

CORRECTED VERSION

LAW REFORM COMMITTEE

Inquiry into property investment

Melbourne — 12 November 2007

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Witnesses

Mr K. Sharp, State Director, and

Ms P. Sciarrone, Association of Financial Advisers.

The CHAIR — Welcome. Thank you very much for taking the time to come in to talk to the Committee. Your contribution is valued. A few preliminary things that you heard me allude to before. The discussions here are subject to the Parliamentary Committees Act in Victoria and that extends parliamentary privilege to anything that you say here, which basically means that people cannot take legal action for anything you have said here, but if you say the same things outside the building obviously it will not apply there. Hansard is recording the conversation. You will be sent a copy of that transcript after the meeting. You can make some slight changes to that but obviously the substance of it cannot be changed. Thank you very much for the material that you have sent to us and that we have had time to look at. We have about half an hour. We will leave it to you and then we will come in with some questions and discussion and round up at about 3.30 p.m.

Mr SHARP — Would you like me to go over the presentation?

The CHAIR — Yes, absolutely.

Mr SHARP — I have spoken to a number of our members, I emailed all our members in Victoria and asked them for responses and we had a conference in Queensland when I publicly announced that we were trying to prepare our presentation to this Committee. I started the presentation with a little about the Association of Financial Advisers. The presentation is quoting some of the comments that some of the members have made. I have chosen those because they seem to be germane to the general view of our members. I have summarised that. The general consensus is that:

Purveyors of investment properties often achieve poor outcomes for their clients.

The opportunity (and actuality) of earning multiple income streams from a property sale may attract those who seek to earn money rather than to provide a service.

The 'industry' is [genuinely] unregulated.

Practitioners are not licensed ...

There is no standard form of disclosure.

For the above reasons, our members are loathe to recommend investment property to their clients.

One of the quotes I have provided here was from a Patrick Byrne who, at one point in his practice, referred clients to someone who was selling investment properties. The outcomes were so poor that it actually cost him clients. So he has vowed that that is not going to happen any more.

The thrust of the presentation is basically that in the view of the Association of Financial Advisers, property investment advisers should be regulated within the existing financial services regulation. Being cognisant that that is, of course, federal legislation and this is a Victorian affair, something similar, maybe. I do not know. Basically that is because it seems to me, in listening to Neil Jenman's comments, it is truthfully all about disclosure. If adequate disclosure were made, then probably people would not be caught up quite as often. That basically is what the financial services regulation does — it imposes a lot of penalties. If I was to sum it up, it is a matter of disclosure.

I have pretty much gone on to explain why that might work. The reason that you might have a disclosure regime or some overarching regulation on how investment property should be sold would be that those who operate in the industry obviously would be obliged to follow the regulation. If they fail to follow the regulation they would not be in the industry very long and if they did follow the regulation, if the regulation was well enough framed, then they would be providing a service who purchased properties from them. So that is basically how that works. I went on to maybe hypothesise on how that might work.

At the very end of the presentation — and unfortunately my appendices markers did not come out because my scanner did not recognise them, but on the very last page of the presentation is something prepared by PRD Nationwide. The only reason I put it in was to show you how much information can be added to a single page. This is actually an analysis of a suburb — Castle Hill in New South Wales. It seems to me that much of that information might be pertinent to a property disclosure, with another little section there on information relevant to that individual property.

I have hypothesised that if property investment real estate agents were obliged to produce a statement of this type, and they were legally responsible and liable for all the statements made in that disclosure, then the person considering purchasing an investment property could seek the advice of a financial adviser who is regulated under financial services regulation. The adviser's role would be to compare this presentation with other options or to compare this presentation with other presentations. I am envisaging a situation where a person who is interested in an investment property might seek, or look at, a number of properties and get a number of fact sheets of this type and then go to a financial adviser who is able to analyse the information on the sheets and compare them to what suits the client.

That is another key to the financial services regulations. The regulations put onerous responsibilities on the adviser to understand the client, not only in terms of debriefing and having the information on file with the questions that were asked, but also in understanding the information they have gleaned from the client. One of the major impediments in FSR from an advice perspective is in offering advice that does not reflect the client's needs. There is no impediment to offering poor advice so long as it meets the client's needs. There may be three options.

As an adviser you cannot be dinged for picking the poorest option; you can only be attacked if you pick an option that does not suit the client. The financial adviser might then analyse these individual sheets of the properties the potential investor has seen and relate those to his particular situation. Further, he might also compare these investment properties with other asset classes. I have suggested that investment property is only a different asset class. As a financial adviser I can access property trusts — listed and unlisted — and other property-based investments. I am suggesting that investment property is only another asset class.

The financial adviser would analyse these individual asset classes in relation to all other asset classes. The advice would, by legislation or financial services regulation, also include an insurance recommendation, or warn the client if the adviser is not capable of making an insurance recommendation that he has insurance needs in terms of income protection and life insurance, and just analysing the things that can go wrong in somebody's life, and wherever possible where a risk has been identified, cover that risk.

The advice the adviser might also then consider is how this particular asset fits in with his overall retirement plans, and depending on the age of the client, how the asset might be realised in retirement or utilised in retirement to provide an income stream. You can see that a financial adviser would add much to just a simple property purchase. Australia has a love affair with property. As Neil said before me, it is perceived that property cannot go down in value; it most certainly can and most certainly does particularly if somebody has paid too much for it in the first place. Even a well-purchased property can go down in value. It is just that the perception of the populace is that it does not occur. My experience of people who I see in my practice in Essendon is that where people have purchased investment properties they think it is a no-risk option, and in truth it is not. I think I have done good service to the presentation I have put before you.

The CHAIR — Thank you. Pina, do you want to add anything?

Ms SCARRONE — No, I do not really. I actually sit on the other side of the fence in terms of also representing the industry in that I work for a life insurance company. Everything that Kerry has put forward makes absolute sense. We see property investments as purely just another asset class. I think the important point here is that what is missing is advice, and overall general advice in slotting property in with everything else and fully disclosing the risks related to property versus other investments as well, and relating it back to the client's needs and where they are in terms of their life stage. I think the holistic approach is really the right way to go with a client. I find that the people who are pushing the property do not necessarily have that holistic approach, and I think that is what is missing.

The CHAIR — Just by way of opening I want to ask a question about the second page of your presentation where you talk about the findings, or the perceptions, that came out from your members in the focus group. There are seven or eight dot points. The first one says:

Purveyors of investment property often achieve poor outcomes for their clients.

I know that is a perception from a group, but is that evidence-based at all?

Mr SHARP — No, only evidenced by the advisers who have made that statement.

The CHAIR — Do you have any research or views — have you any hard evidence — on the number of financial advisers who actually give advice about direct property investment?

Mr SHARP — There are difficulties in relation to this. There are two difficulties, and I probably need to go back a little. Financial services regulation creates an entity called an Australian financial licensee, in other words someone who holds a licence. It also creates authorised representatives; somebody who the licensee authorises to sell. The licensee must have an approved product list and the authorised representative can only sell products that are on the licensee's approved product list, or he may gain an exemption to include a product that is not on the list. You can see that that structure precludes recommending on individual property as an adviser. As a financial adviser I cannot create a financial plan for somebody and slip in a recommendation to buy an investment property. Investment property actually is not a financial product, so therefore I am able to sell it. This talk about it not being on an approved list to some degree is not relevant because I can choose to sell an investment property in any capacity that is suitable. The difficulty is that I cannot include it on a plan because the licensee would walk away from it, the professional indemnity insurance would walk away from the recommendation. With this background you will see it is very difficult for a financial adviser to recommend property at all. That is why the comment was made earlier from one of our members who said he referred to people of this class and found that the recommendations cost him the trust of his clients.

Ms SCARRONE — You do have some financial advisers who will go out and get a real estate licence but that is few and far between. There are some groups that do that.

Mr SHARP — There are some groups who actually market. I can think of one in particular who developed retirement villages and they sell these retirement units as a recommended product through their adviser base. There are a few others, I suppose they term themselves as wealth licensees.

Mr FOLEY — But in doing so they are still subject to the FSR regulations as a result?

Mr SHARP — No, because property is not a financial product. It skips financial services regulation entirely.

Mr FOLEY — So they take their FSR-accredited hat off and do not put any accredited hat on.

Mr SHARP — They change hats. What hat they put on, I do not know.

The CHAIR — One of the questions we thought of asking you in preparing for this was: do any of the existing education courses for financial advisers provide training about direct property investment? How does that question in a way make sense given what you have just said?

Mr SHARP — It does not given that it is very rare, but yes, there are courses that do exist. I was involved, when I was on the professional standards of the AFA, with a college in Sydney that was running a direct property course as part of financial advice. It is relevant because as advisers we come across clients who have direct property. I think the course was aligned to understanding property at a greater depth in case that might impact on their affairs — I did not ever do the course. But yes, there is training available.

The CHAIR — Right. But it is really training, going back to what you said before about being careful to keep a separation between them and saying that you really ought not be providing advice around property because of the fact that it is not a financial product, direct property.

Mr SHARP — Absolutely, but you would not need to be trained for that.

The CHAIR — Exactly.

Mr SHARP — That is part of the financial services regulations under which we are all judged and audited. I am audited twice a year. The licensee pulls out four files and audits them in relation to a list of 195 questions — I have included ones that would be reported to ASIC if these were breached, so these would be serious breaches. It is not that advisers need to be trained to work in the environment, they understand the environment. I suppose at the end of the day it is an asset class that could be analysed in just exactly the same way as any other asset class can be, with the exception of course that location is an unquantifiable event. Maybe the age of the property ends up quantifiable. I guess with an investment property there are things that cannot be dealt with quite as statistically as the investments we are currently used to dealing with.

Ms SCARRONE — The advanced diploma in financial planning does cover direct investments from a risk point of view in terms of comparing the risk of that compared to shares or something else. It does bring in direct property.

Mr FOLEY — Just one as a part of a broader catalogue.

Ms SCARRONE — That is right; or capital gains tax implications, for example, when people are talking about that. It will pool direct property in that way.

Mr FOLEY — The Committee has heard that there is a whole range of different groups and occupations involved in property investment, not surprisingly — accountants, lawyers, valuers, real estate agents, clubs, loan raising schemes, developers, financial planners, all sorts of people, financial advisers. If we were to be persuaded by your argument that the FSR-type of model was the way to go, which of course is, as you say, a national regulation, how do you think that would play out across all of those groups? That is assuming of course that there is an appetite at the Commonwealth level to go down that path; I suppose I am asking you to be hypothetical there. If the Commonwealth were not persuaded to go down that path, what is your Association's view on any one or more state jurisdictions striking out alone down that path of an FSR-type model? And what would that do to compliance and comparative positions between jurisdictions? Would we see flight of capital?

Mr SHARP — Let us take it one at a time. National legislation seems like the answer, to me. What would state legislation look like? We have got a mortgage broking industry which is not regulated nationally. The previous point about self-regulation does not work. It probably does not because it is not mandatory, but the peak bodies, the AFA, the mortgage broking association — I am talking about mortgage broking because it is viewed as a financial product but it is state controlled — the mortgage body implement the sorts of standards that probably would be put in national legislation, if it was applied, and then they mandate their members to follow it. Self-regulation can, if you like, set the scene, but it does not to my mind really have the teeth. How would state legislation work if it was to come in? It would be probably along the same lines. The difficulty that we see in investment property is it is very disparate. There is not a body that sells investment properties. Every real estate agent would feel that it was his bailiwick to sell investment property. Every property developer would view that they could sell investment property. The sort of marketing companies that Neil Jenman was talking about think it is their role to sell investment properties. It is not as if there is actually an industry per se in relation to investment property, so it does become a major problem from my perspective. Did I pick up —

Mr FOLEY — Yes, pretty much.

Mr BROOKS — I was just going to ask about the issue that has been raised by a number of witnesses at the hearings about the conflict that arises between people providing advice on commission compared to people charging a fee, and how you might see that work in relation to property investment advice.

Mr SHARP — By conflict of interest do you mean where an adviser makes additional money from a non-disclosed choice of investment?

Mr BROOKS — Yes. So you say it comes back to disclosure.

Mr SHARP — Yes, it comes backs to disclosure. Conflict of interest is impossible in the financial services regulation — if it is followed. We have heard about financial advisers who are accused of conflict of interest; that is only because they have not followed the legislation. It is totally impossible. In fact, on the page with the heading 'Disclosures' and continuing on the following page with the headings 'Applications' and 'File maintenance', it states:

Have all relevant fees and commissions been disclosed in writing?

Have any bonus entitlements been disclosed?

Have soft dollar benefits been disclosed?

That, incidentally, refers to when, for example, you have a computer system provided by somebody whose product might be favoured.

Have generic incentive awards been disclosed?

Have cumulative rewards or bonuses been disclosed?

Have all initial, exit and ongoing fees been disclosed?

Have ... deferred entry products been disclosed?

Has the affiliation ... been ... disclosed?

It goes on to refer to referral fees and conflicts being adequately identified and managed. You can see, without reading them all, that conflict of interest is well covered under the financial services legislation and consequently, in my view, does not exist. The choice of whether a client accepts the payment that is due to an adviser through writing a cheque or by having it basically added to the cost of the product they purchase is entirely their choice. My view as an adviser is, I merely need to be paid. How the client chooses to do that in my view becomes a financial planning exercise. So if I can devise a way where their fees are deductible and non-cash flow, that is better than their writing a cheque. Often the way that that is most ably done is through a commission. So the mode of payment is not a potential conflict of interest; it is only lack of disclosure.

Mr FOLEY — You would not have any difficulty if that were mandated for all the groups in the property advisory area to have a similar disclosure of such commissions and outcomes?

Mr SHARP — No.

Mr FOLEY — Because you do it now in the financial products.

Mr SHARP — If clients know about things, they can make informed decisions. The truth is that the clients do not read the plans. I can produce a financial plan that is very succinct but twice as thick as this — no padding — and I can say to a client, ‘Here, read this’, and they will say to me, ‘No, no, no. I believe that is good. Where do you want me to sign?’. Okay, I have been dealing with them for a while and they trust me, but the point I am making is that once trust is established, whether it is deserved or not, the clients do not actually read the plans.

The CHAIR — Can I just ask: when you started out, you said that one of the key informing issues here is the matter of disclosure, and I was thinking that disclosure itself is not unproblematic in that when you put that document in front of someone — yes, partly it is a matter of trust and people not wanting to do something that is arduous when someone has already done it for them — it is partly because documents like that are difficult.

Mr SHARP — Absolutely.

The CHAIR — Going back to Neil Jenman’s contribution and his description of the kinds of people we are talking about, we are talking about people — I am like that myself in a lot of ways, too — without any skerrick of understanding of a lot of things to do with the technicalities of law. These areas that you dot point here — each one of those, I would suggest, is quite complex. Disclosure itself carries with it a whole series of complexities, which goes to the education of the community and the consumer, which is part of what we are up against.

Mr SHARP — Or it goes to the potential property purchaser having the ability to seek financial advice off a standard disclosure, so they can see three properties and then go and see a financial adviser, who will be able to make sense of it for them. If those standard documents include the disclosures, then the adviser can make sense of those disclosures. That is what a financial adviser does. My view is, I merely devise strategies that achieve outcomes for clients — that is pretty much it — and make sure they understand it. There is a very big educational element.

The CHAIR — All right. As there are no further issues, we thank you both for coming along and sharing time with us, and especially for this quite detailed submission that you lodged with us last week, which is terrific. You will, as I said, get a copy of the Hansard transcript that you can have a look at, and ultimately that will appear on our website as part of the work of the Committee. I am sure that Kerryn and Susan will be in contact with you if there are any matters that we need to follow up.

Witnesses withdrew.