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Government Consultation: Financial System Inquiry Recommendations

This is a joint submission by:

- the Mortgage and Finance Association of Australia (**MFAA**)

  The MFAA is the peak national body providing service and representation to over 10,000 professional accredited advisers (mortgage and finance brokers, mortgage managers and aggregators) and lenders to assist them to develop, foster and promote the mortgage and finance industry in Australia.

  Many of these lenders and accredited advisers are involved in assisting Self-Managed Superannuation Funds (**SMSFs**) to borrow to purchase property in accordance with the requirements of section 67A of the Superannuation Industry (Supervision) Act (**SIS Act**).

- the Commercial Asset Finance Brokers Association of Australia (**CAFBA**)

  The Commercial Asset Finance Brokers Association is the peak national body of professional commercial equipment finance brokers. CAFBA has over 600 members, who write new business volume in excess of $7b pa. CAFBA advocates for the equipment finance industry to policy makers and regulators and provides education and resources to those involved in the equipment finance industry.

The Financial Systems Inquiry (**FSI**) Final Report contains 44 recommendations designed to *"…promote the efficiency, resilience and fairness of the financial system to facilitate the system's role in supporting a vibrant, growing economy that improves the standard of living of all Australians*."[1]

This submission relates solely to Recommendation 8, that the Government should remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements (**LRBAs**) by superannuation funds.

[1] Financial System Inquiry Final Report, 28 November 2014, page xxvii

Background

An exemption to the borrowing restriction contained in section 67 of the SIS Act was introduced on 24 September 2007 by the commencement of Schedule 3 of the Tax Laws Amendment (2007 measures no. 4) Act 2007.

In 2010, section 67(4A) was repealed and replaced with section 67A of the SIS Act. The new section represented a fine tuning of the restricted terms of a permitted borrowing, to:

(a) ensure that any borrowing could only be applied to a single asset (or bundle of identical assets);

(b) make it clear that the recourse of any guarantor for any amount paid under any guarantee was limited to the asset; and

(c) clarify that an existing LRBA could be refinanced.

The Australian Taxation Office (**ATO**) collects data about the investment and borrowing activity of SMSFs, and publishes quarterly and annual SMSF statistical reports.[2]

Those reports evidence the fact that whilst borrowing by SMSFs has increased since 2009, the level of contraventions arising in relation to borrowing has remained relatively unchanged, at 7.5% to 8.0% of the total number of SMSF contraventions reported to the ATO.

Accordingly, whilst the number of LRBAs has increased, the quantity of contraventions related to LRBAs has not increased with it.

The ATO's statistical data also confirms that despite the ability of SMSFs to borrow, only a very small percentage of them elect to do so,

Regulation of LRBAs

There are two sources of regulation of LRBAs:

1. government regulation - through the SIS Act and Regulations, the ATO's oversight of SMSFs and ASIC's oversight of financial advice; and

2. industry self-regulation.

The SMSF sector has been assessed favourably by ASIC and the ATO. As the regulators of SMSFs and their advisers, ASIC and the ATO are in the best position to make an assessment about any systemic risks associated with LRBAs.

Aside from property spruikers and unlicensed or inadequate advice, the regulators have expressed no concerns about LRBAs.

As an industry body, the MFAA has sought to increase the knowledge and expertise of its members in relation to LRBAs. MFAA brokers can undertake further accreditation to become specialists in providing assistance to SMSFs wishing to enter into an LRBA.

[2] 'Self-managed superannuation funds: A statistical overview', Australian Taxation Office (2008-09 to 2012-13)

Lenders who offer LRBAs also take significant steps to assist to mitigate against risk in the industry by maintaining strict credit policies, and by requiring an SMSF to obtain independent advice when taking out an LRBA.

For example, many lenders have requirements in relation to:

1. the minimum fund balance an SMSF must have before the lender will approve an LRBA;

2. the minimum amount of liquidity that the SMSF must have post settlement of an LRBA; and

3. the ability of the SMSF to service the LRBA without relying on additional member contributions.

These steps go beyond the legislative requirements and have been introduced to lift general credit standards.

It is also not uncommon for lenders to refuse to deal with certain groups who have agreements in place with property developers, or who have a reputation for providing inadequate advice.

The requirement of many lenders for SMSFs taking out LRBAs to seek independent advice brings those SMSFs into contact with the advice system, providing an opportunity for trustee education and compliance risk identification.

Further, the lender and its lawyers play a role by reviewing LRBA transactions to ensure that they are SIS Act compliant.

As a consequence, the rate of default on loans to SMSFs by financial institutions is practically zero.

Risk magnification

The FSI expressed concern about the potential risk magnification of leverage. However, it did not point to any evidence of risk, damage or loss arising from LRBAs. The evidence cited in support of the ban is anecdotal at best.

A ban on borrowing will be ineffective because SMSFs will still be able to invest in derivatives and other traded products with built in leverage. If the underlying company or investment scheme fails there is no residual value in the asset.

This is not the case with property, which is the primary asset acquired through the use of LRBAs. With property, even if values fall, the asset still has a residual value. It is also rare for yields to be materially adversely affected.

As discussed below, unregulated leveraged options, which will continue to be available if SIS Act regulated direct leverage is banned, are far riskier than LRBAs.

Alternative leverage strategies

Banning LRBAs will simply channel SMSFs into less regulated, riskier structures that also use leverage, such as unit trusts, warrant products and derivatives.

Whilst LRBAs are within the oversight of the ATO and must comply with the strict rules set out in the SIS Act, unit trusts can borrow on a full recourse basis in a less regulated environment.

Property spruikers and associated advisers may look to encourage SMSFs seeking access to direct property investment to join with other SMSFs to purchase property through unit trusts.

SMSFs which invest in property via a unit trust structure can easily contravene the in-house asset rules. In contrast to the static nature of LRBA related contraventions, according to ATO data, contraventions arising in relation to in-house assets have steadily increased.

Whilst SMSFs would retain the ability to invest in managed investment funds holding direct property, SMSFs should not be obliged to divest themselves of control and be subject to fund management fees to achieve the same commercial objective of investing in geared real estate.

Stability in superannuation

In making its recommendations, the FSI stated that Government intervention in the financial services sector *"…should seek to balance efficiency, resilience and fairness in a way that builds participants' confidence and trust."*[3]

In order to give Australians confidence in superannuation it is important that regulation of the industry is stable. Many trustees enter into long term investments, and making regular changes to the superannuation law means that trustees lack the necessary certainty to make such long term, stable investments.

Any changes to superannuation legislation should provide for appropriate grandfathering to ensure that SMSFs which have made long term investments are protected from any adverse outcomes.

Equity and fairness in superannuation

The FSI report and subsequent comments by the Government have focused on ensuring that the superannuation system is fair and equitable.

Statistics demonstrate that over the past 20 years, residential property has outperformed Australian and global shares.

Property also has the double benefit of providing capital growth as well as an income stream in retirement. Whilst rental returns are predictable and can be used to fund a pension, dividends are not and so share holdings may need to be sold when the fund moves into pension mode.

One consequence of banning the ability of SMSFs to use leverage to invest in direct property is that only the wealthy, with high balance funds, will be able to invest in direct property and retain a diversified asset base.

Australians with lower fund balances, due to lower incomes or broken work patterns, are unable to invest in direct property without leverage. These same individuals are also more likely to be unable to invest in direct property outside of superannuation because of inadequate savings, or an inconsistent income stream. Allowing these individuals to use

[3] Financial System Inquiry Final Report, 28 November 2014, page xv

their superannuation savings and leverage to invest in an asset which offers long term stability and capital growth will assist them to fund their own retirement in accordance with the aim of compulsory superannuation.

In addition, because of the long term performance and stability of property, if borrowing is banned, SMSFs with moderate balances will still invest in direct property using cash. Such investments will be at the expense of fund diversification.

Banning leverage will also have a significant impact on small business. Many small business proprietors use leverage to assist their SMSF to purchase their business property which is then leased to a related trading entity. This enables small business proprietors to ensure that their investment in what is often their most significant business asset can be conducted inside an SMSF to provide for their retirement. Upon retirement, the business can be sold as a going concern and the property then leased to that party to generate income for the SMSF to meet the retirement needs of the members.

Choice and competition in superannuation

Because superannuation is compulsory, individuals should have the discretion of where and how to invest those savings. SMSFs are essential to consumer choice and competition and allow people to build their retirement savings in a manner which suits their needs and preferences. SMSFs with more than one member benefit from economies of scale, both in relation to investment choice and fees.

It is the self-directed nature of SMSFs which accounts for the fact that SMSFs generally receive more concessional contributions than APRA funds. The ability of SMSFs to invest in direct property is a factor which encourages people to save for retirement.

However using an SMSF to invest in direct property is not the only tax effective way of investing in property. If SMSFs are unable to borrow to purchase property within superannuation, individuals are likely to keep the additional contributions they would have put into an SMSF and use those funds to invest in property outside of superannuation.

Options for improving LRBAs

The parties to this submission recognise that enhancements can be made to the current regulatory framework to mitigate against the risk of inappropriate fund establishments and LRBAs.

<u>Fund establishment</u>

The attraction of SMSFs is that they are designed to be exactly that – self managed. Whilst it is undesirable to mandate compulsory advice and education for SMSF trustees, regulators need to ensure that SMSFs are not established inappropriately, and that when advice is sought it is delivered by appropriately qualified professionals.

It is the view of the parties to this joint submission that the real risk to SMSF investors is inadequate or inappropriate advice.

One way of preventing the inappropriate establishment of an SMSF is to require SMSF establishment to be handled by a solicitor, accountant or financial planner.

Adopting such an approach would bring SMSFs into contact with qualified advisers and make it more difficult for property spruikers and unlicensed parties to become involved in SMSF establishment.

Ban on related party LRBAs

Borrowing from a lender rather than from a related party means that the lender and its lawyers review the transaction to ensure that it is SIS Act compliant. Lender credit policies and the requirement for independent advice also have the effect of ensuring that funds which have been established inappropriately are unable to access LRBAs.

Such policy constraints and advice requirements are not present in related party loans to SMSFs and data released by the ATO shows that compliance breaches in relation to LRBAs commonly (if not exclusively) arise from related party loans to SMSFs.

Related party loans to SMSFs are often provided without appropriate advice and documentation. For these reasons, the ability of related parties to provide LRBAs to SMSFs should be banned.

Removal of member guarantees

A number of submissions to the FSI raised the option of removing personal guarantees by members to ensure that other assets of an SMSF are not liquidated to avoid a claim by the lender on the members.

However the removal of personal guarantees will result in lenders lowering the LVRs for LRBAs, meaning that SMSFs will need to contribute more of the purchase price for a property. This may impact on the ability of the SMSF to diversify its asset mix because more of the SMSF's funds will be applied to the acquisition of the asset. It may also restrict the availability and cost of finance.

In light of the very low default rate of LRBAs, the parties to this submission do not believe that the removal of member personal guarantees is justified.

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