Australian Greens—Dissenting Report

1.1 The boom and bust in forestry managed investment schemes (MIS) is an almost perfect reflection of the boom and bust in the United States mortgage market that precipitated the global financial crisis (GFC). The core ingredients are all there: political backing at outset; highly leveraged investors enticed by advisors receiving outrageous commissions; irresponsible lending by supposedly venerable banking institutions; ratings agencies providing fanciful evaluations; overstated yields; and inflated asset prices. Along the way alarm bells were sounded and ignored by successive governments, and then the cards came tumbling down. Forestry MIS was Australia's GFC moment.

1.2 Forestry MIS was designed to encourage investment in timber plantations on the back of aggressive government policy to treble the amount of timber plantation in Australia. MIS managed to do with varying degrees of success. It went from being a relatively obscure financial instrument when formally established in 1998, to attracting more than $4 billion worth of investment. Eighty per cent of that investment flowed during a heady five year period from 2004 to 2008. However, it was a Ponzi scheme, and when it collapsed tens of thousands of ordinary Australians lost their money; a network of fast-and-loose financial practices were exposed; and farming communities around the country were left reeling by the rapid takeover and then abandonment of agricultural land.

1.3 Forestry MIS is perhaps the most complicated and intricate of what are now a series of financial scandals that have been uncovered in Australia since the GFC. These misdemeanours have been the subject of number inquiries by this committee, including ongoing inquiries into the conduct of financial advisers and penalties for white collar crime, and the inquiry completed in 2014 into the conduct of ASIC. The ASIC inquiry recommended that the government establish an independent inquiry—possibly a Royal Commission—into the misconduct of advisers and planners within the Commonwealth Bank. Since that time, instances of misconduct have been also been uncovered at the National Australia Bank, ANZ Bank, Macquarie, IOOF and, again, at the Commonwealth Bank. The Greens believe that the grounds for a Royal Commission into the financial services sector are now irrefutable, for the sake of the hundreds of thousands who have been affected, and for the integrity of the financial system. This report into the collapse of forestry MIS should be used as a further opportunity to highlight the need for the highest level of scrutiny to be applied to how Australian's money is being managed.

Recommendation

That the government establish a Royal Commission to examine misconduct within the financial services sector.

Investors and incentives

> Pooling funds from investors is usually more easily achieved with either a company or a commercial trust. The only reason the current MIS structure was chosen was to enable growers to get a tax deduction for their upfront investment.[1]

1.4 The Chair's report seriously underplays the role that taxation incentives provided in fuelling the forestry MIS bubble. The Chair's report's inadequate response to this issue is the principle reason The Greens have submitted a dissenting report.

1.5 While it is true that a number of investors claimed not be have been motivated by taxation incentives, the tax treatment of forestry MIS underpinned confidence in the entire system and was clearly identified by ASIC as the most common reason for investment in MIS as early as 2003, before the bubble.

1.6 Taxation incentives induced demand among investors looking for a vehicle to write-off a lump-sum amount against their income. On the other side of this equation, the upfront payment made by investors provided easy finance for parent companies to establish forestry MIS so long as the responsible entity could provide the illusion that investors were carrying on a business.

1.7 Taxation incentives also gave assurance to banks to lend money—at full recourse—for investment in forestry MIS; and commission structures encouraged the sale of forestry MIS to people ill-equipped to understand the product risk.

1.8 The increase in investor demand for forestry MIS inflated the demand for land for forestry. This contributed to localised increases in the price of land which, in turn, encouraged trees being planted on unsuitable land. With the assistance of drought conditions throughout the period of the forestry MIS bubble, and the inevitable downturn in the value of pulp as a global commodity, this meant that the value of the underlying asset was not able to support investor claims when forestry MIS collapsed: too much was paid for land on which trees didn't grow.

1.9 The business model was fundamentally flawed, and new tax-driven investors were required to keep up the charade; to keep cash flowing. Forestry MIS became a Ponzi scheme.

1.10 The ATO sought to address the perverse tax incentives in 2006 by recognising contributions to forestry MIS as investment in capital. However, the Federal Court found differently, and the government of the day chose not to protect the ATO's view in law. Instead, the then government legislated a specific workaround for forestry MIS that allowed for 70% of investment to be deducted upfront without even having to prove the carrying on of a business.

1.11 Even so, the mere questioning of the validity of MIS tax breaks during this period was enough to act as a catalyst—one of a number—for the collapse of forestry MIS. This puts paid to any suggestion that taxation incentives were not at the heart of

1 John Lawrence, *Submission 194*, p. 2.

the forestry MIS bubble: if tax mattered so little, then why was the threat of any change to the tax deductibility of investment so devastating?

1.12 The recommendations in the Chair's report for Treasury and the Productivity Commission to review tax incentives for MIS would assist in understanding this question better, but they also further avoid a decision on this issue. It is clear that the upfront deductibility facility available through MIS was—and is—a primary incentive for investment in unviable plantations. The Greens believe that the rationale provided by the ATO in 2006 remains valid and that the committee should seek to have this view enshrined in law to prevent another MIS bubble.

Recommendation

That the government should legislate to require investment in forestry MIS to be treated as investment in capital, and for tax deductions to be spread across the life of the asset.

1.13 While the economic story of the collapse of MIS has been laid bare, the political story that sits behind it has not been fully told. Serious questions remains as to why the government didn't act when alarm bells were sounded. Why did cabinet overturn the recommendation of the Minister to change the tax incentives in 2006? What was the role of industry lobbyists in convincing the government to keep forestry MIS and a highly ambitious plantation target? In Tasmania, what was the role of the proposed Tamar Valley pulp mill in providing end-market pressure?

1.14 A litany of reports signalled problems with forestry MIS, including the aforementioned 2003 ASIC report; the 2004 Senate Regional Rural Affairs Committee report into the veracity of the government's plantation targets; the 2009 Parliamentary Joint Committee on Corporations and Financial Services Inquiry into MIS; and the 2012 Corporations and Market Advisory Committee report into MIS.

1.15 It is disappointing that the Chair's report has made little mention of the political failure to prevent a the forestry MIS bubble. That said, it beyond the powers of this committee to compel the witnesses and evidence that is necessary to properly understand the role of vested interests in the boom and bust of forestry MIS. The committee was unable to get company management, accountants, financial planners or rating agencies to appear at public hearings. These people have stories that the mums and dads who lost their money, and the farmers who are left saddled with debt, deserve to hear. This is why a Royal Commission, with all of its coercive powers, is needed into the financial services sector—including forestry MIS—to understand the culpability of government: what did they know, when did they know it, and what did they do about it?

1.16 A Royal Commission is all the more important because, it would appear, that the majority of actors involved in the collapse of forestry MIS did not actually break the law. It is extraordinary that billions of dollars of value and wealth have been wiped out around this country on the back of an asset class that, essentially, the government set up. A lot of people made a lot of money along the way, but it is not clear that there was, technically, any systemic wrongdoing. The laws covering forestry MIS largely relate to whether there was misconduct, or deceptive behaviour, or fraudulent behaviour around the communication of risk; otherwise it was just a really bad investment.

1.17 A Royal Commission will help provide a better answer to victims than 'sorry, it is not illegal for billions of dollars to be wiped out and lots of people to have made money on your behalf'. A Royal Commission will establish who was to blame.

Promoters and producers

1.18 The Chair's report makes a swathe of recommendations covering the regulatory framework for financial advice relating to forestry MIS. These include recommendations relating to the use of ATO product rulings; clarifying the role of accountants; ethical and educational standards for advisors; preventing banned advisors from managing companies; improving product disclosure requirements; and extending consumer credit protections.

1.19 More often than not, these recommendations sit within the broader regulatory framework covering all financial advice. There has been a lot of progress on these and a number of other issues in the eighteen months since the inquiry into forestry MIS was established. This is a result of the work of the other aforementioned inquiries undertaken by this committee, and the government's own Financial Systems Inquiry.

1.20 In this context, the recommendations in the Chair's report, while laudable, often use unnecessarily forgiving language. On no less than eight occasions, the Chair's report suggests that 'government consider' the content of particular recommendations. The lack of conviction in the Chair's report is disappointing given the level of progress made in relation to consumer protections for financial advice, and fails to adequately respond to the gravity of issues raised during this inquiry.

1.21 One the recommendations where the Chair's report fails to show conviction is in relation to the regulation of 'full recourse' loans. As noted earlier, the ability of investors to borrow the full amount of their investment in forestry MIS contributed to the creation of an asset bubble; and, because of the full recourse nature of the loans, dramatically increased the exposure of retail investors to losses when the bubble popped.

Recommendation

That the government legislate such that only limited recourse loans are able to be provided for investment in complicated financial products.

1.22 Of those recommendations that do demonstrate conviction, one sits out as being bizarre. Recommendation 4 details the changes that should be made to the school curricula to improve the financial literacy of school leavers. While this is worthwhile in and of itself, it is completely incongruous to the findings of this inquiry. In the Chair's reports own words 'agribusiness MIS are complex products and difficult to understand'. In evidence provided by ASIC, they stated that:

> …the number of failures and the size of those failures go to the fact that it certainly has not been an investment class that retail investors could have confidence in.[2]

1.23 In other words, forestry MIS was a highly risky financial product that many banks themselves considered unworthy of investment; and it should never have been sold directly to mums and dads. While The Greens have every faith in the ability of the next generation of Australians, changes to the school curriculum will not stop another forestry MIS.

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2 Mr Greg Tanzer, Commissioner, Australian Securities and Investments Commission, *Committee Hansard,* 14 October 2015, p. 19.