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Property Investment Advice Working Party
Office of Fair Trading
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28 October 2004

Dear Sir/Madam

Submission in response to the Property Investment Advice Discussion Paper

The Consumer Credit Legal Service (Vic) Inc (CCLS) is pleased to contribute this submission to the Ministerial Council on Consumer Affairs Working Party.

CCLS is a community legal service that aims to serve individuals and groups who have been mistreated in the financial services market and who are disadvantaged in their access to legal redress, and to influence and effect reform to unfair practices and the law through policy work, research and advocacy.

This submission is endorsed by the Consumer Credit Legal Centre (NSW) Inc.

CCLS has had considerable experience in litigating on behalf of students enrolled in Henry Kaye's National Investment Institute Pty Ltd. Our NII clients were, as a class, no more 'sophisticated' than consumers generally and displayed the same vulnerability as consumers do when confronted with complex financial products. Our experience and, anecdotally, the experience of other caseworkers, shows that the traditional dichotomy between 'consumer' and 'business or investment' upon which consumer protection remedies are based is not an accurate representation of the genuine community need for protection in the financial services market generally.

Our clients frequently did not fully understand the mechanics of the investment strategy being promoted, but were convinced to sign up based upon broad representations of low-risk, high-yield investments. When our clients paid for and attended property investment courses and seminars, or attempted to put such strategies into play, they found that the complexity and sophistication of the strategies made them inappropriate for use by all but the most experienced property investors.

In addition to our experience with NII matters, we are also familiar with the promotion of some property investment strategies or schemes such as "wraps" (vendor terms) or lease options, through providing advice to consumers who have purchased properties from the investors.

We set out our responses to a selection of the questions raised in the Discussion Paper as follows.

1. What do you see as the key factors driving the growth in retail property investment in Australia in recent years? [Section 3]

For some years there have been strong messages (from many sources) that we all need to invest more – particularly to ensure a comfortable retirement. For consumers who do not understand (or feel comfortable with) other forms of investment, real estate investment may feel familiar or somehow less risky (whether real or perceived). Many people have purchased their own home – if not, they have been a tenant (and possibly resented paying the landlord's mortgage). Many know that their parents paid very little for the family home that is now, worth hundreds of thousands of dollars. While our family home may have dropped in value from time to time, this is held over a long period of time and such drops in the market have not seemed significant. We can see and touch real estate. It appears simple to understand.

Marketers of property investment advice (or others who may gain financially from property investment) use this to their advantage. Some marketing strategies by businesses have even been described as aggressive. Indeed, an ASIC investigation earlier this year found that the advertising and marketing strategies used by some property seminars 'recklessly overstate benefits and use psychological manipulation to draw people in'.

In addition to property investment advisors, many industry participants benefit from consumers' enthusiasm for property investment, including lenders, finance brokers, estate agents, property managers, conveyancers, solicitors – even newspapers.

2. Have retail investors generally had a sufficient appreciation of the down-side risks associated with property investment? If you think a significant portion have not, can you suggest why this may be the case? [Section 3]

For some of the reasons stated above, we don't believe that many retail investors understand the down-side risks. While familiar with borrowing for the family home, they may have little experience of borrowing to invest in property, in assessing the impact of tenant demand in the market, or little understanding of tax implications or concepts such as negative gearing.

3. How does the market for investment advice about property operate in Australia today? How are advisory services being provided and by whom? [Section 4]

Possibly a relatively new problem for regulators is the promotion of myths in the market place. CCLS has worked for some time on problems arising from misleading sale of line of credit mortgages, however it has become clear that while some finance brokers are making clearly misleading statements, there are a large number of players in the industry – and in the media – who promote this myth.

Some problems relating to property investment advice appear similar. Consumers have some basis for believing that property is a good investment, and some promoters engage in conduct that is clearly misleading. However, the myth that property is "always a good investment" and that "you can't lose on property" is more subtly perpetuated by many players in the marketplace. For example, one website that refers to property investment says " There is probably no doubt in your mind, that the best investment you have is your home. So why not invest further in real estate".

For some consumers, we understand their beliefs about property investment arise from a combination of many messages from a large number of sources. It is therefore important to recognise that it is not only the "big" misleading statements that distort the market.

The other "players" in the property investment market (not clearly identified in the discussion paper) are those companies that offer information to investors (and sometimes purchasers) about "wraps" or lease options. Some of these organisations also play a facilitation role – dealing with the investors and purchasers, drawing up contracts etc. Some of these organizations also play a facilitation role – dealing with the investors and purchasers, drawing up contracts etc.

These arrangements often cause problems for the purchasers (who are usually not investors), including:

- Risks involved if the "investor" fails to maintain payments on his or her mortgage;
- High costs;
- Low quality housing requiring significant spending on maintenance;
- Complex legal arrangements.

However, the other party (the investor) has often followed this strategy on the advice of an organization that has arranged the contracts, or from a book, kit, "boot camp" or website. We believe that in some cases it is likely that investors have not been provided with balanced advice, and that investors – as well as purchasers – could be at risk using some of these strategies.

For example, wrapping is often presented as a "win-win" where both parties benefit. However, at least on the relevant websites, there is little, or nothing, about risks such as inability to find consumers interested in a wrap either initially, or if the wrap deals falls over. It appears that most wraps involve lower priced properties – often in regional areas – where historically property values have not increased as they have in the city. This creates significant risks for the purchaser as well as the investor. See Appendix 1 for examples of how this information is sometimes presented to investors.

4. Is our characterisation of the seminar operators/investment promoters fair and accurate? If not, in what respects is it inadequate? [Section 4]

The characterisation of the seminar operators/investment promoters in the discussion paper aligns with the experience of our clients. However, as stated elsewhere in this response, we believe the problem goes well beyond seminar operators/investment promoters.

8. Do you have any comments on our outline of the current legal framework? Apart from those we have considered, are there other laws or regulatory mechanisms relevant to the regulation of property investment advice and training activities? [Section 6]

The current legal framework is complex, and the responsibility is divided between too many regulators.

9. Do you agree with the stated objectives of government intervention in the property investment advice market place? If not, what should government's objectives be? [Section 7]

We agree with the stated objectives of government intervention.

12. If a new regulatory scheme were to be introduced, what should its scope or coverage be? What activities should be covered, in respect of what types of property, and who should be protected? Do you agree that related advice about the financing of property investment should be covered? [Section 8]

Consumers who borrow to purchase an investment property do not have the protections of the Uniform Consumer Credit Code, because the purpose of the credit is "investment". In fact these consumers do not even have protections offered by (albeit inadequate) State based finance broker legislation.

A new regulatory scheme should ensure that advice about finance is covered – and also that the credit contract is regulated by the Uniform Consumer Credit Code.

The number of players who are often involved in property investment deals is a problem that must be addressed. Increasingly, in a range of areas such as credit and property investment, a number of parties may play a role – for example an advisor, a vendor, an agent, a solicitor and a finance broker. The consumer may not know the roles of various parties (for example whether they are agents of another party) and may be unable to identify which party was responsible for certain conduct. This is the same problem that often arises in relation to complaints against banks or finance companies where finance brokers are involved.

Consumers should not be disadvantaged because a transaction involves a number of parties who may not be in agent-and-principal relationships. While linked credit provisions in the Trade Practices Act, and Uniform Consumer Credit Code, have provided important protections, they are limited to referral by a seller to a lender. We believe that similar, but broader, provisions should be introduced that increase the obligations of the provider of goods, services or credit as a result of breaches of the law by those with agreements to refer customers. Failure to tackle this problem may seriously reduce the effectiveness of regulation.

14. Is there a role for self-regulatory or co-regulatory mechanisms (for example a voluntary industry code or a mandatory code) in the regulation of property investment advice? [Section 9]

We are not convinced that self-regulatory and co-regulatory schemes provide effective consumer protection, particularly in sectors which comprise a large number of small businesses and which lack a strong industry association with near-universal subscription by those businesses. The problems which have faced the finance broking sector are a good example of the regulatory difficulties which may be met.

15. If a new regulatory scheme were to be introduced, how detailed and prescriptive should the scheme be? Are there particular regulatory requirements or mechanisms that should/should not be introduced? Should those involved in the provision of advice about property investment be required to be licensed? [Section 9]

We favour the establishment of an industry-based alternative dispute resolution schemes to cover the provision of property investment advice. Historically, and with particular reference to the financial services market, industry-wide membership of such schemes have conferred considerable benefits upon consumers in a cost-effective manner. However, licencing of advisors is required to enable compulsory membership of a scheme, professional indemnity requirements and to enable monitoring and effective enforcement in relation to unfair conduct.

While we are aware that licensing imposes compliance burdens upon industry and is considered a barrier to new market entrants, we believe that the benefits to consumers in restricting the activities of rogue traders outweigh these negative implications.

Further, we are not satisfied that markets in which complex products prevent effective demand-side engagement in the competition process suffer significant detriment as a result of anti-competitive regulatory frameworks. The property investment advice market deals in products of such complexity that, in almost every transaction, it is only the supplier who can fully and expertly assess the relative merits of the subject product. In such markets, competition does not confer as many tangible benefits upon consumers because, without expert training, they are commonly unable to objectively assess whether one product represents a superior choice than another. Consumer choice is more likely to be driven by convenience, word of mouth and saturation-level of advertising. Often, a large organisation will obtain greater custom merely because its size suggests to consumers that it has a greater prudential standing than another. In the context of a market which operates in such a manner, the lessening of competition attendant upon comprehensive regulation is clearly outweighed by the benefits conferred by increased consumer protection.

16. What is your preferred Option among those outlined in section 9? Why? Are there other or variant Options that we should consider? [Section 9]

We support Option Three.

Property investment advice warrants comprehensive regulation in that, similarly to financial services, it is a complex product involving high-value transactions which is marketed to ‘mums and dads’ who lack expertise. Accordingly, the retail investment market is as a whole suffering from an imbalance of bargaining power and ability to understand the nature of the products and transactions which places the supply side of the market equation at a distinct advantage to consumers.

17. If a new regulatory scheme were to be introduced, should it be a Commonwealth or a State and Territory responsibility? [Section 10]

At a minimum, nationally uniform regulation is required. However, its effectiveness would depend on the commitment of each individual State agency – and our experience with the national Uniform Consumer Credit Code suggests that this form of regulation can be difficult and slow to amend, even where clear problems or loop-holes are identified. We would prefer national legislation, on the condition that it was placed with a regulator that had the resources to enforce it.

Please contact me on 03 9670 5088 or with any queries in relation to this matter.

Yours sincerely

CAROLYN BOND
MANAGER

Appendix 1 – Examples of websites promoting property investment

This appendix includes text from property investment promotion websites, as at 28 October 2004. The websites themselves can be accessed by following the links.

http://www.thekeyresult.com.au/investors.htm

The Key Result

Are you asset rich but cash poor?
Are you concerned about having enough money for retirement?
Are you aware of the Equity in your property?
According to the ASFA "50% of aged pensioners in Australia are in the poorest 30% of the community". Superannuation may not be sufficient to cover your needs at retirement. Have you thought about where you will be at retirement?
The Key Result's 'Key Investment' is a program designed to enable you to utilise the equity in your property to generate a positive cash income. You can use this income to pay out your existing Mortgage up to 4 times faster than normal or to positively gear any investment properties you may have.
Equity is the difference between the value of your property and the amount owing to the banks. The 'Key Investment' program can unlock this Equity in your home and make it work for you immediately.
How it works
We help people (Home Buyers) who are serious about home ownership but don't qualify for a bank loan. You, the Investor, purchase their home and receive regular repayments from the Home Buyer for the following 5 years. You retain the property title until the purchase is complete.
The Key Result guarantees a return typically in excess of $100 profit per week to the investor.

You can use the 'Key Investment' program in one of two ways:
Debt reduction
Pay off your mortgage between 2 and 4 times faster than normal.
Find out how quickly your Mortgage could be paid off.
Weekly cash flow
A great way to generate a weekly disposable income.
Let us show you how it works.
Unlock Your Future. Call us today. It could be the best decision you ever make.

http://www.propertyinvesting.com/strategies/positivecashflow.html

Positive Cashflow Returns Through Property Investment

Are all property investments equal? This special insight article examines the types of returns you can expect from property investing and whether or not they are consistent with the goal of attaining financial independence.

Making Money In Property
There are three possible outcomes from property investing:

You make money
You lose money
You break even
And in the world of property investing you can only make money in two ways - either capital appreciation and/or positive income returns.

Capital appreciation is straightforward enough. Over time your property increases in value so that it becomes worth more later than what you initially paid for it (this is also known as an increase in equity).

The only trick with capital appreciation is to remember that the amount you pay for a property is the contract price plus closing costs, and the amount you receive when you sell is the sales price less agent's commission, your loan payout and other selling costs.

You can only turn your capital appreciation into positive cashflow by redeeming your equity through refinancing or by selling your property.

The second way you can make money in property is by securing a positive income return.

(Please note that the word rental is deliberately avoided here because some real estate investing techniques - such as wraps - generate positive income returns that have nothing to do with tenants.)

Positive income returns occur when your investment income is higher than your investment expenses.

This concept is different from 'negative gearing' which focuses on capital appreciation at the expense of a positive income return. In fact, negative gearing is all about creating an income loss so you can claim a tax deduction.

What Is It You Want From Your Investment?
Assuming that you're investing in property to make money, does it really matter whether you focus on capital appreciation or positive cashflow returns?

This question has been the centre of a lot of debate recently and the property gurus seem divided. Some swear that capital appreciation is the way to go whereas others strongly advocate positive cashflow income returns.

The truth is that there's probably no absolute right answer. In other words, the best anyone can say is "it depends".

Depends on what? Well, the reason why you want to make a profit in the first place.

You need to clarify your investing purpose so that you can decide what type of property you should buy to obtain an outcome that is consistent with your investing objective.

For example, if you want to buy a property that's likely to appreciate in value, then you'd be wise to focus primarily on location. However if you want a positive income return, then a property's location isn't as important as the likely income and expenses.

Financial Independence and Passive Income
Financial independence is an investing outcome that is becoming increasingly more popular as disgruntled employees look for a better quality of life.

Financial independence means the freedom or release from the need to have to work.

It can occur in varying degrees from partial independence (when you get to take a few hours off work a week) to complete financial freedom (where you no longer need to work at all).

The way to attain financial independence is through acquiring passive income.

Passive income is something that flows to you and is largely independent of the number of hours worked in a job.

It needs to be pointed out that there is really no such thing as completely passive income because every dollar of passive income must flow from some kind of work or effort in the first place.

For example, while rental income might seem to be passive income, the task of finding and investing in property, together with managing the tenant, filling in tax returns etc. is anything but passive!

A good example of passive income is royalty payments paid to musicians. They write a song once and are potentially paid a royalty each time the song is played. The initial act of writing and recording the song wasn't passive, but the ongoing payments when it is included on music CDs (sometimes many years later) is. Just think of the Beatles!

The word 'passive' really means avoiding being paid by the hour.

Instead you seek to do some work today and leverage off it tomorrow. This leverage is in the form of receiving multiple payments without the need to work again.

For example, if you invest in a positive cashflow property then you hope that the work involved in finding and acquiring the property will create a positive income stream that will last until you sell the property. One days work now for a lifetime of return later.

It's like an extended form of delayed gratification.

Time And Money
A myth about financial independence is that it's all about money. It's not. It's all about time.

As we age we begin to realise that we're getting older, we begin to see that time is quickly running out. Sooner or later we even realise that time is actually more valuable than money. For example, if you knew the exact moment that you were going to pass away, what price would you put on your last hour alive?

Time is finite - money isn't.

Yet money in the form of regular and constant passive income can buy us freedom to spend time (that we would otherwise allocate to working in a job) doing the things that we really love. That is, money can buy us control of our time that we would normally otherwise sell to an employer in exchange for money to fund our lifestyle.

Now for some people the freedom from having to work means little because they love their job to begin with. That's fine... but it would be even better if you were the one calling the shots and not your boss!

But the reality is that most of us have other things that we'd rather be doing, such as giving time to the kids, exploring spiritual matters, making the world a better place or maybe even playing more golf.

And all this would be possible, if only we didn't have to work in the first place! After all, electricity isn't free and neither are the groceries.

If you want to work less but don't want to take a cut in your lifestyle then you're going to need to focus on finding some sort of passive income to replace the salary you'll forgo when you cut back your hours.

Look at it this way... if you were paid $40,000 per annum in a standard 9 to 5 job, how much passive income would you need per week in order to take every Friday off without suffering a drop in lifestyle? [Hint: go grab a calculator!]

Your answer $ Check Answer
Answer response Show Solution

Annual salary = $40,000
Weekly salary ($40,000 / 52 weeks) = $769.23
Daily salary ($769.23 / 5 days) = $153.85

Therefore, you would have to earn $153.85 per week in passive income to be able to take every Friday off without a drop in lifestyle.

The outcome to this discussion is that unless you plan to work until compulsory retirement age, you're going to need to start building some passive income that will substitute your wages as you gradually work less and less in your normal day job.

Use the calculator below to determine how much you are paid per day and week based on your annual salary and assuming you take four weeks annual leave per year.

Your annual salary $ Calculate
Your Pay

Passive Income and Property Investing
Let's just do a quick review of the discussion so far.

There are two ways to make money in property investing; your property can increase in value and / or you can earn positive cashflow if your investment income is higher than your property and finance expenses.

Both are valuable and can occur independently to the other. That is, you can have capital appreciation and no positive income returns (this is negative gearing), or you can have a positive income return and no or negative capital appreciation, or you can have no capital appreciation and no positive income too (or both).

Is capital appreciation better than a positive income return? Perhaps, perhaps not.

But if you're looking to retire from you job without necessarily taking a lifestyle or pay cut, then you're going to need to source some kind of passive income to replace the wages you lose from cutting back at work.

Now you can do this by converting your capital appreciation into a series of payments - but once you've spent the gain then it's gone forever. Your financial independence becomes dependent on further capital appreciation which is by no means certain.

Positive income returns on the other hand regenerate, which means they may continue on indefinitely. Sure, tenants will come and go and there may be times when your property will be vacant, but generally speaking your passive income stream is not limited or capped.

Conclusion

If the reason why you want to make money in real estate is to try and attain some degree of financial independence to gain the freedom from having to work, then it makes sense that you should focus on positive income returns rather than capital appreciation.

This is because you can't use your 'capital appreciation debit card' to fund your weekly grocery bill, but you can pay for it out of a property income surplus.

The ideal situation would be to have both capital appreciation and positive income. But opportunities offering this can be quite rare.

It's fair to say that different property investments offer the potential for different types of returns. Some are specifically designed for capital appreciation and focus on location irrespective of cashflow returns (such as inner city apartments).

At the other end of the spectrum are investments that offer high cashflow returns but no/low prospect for capital gains (such as regional or country properties).

You can only determine what property you should buy after you've clarified what outcome you're working towards.

If that's working less then you wouldn't buy a negatively geared property that was designed to lose money which meant you had to work harder to pay for the loss.

Instead you'd focus on properties that delivered ongoing positive cashflow returns, since that's what you'd need to replace your salary and fund the lifestyle you deserve.

PropertyInvesting.com is a website designed to help you discover more about how you can profit from positive cashflow real estate investing.

We don't sell properties. Our philosophy is to help you to learn how to source, buy and harvest your own deals.

Be sure to sign up for our free newsletter, read and post on our free forum board and also look at the resources we have available to help you boost your real estate returns.