion of overall property sales but it would represent over 10% of investment property sales. For some geographic areas or property market segments the percentage could be higher. As noted above, there is likely to have been growth in the number of such purchases since June 2012.

<u>Superannuation legislative requirements regarding property</u>

In order to be an appropriate investment for a superannuation fund, having regard to the Sole Purpose Test in the SIS Act, the investment rules in the SIS regulations and the requirements of the APRA Superannuation Prudential Standards, any property would need to be leased out on an arm’s length, commercial basis.

<u>Social Security</u>

From a social security perspective the primary place of residence is largely exempted from means tests imposed with respect to eligibility for Commonwealth income support payments and other entitlements. Similarly to the CGT primary residence exemption above, the exemption of homes from mean testing could, in some circumstances, lead to an individual consciously tying up a significant proportion of their wealth in their primary residence, as opposed to investing in alternative assets which would be subject to means testing.

Again, like the CGT exemption for a primary residence, there are a number of personal and lifestyle reasons which lie behind decisions as to the primary residence and considerations as to means testing are most likely to be pertinent is when it comes to any decision as to whether or not to “down-size”.

States and Territories

At the level of State and Territory governments, the most obvious taxes and levies which drive behaviour and distort markets are the imposition of stamp duty on the acquisition of property and the land tax on property other than the primary place of residence.

The imposition of stamp duty, as a significant transaction cost, represents a material barrier to the ready sale and acquisition of property, especially in those states where the stamp duty is at a higher rate. Like CGT and social security means testing, the imposition of stamp duty can act as a disincentive to "down-sizing" properties at some stage after children have left home.

Victoria offers a concession with respect to purchases of land and building packages or refurbished lots. It allows a deduction from the contract price of the cost of construction or refurbishment which will occurs on or after the contract date, so effectively duty is only paid on the improved value of the land, the non-deductible costs and the degree of completed construction or refurbishment as at the contract date. This can act as an incentive to acquire a property "off the plan" and serve to stimulate building construction.

The imposition of land tax on properties other than the primary place of residence can also drive behaviour which distorts the market, as it can act as a significant barrier to investment in property.

(a) the role of all levels of government in facilitating affordable home ownership and affordable private rental, including:

(v) the regulatory structures governing the roles of financial institutions and superannuation funds in the home lending and property sectors

Superannuation trustees first and foremost owe a fiduciary duty to the members of their funds. Accordingly, they determine their investment strategies, options offer to members, asset allocation and individual investment decision on the basis of seeking the best risk adjusted returns for their members, having regard to factors such as the demographics of the fund and the flow of contributions and benefits.

Superannuation trustees are also subject to the provisions of the SIS Act, including the Sole Purpose Test; the investment specific provisions of the SIS regulations and APRA's Superannuation Prudential Standards with respect to investments. The Sole Purpose Test essentially states that the fund must be maintained for the purposes of providing benefits to members on their retirement or in the event of death, disability or severe financial hardship prior.

Legally - investing in property, either directly or indirectly, generally is available to trustees of a superannuation fund, with some (limited) exceptions with respect to imposing a: -

- limit (5% of total fund assets) as to how much can be invested in an "in-house asset"; and
- prohibition on the acquisition of an asset from a member of the fund or a relative of a member.

An in house asset is a loan to, an investment in or a lease to a related party or trust of the superannuation fund, such as an employer or member. An asset of the super fund that is leased to a related party is also an in-house asset. There is an exception for *business* real property which is subject to a lease between the fund and a related party of the fund.

Investing in housing debt can involve other challenges for superannuation funds. Legally, superannuation fund trustees are not registered credit providers and so are unable to provide direct loans to consumers for housing. However, superannuation funds do invest in securitized housing debt. That said, to invest in securitized investment superannuation funds still need to have credit skills. Housing supply bonds are one way of accessing housing debt but securitization in Australia is the most prominent method at the moment for institutional investors such as superannuation funds.

(d) The contribution of home ownership to retirement incomes

Home ownership with no mortgage debt makes a substantial contribution to the living standard of retirees.

An average weekly rental of $400 a week often would be involved for even a modest dwelling if the retiree is in private rental accommodation, particularly in the case of major capital cities. This would involve an annual expense of around $17,000 a year in excess of the likely expenditure on the ongoing costs of home ownership. An average retiree would need in excess of an additional $420,000 in retirement savings to cover the long term costs of rental accommodation.

The pressure on a retiree's budget is less if they are in public housing at a subsidised rental but public housing is generally subject to means testing and other limits on access.

(l) the role of innovative and responsible funding mechanisms used in other countries, including the United Kingdom, United States of America, France, Canada, Austria and the Netherlands, that provide a stable and cost effective way of funding affordable rental and social housing, such as affordable housing supply bonds and an affordable housing finance corporation

The extent to which superannuation funds would be prepared to invest in housing supply bonds would be dependent on the way the bonds are structured and their underlying risks. Housing supply bonds in other jurisdictions have involved government taxation concessions. If government support is provided that addresses bond investors' needs around risk and volatility then superannuation funds though their fixed interest investment managers would consider such investments as part of their portfolio.

We that the Australian Government has attempted to stimulate private investment in affordable housing through the National Rental Affordability Scheme. This scheme has struggled to attract institutional investors due to a range of factors including the commerciality of projects. The challenge that superannuation funds would face investing in housing supply bonds is the degree to which the investor is exposed to construction risk. Investment return is one component that determines the appetite for investment. Just as important is risk. Bond investors are seeking low volatile investments. A key element of any housing bond would be guarantees around the actual risk of the project both in terms of construction, and in terms of tenancy revenues.

For larger superannuation funds directly investing in equity in housing, while possible, poses particular issues with respect to managing the property or properties, including its leasing and maintenance, and its relative illiquidity. Indirect investment in equity in property tends to occur through the use of property trusts, although these are generally invested in commercial property, not housing.

(p) any other matters the committee considers relevant

One additional matter which is not explicitly addressed in the terms of reference but which is likely to be raised is whether early release of superannuation should be allowed for the purpose of purchasing a first home.

For the superannuation system to be truly effective any payments made from it should be in the form of income in retirement (other than in the event of death, disability or extreme financial hardship prior to retirement).

ASFA does not support any proposal to allow the early release of superannuation savings for the purpose of acquiring property. As a result of the compounding effect on the value of savings and investment, any early release of superannuation leads to a material reduction in the amount of superannuation accumulated to provide income in retirement.

An additional consideration is that it could be argued that any early release of superannuation would only serve to further inflate house prices and make housing less affordable than it is at present.

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If you have any queries or comments regarding the contents of our submission, please contact me on (03) 9225 – 4021 or 0431 490 240 or by email fgalbraith@superannuation.asn.au.

Yours sincerely

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