Submission in Response to Financial System Inquiry Final Report

25 MARCH 2015

Review copy for attention of:

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Member for Kooyong
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SUBMISSION IN RESPONSE TO FINANCIAL SYSTEM INQUIRY FINAL REPORT
25 MARCH 2015

1 WHO WE ARE – CONCERNED SUPERANNUATION-BASED PROPERTY INVESTORS

This submission is prepared on behalf of a group of concerned residential property investors and property and SMSF market participants ("us" or "we") in response to specific recommendations in the Financial System Inquiry (FSI) Final Report. A detailed description of persons and companies endorsing the submission and our reasoning for making the submission are provided at Appendix A.

2 OUR POSITION AND RECOMMENDATIONS IN RESPONSE TO THE FSI FINAL REPORT

A. We strongly ***endorse Recommendation 9 of the FSI Final Report for clear, bi-partisan objectives of the superannuation system to be enshrined in legislation***, including consideration of clearly defined sub-objectives, in particular housing investment policy.

B. At the same time, we ***strongly disagree with Recommendation 8 and any attempt to ban borrowing in self-managed superannuation funds, through limited recourse borrowing bans***. In this submission we:

- explain why a ban is not warranted;
- explain why retaining LRBAs represents good economic policy, and how a ban would expressly discriminate against under-supplied residential housing while favouring asset-classes like bank equities, commercial property and infrastructure;
- put forward alternatives to a ban that we believe address the underlying concerns raised by the FSI; and
- offer our expert group to work with government to examine options to address any concerns about investing superannuation savings in leveraged assets (e.g. bank and other shares, commercial property, housing or infrastructure); and make sure long-termism and diversity are central drivers of future arrangements.

C. We think the ***central pillar of superannuation policy should remain the accumulation of savings (and income producing assets) to assist retirement years***, and that the maximum, long-term rate of risk-adjusted return should continue to drive all investment in superannuation. A secondary pillar, or sub-objective, should be portfolio diversification. Government can strengthen both these pillars by framing ***all future policy settings to encourage long-term investment, and to discourage short-termism*** and myopic speculation. By focusing on principle-based policy settings, government can remain agnostic about individual asset-classes, like bank equities, residential housing, infrastructure equities or commercial property.

D. We ***endorse the FSI approach of referring tax-related issues across to the Tax Reform White Paper***. We would encourage government to include in the one set of considerations - the Inter-Generational Report, and the Future of Federation Review. All four, together, are part of developing a long-term, bi-partisan reform roadmap for superannuation and housing.

3 ALTERNATIVES TO THE BAN ON DIRECT BORROWING BY SMSFS RECOMMENDED BY FSI

The reasons why a blanket ban on LRBAs, that will in effect impact one specific asset-class (leveraged housing equity), while still allowing many other leveraged equities investments in super (including, but not limited to, bank equities, corporate equities, commercial property equities, and infrastructure equities) is not warranted are set out in section 4, below.

Prior to examining those reasons, in this section, we present the many policy levers available to government to address concerns raised by the FSI that it suggests could over time pose a risk.

Firstly, it should be noted that the FSI has not suggested that a systemic risk currently exists. Rather it states (our emphasis added) that:

*"Further growth in superannuation funds direct borrowing would, **over time, increase risk** in the financial system".*

It adds:

*"Although the level of borrowing is currently relatively small, **if** direct borrowing by funds continues to grow at high rates, **it could, over time, pose a risk** to the financial system".*

The FSI acknowledges that alternatives exist [other than an outright ban] that would *"**limit the risk associated with borrowing** by superannuation funds, and **provide funds with more flexibility to pursue alternative investment strategies**".*

It adds: *"However, these options would also impose additional regulation, complexity and compliance costs on the superannuation system"*. And in doing so suggests that a ban is warranted.

Given there is no immediate or pressing systemic risk either present or likely to emerge in the short-to-medium term, time is demonstrably on the side of government. In our view, the government should fully explore the many options set out below before it commits to a policy position that could have far-reaching ramifications, including seriously undermining Australia's ability to secure the funding required to build the housing supply necessary to accommodate 40 million people by 2015, as per the Intergenerational Report's latest forecasts.

It is further our contention that none of these potentially very effective options imposes unwieldy or onerous *additional regulation, complexity and compliance costs on the superannuation system* as the FSI seems to imply they would.

Options to an outright ban:

Many controls on SMSFs already exist, and these controls can be 'calibrated' to address any perceived or real concerns, as compared to strict punitive bans that discriminate against one specific asset-class (viz., Aussie housing).

The five key options we recommend the government consider are as follows:

a) **SMSFs should be categorised as a distinct financial product, not just as a sub-set of "superannuation".**

- As products, SMSFs have unique features, opportunities and risks. As an increasingly important part of the overall superannuation landscape now accounting for one-third of total savings in dollar terms, SMSFs deserve tailored advice.

- The ATO has regulatory responsibility for SMSFs. Retail and industry funds are APRA-regulated funds, yet under Australian Financial Services Licensing ASIC considers them both simply "superannuation" products.

- This means financial advisors *without* strong knowledge of the establishment, operation, benefits and risks associated with SMSFs are still allowed to provide advice on SMSFs, merely because they have authority to advise on "superannuation".

- The two product types should require specific licensing, education and knowledge which an adviser or AFSL licensee should be required to obtain before being allowed to provide advice on or deal in the relevant product type.

- Implementing this recommendation could be straightforward. ASIC could update and/or issue new Regulatory Guides (RGs) requiring that financial advisers hold relevant industry qualifications specific to SMSFs to: 1. provide advice about the establishment and operation of SMSFs; and 2. to deal in (or advise on) SMSF-related products including Limited Recourse Borrowing Arrangements (LRBAs).

  Implementing this recommendation would solve a lot of issues concerning financial advice for SMSF clients, not just LRBAs.

b) LRBAs could also be, and should be, categorised as a financial product.

- Like SMSFs, LBRAs and the associated direct asset investment (commonly Australian housing) deliver unique benefits and costs that consumers need to clearly understand. An adviser (including credit representatives) should need qualifications and authorities to provide advice on LRBAs. Again, this could potentially be handled through updating existing RGs or issuing new ones.

c) The loan-to-valuation-ratios (LVRs) associated with LBRAs should be capped at circa 70% and interest serviceability buffers should also be set (say at 2% above the average 20-year home loan rate).

- These two recommendations address the key risk associated with LBRAs applied to direct housing: the probability of default; and the risk that this event will exhaust the SMSF's equity in the property asset.

  Note that precisely the same risks apply to any leveraged investment on the ASX, be it the major banks, which are leveraged over 21 times,[1] leveraged corporates, or commercial property and infrastructure investments, which typically have significant gearing. In all these cases, the investor's equity can be exhausted.

- The policy goal should therefore be to impose some reasonable minimum tests that ensure both borrowers and lenders entering into LBRAs are acting prudently. By imposing a maximum LVR of 70% savers would be protected against a severe housing downturn (e.g. a 20% fall in house prices). Requiring a serviceability buffer of say 2%

[1] http://www.afr.com/opinion/columns/big-four-more-risky-than-pregfc-20140829-jd41e

above the average 20-year historical home loan rate would likewise ensure savers could service repayments in scenarios where there was a substantial increase in interest rates (some 3 to 5 percentage points above current rates) and reflects current best practice, as defined by APRA.[2]

d) Related-party lending to an SMSF could be banned.

- Wealthy SMSF members are currently able to lend their SMSF cash as a way of pushing assets into a friendlier tax environment. LRBAs could be required to be on a non-related party basis, as well as an arms-length basis. This could potentially be readily achieved through an amendment to the SIS Act. Adopting this recommendation also addresses issues of inequity raised by the FSI Final Report in Chapter 2.

e) Banning the use of personal guarantees could be considered, but this notion would need to be fully explored for unintended consequences.

- We consider that options exist for restrictions on personal guarantees rather than an outright ban. A ban could unfairly limit the ability of SME owners and self-employed persons to access this legitimate investment option as they are generally (and it seems quite reasonably) asked to guarantee loan repayments as they do not generally benefit from guaranteed superannuation contributions.

This is a non-exclusive set of options for reform that avoid punitive bans. They are examples of the call for a clearer set of recalibrated rules on limited recourse borrowing.

Other options include not allowing interest-only LRBAs; and/or capping repayment terms of loans to say age 75.

The worst-case policy outcome would be unilaterally banning specific instruments, or specific investment options, while ignoring exactly the same problems in other (favoured) asset-classes, which would likely propagate adverse long-term economic consequences (e.g. choking investment in new housing supply).

[2] http://www.apra.gov.au/mediareleases/pages/14_30.aspx

4 WHY A BAN IS NOT WARRANTED AND WHY PRESERVING LRBAs REPRESENTS GOOD POLICY

A ban on LRBAs within SMSFs is not warranted because:

a) No systemic risk currently exists and none is likely to emerge in the short-to-medium term.

- The ATO reports that limited recourse borrowings remain very low as a percentage of SMSF assets at only $8.7Bn or 1.56%[4].

- The FSI concern may be because of the speed of growth of SMSF borrowing in superannuation over the past five years. This growth in borrowing is quoted as approximately $497M to $8.7Bn throughout the sector over the past five years.

- This figure is misleading, however, when put into context. Borrowing under Section 67A of the Superannuation Industry (Supervision) Act 1993 (SIS Act) was only approved in 2007, and only began in any commercial way in practice from around 2009. That section 67A has existed, in practice, for six years, is not an argument for a 'jump in activity' in the past five years. If anything, section 67A is doing exactly as it was intended.

- Limited recourse borrowing arrangements within SMSFs are already subject to a unique set of rules, with the SIS Act and various ATO rulings now in place.

- The ATO has a series of detailed rulings on the use of LRBAs. Borrowing arrangements must be structured using a holding trust and 'limited recourse' means that the lender only has recourse over the property that has been financed, not other assets of the fund. Whilst this is an advantage for the borrower, it usually means the risk is greater for the lender.

- This *risk to lender*, rather than borrower, is at odds with concerns expressed by the FSI, who seemed to express concern about collective-debt amongst borrowers eroding the integrity of the superannuation base.

- But as the respected economist Christopher Joye points out (see Section 6 below), the FSI's logic is inconsistent. Joye highlights that whereas the typical SMSF investment in housing equity is leveraged a maximum of 5 times (i.e. a maximum 80% LVR), SMSF investments in major bank shares, which account for a large percentage of many SMSF portfolios, results in them assuming leverage of north of 21 times. APRA-regulated industry and retail funds have similar significant investments in those same shares.

- The risk of investments in leveraged bank equities was highlighted during the global financial crisis when bank stocks fell in value by 60%, which radically altered many retirement plans. The fundamental issue with the FSI recommendation is that it highlights one potential concern associated with no/limited recourse leverage in super in one specific asset-class (housing), but it

[4] https://www.ato.gov.au/super/self-managed-super-funds/in-detail/statistics/quarterly-reports/self-managed-super-fund-statistical-report---june-2014/?page=2#Asset_allocation_tables m

fails to apply the same critique to the many other forms of leverage available inside both APRA-regulated funds and SMSFs.

b) These risks that the FSI Final Report suggests could emerge over time can be managed through current regulatory frameworks.

- Alternatives to address perceived risk are straightforward and can be readily implemented as we have setout in section 3, above.
- Implementing some or all of the recommendations in section 3 above will not lead to onerous *additional regulation, complexity and compliance costs on the superannuation system.*

Preserving LRBAs (while tightening the rules around their use) is good policy because:

a) The prudent use of investment debt is a legitimate tool for increasing the size of fund assets and income streams in retirement, which is a critical objective of any retirement savings scheme.

- APRA regulated funds are free to use leverage as the fund managers deem appropriate, and traditional corporate, industry, retail and public super funds have allocated tens of billions to leveraged hedge funds, leveraged private equity funds, leveraged infrastructure equity funds, leveraged commercial property equity funds, and leveraged bank stocks that carry up to more than four-times the relative debt used in residential housing.
- It is an affront to SMSF trustees and members that they are incapable of managing the risks associated with the use of leverage within superannuation while suggesting that retail and industry fund managers (that SMSFs members have turned their backs on) *are* capable of doing so.
- As the FSI has noted, retaining freedom and choice within a compulsory system is fundamental to meeting the needs of individual superannuation fund members, even though this may involve costs.
- It is anti-competitive to consider such discrimination against one asset-class (or direct investment generally).
- The institutionalised wealth management complex has a bias towards shares and managed funds for commercial reasons. Not preserving LRBAs, unwittingly favours the banking model by directing capital away from direct and into (expensive) managed indirect assets. Getting the policy settings right on the other hand increases competition and diversity.

b) The efficiency of the superannuation system should be improved by policy measures aimed at removing barriers to innovation and increasing competitive pressures, not limiting them.

- A ban on LRBAs would limit opportunities for portfolio diversification; limit rates of return SMSFs are receiving through various structures; adversely impact the supply of capital available to housing; and would do this by fixing a 'non-problem'.

c) While the use of LRBAs is not strictly limited to investment in property the primary use for LRBAs in an SMSF is to acquire residential and commercial investment properties.

- History has established that investment in residential real estate provides consistent, stable returns and it is also vital to the country's economic prosperity. Without it Australia will not be able to sustain its current levels of population growth, housing prices will increase, rents will increase and government's will face further pressure on public housing.

- As an investment, diversified property prices are less volatile than shares; so many investors are attracted to this conservative risk option within a portfolio.

d) LRBAs provide a vital tool to small-to-medium business owners and operators who are generally self-employed and don't enjoy the benefits of guaranteed superannuation contributions.

- Whilst SMSFs are prevented from acquiring residential property assets from, or renting to, trustees, members or related-parties, they are able to acquire commercial real estate for business purposes from, or lease it to, a trustee, member or a related entity.

- As explained in the RBA's March 2014 submission to the FSI[5], one of the most common reasons for buying property via an SMSF is for SME operators to be able to afford to buy their business premises.

- It should be noted that the ATO reports that as at 30 June 2014[6] investment in non-residential (commercial, industrial etc) property by SMSFs is currently three times larger than investment in residential real estate assets being $64.9Bn against $19.5Bn.

e) The central pillar of superannuation should be to maximize retirement savings.

- It does not follow however that individuals managing their own risk erodes this central pillar; nor that more creative investment options beyond the share-market are erosive to this central pillar. Rather, the best rate-of-return in the long-term, combined with portfolio diversity, should be the key drivers of all prudent decisions for investors.

- Government should be agnostic about where that long-term rate-of-return, and that portfolio diversity, is found. Above all else, government policy should encourage long-termism and discourage short-termism.

- The challenge for government is not to choose one investment option over another – for example, property or shares. The challenge for government is to get the framework for investment correct, so that rates of returns for individuals are maximized, and long-term investing in diversified portfolios is encouraged.

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[5] http://www.rba.gov.au/publications/submissions/fin-sys-inquiry-201403/superannuation.html

[6] https://www.ato.gov.au/super/self-managed-super-funds/in-detail/statistics/quarterly-reports/self-managed-super-fund-statistical-report---june-2014/?page=2#Asset_allocation_tables m

- Attached to this thinking is the opportunity for government to deeply consider the sub-objectives of superannuation, with the right fiduciary settings. One example of enormous opportunity where investment dollars can be linked to a national social welfare challenge is housing.

- This should not at any time threaten the central pillar of superannuation (maximizing savings for retirement), but establishing a tight framework with state and local authorities that encourages long-term investment in a key social policy area is an opportunity government should deeply consider.

- By emphasizing the importance of a quality fiduciary framework for investment, it is the natural corollary of this that we strongly warn against any 'ad hoc', short-term, reform that may inhibit housing investment. This includes any re-introduction of bans on limited recourse borrowing and/or negative gearing changes. If either or both occur, it would have widespread consequences, many unintended.

f) Australia's population is forecast by Treasury in its latest Intergenerational Report to grow from circa 24 million people currently to circa 40 million residents by 2054[7].

- Based on 2011 ABS Census average persons per household statistics[8], the 16 million new people will necessitate the construction more than 6.2 million new homes on top of our existing housing stock. The policy question is who will fund the investment required to underwrite the development and construction of 6.2 million new residential properties; of which nearly 2 million will need to be permanent rental properties based on the same 2011 Census data?

- Numerous government studies over the years have bemoaned the inability of the traditional corporate, industry, retail and public super funds to allocate substantial capital to residential property investments, which make up less than 1 per cent of their total portfolios.

- As the economist Christopher Joye first highlighted in his seminal 2003 study for the Prime Minister's Home Ownership Task Force[9], Australia's inelastic housing supply, and the dearth of private institutional investment in residential property, has exacerbated the housing affordability crisis.

- New housing supply in Australia has historically been funded by private individual investors, which have given Australia one of the largest private (as opposed to public or government funded) rental markets in the Anglo world. But with more and more pre-tax income from savers being forced into superannuation, it has become increasingly difficult over time for them to use any residual income for the purposes of acquiring an investment property.

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[7] http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2015/2015%20Intergenerational%20Report/Downloads/PDF/04_Chapter_1.ashx

[8] http://www.censusdata.abs.gov.au/census_services/getproduct/census/2011/quickstat/0?opendocument&navpos=220

[9] http://www.rismark.com.au/pdf/mrc.pdf

- Savers should have the same opportunities to invest in private residential property within SMSFs as they have outside of it. Over the long-run, this scarce capital could become a crucial part of the market-based solution to Australia's immense housing supply problems, which mount every day.

- Providing cost-effective housing is a universal challenge for the community and government. That those within the investment community are looking for investment opportunities as a consequence of this challenge is not to be discouraged, but rather, to be encouraged. It is the very nature of what drives investment in a free market economy.

g) What the FSI may have been alerting government to in warning of risks associated with the use of LRBAs is the threat of speculative investment.

- We endorse these concerns, and support action that encourages long-term investment in all investment products, including housing, and discourages short-termism.

- This can be done by government focusing on the financial framework for investment and making sure this has policy reason and intent.

- If government provides the right financial framework, including rules about quality accredited advice, rules on loan-to-valuation ratios, rules to fool-proof against speculation and uneducated investment, then investors *should* be allowed to consider the rates-of-return in long-term investment opportunities in property, and the risks of these decisions should be weighted no differently to any other risks of considered investment.

- By comparison, that APRA Reported that as at 30 June 2013 over 30% of APRA-regulated superannuation funds are invested off-shore (25% in equities and 6% in fixed-interest)[10] has risks of its own, and a case could be made that those risks are greater than any investment in domestic property in a stable economy with a growing population base.

- By getting the framework rules right, governments can fulfill a sub-objective of financial services, and that is the encouragement of investment towards the challenges of social and community housing, as well as supply-side and affordability challenges. By not doing so, the universal obligation to a stable economy, with a reliance on government to provide answers to a housing crisis, has risk. And by not doing so, the limit on diversification of portfolios so that they remain 'long equities' has risk.

- Instead, adopted in the right way, a focus on framework objectives and sub-objectives could strategically position Australia's financial sector as a lead example for other governments.

- Government should welcome the in-flow of capital looking for strong, safe and secure investment, while being largely agnostic of the investment type.

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10 http://www.apra.gov.au/Super/Publications/Documents/Revised%202013%20Annual%20Superannuation%20Bulletin%2005-02-14.pdf

- Put simply, if there is a long-term rate-of-return to be gained by assisting on the supply side of housing, and it is to be done in an attempt to diversify a superannuation portfolio, then diversification in long-term products that deliver a rate-of-return, and/or retirement income stream, is sensible policy for both the individual and the nation together.

h) A ban on LRBA within SMSFs would above all else, unnecessarily and with no long-term policy benefit, rupture the social contract between government and community.

5 KEY STATISTIC S THAT NEED TO BE CONSIDERED IN THE DEBATE

Self-managed Superannuation – a cost effective, well-managed competitor to bank and union dominated retail and industry funds

The SMSF sector is the largest sector in Australia's $1.85 trillion superannuation industry.

As at 30 June 2014 the ATO reported that Australia's 534,000 SMSFs had more than 1,000,000 members (8% of the roughly 11.6M members in the country) and held more than $557Bn in assets, or a favourably disproportionate 30% of total superannuation assets in Australia.[11]

SMSFs are also the strongest growing sub-set within the sector. In the five years to 30 June 2013, the ATO reports that SMSF assets grew by 53% against total fund growth (including large funds) of just 42% for the same period of which the SMSF sector contributed the largest portion of overall growth at 37%.[12]

In part the growth continues from the establishment of new funds which (as the ATO annual reports show) over the past six years have been running at an average rate of 26,000 net new establishments each year.

SMSF trustees and members seem not to favour managed funds or managed investment schemes, with historical ATO reports indicating that around 80% of SMSF assets were directly invested[13].

Increasingly those on higher incomes (and generally still in the wealth-creation phase of their lives) are turning to SMSFs, with ATO data published for the year ended 30 June 2012 (the latest available for this statistic) showing the average age of fund members of newly established funds being just 52 years whilst 32.7% of new fund members are under 45 years.

The same FY2012 ATO data showed that SMSF members were earning on average $97,000 pa against the non-SMSF average of just $56,000 pa whilst those aged 35-49 had an average taxable income of $123,000 pa versus just $68,000 pa for their non-SMSF peers.

The average SMSF member balance as at 30 June 2012[14] was $487,000 which the ATO reported was 16 times higher than the average balance of a non-SMSF account. While based on the same data from the ATO, the average member balance of a newly established SMSF was $186,000 with average total assets of a new fund being $331,000. The ATO further reported an increase in the average SMSF member balance to $537,000 as at 30 June 2014.

According to ATO published data SMSFs perform at least as well as, and in many years have outperformed, their non-SMSF counterparts in terms of asset growth and investment returns.[15]

The aforementioned ATO statistical reports show that SMSFs can also be cost-effective, with the average fund having an estimated operating expense ratio of 1% of assets in line with an

[11] https://www.ato.gov.au/super/self-managed-super-funds/in-detail/statistics/quarterly-reports/self-managed-super-fund-statistical-report---june-2014/?page=2#Asset_allocation_tables__m_

[12] https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Annual-reports/Self-managed-superannuation-funds--A-statistical-overview-2012-2013/

[13] https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Annual-reports/Self-managed-superannuation-funds--A-statistical-overview-2012-2013/?page=20#SMSF_asset_allocation

[14] https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Annual-reports/Self-managed-superannuation-funds--A-statistical-overview-2011-2012/

[15] https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Annual-reports/Self-managed-superannuation-funds--A-statistical-overview-2012-2013/?page=23#Investment_performance

average of 0.95% for both retail and industry super funds (as extracted from APRA FY2013 Annual Superannuation Bulletin data[16]).

Direct property (all types including commercial and residential) accounts for a relatively modest 15% of SMSF assets – or around $84.5Bn – with residential real estate accounting for a still relatively small $19.5Bn as at 30 June 2014 according to the aforementioned ATO referenced in footnote 10.

Direct equities accounted for a significant $177Bn whilst SMSFs had cash holdings of more than $157Bn as at 30 June 2014. Limited recourse borrowings remain very low as a percentage of SMSF assets at only $8.7Bn or 1.56%[17].

Residential Investment Property – a stable $1.3 trillion investment market

According to ATO statistics more than 1.76 million Australians own more than 2.78 million residential investment properties[18] that provide vital housing at affordable prices for more than 7 million Australians based on the latest ABS Census data.

In its most recent quarterly property price statistics, the ABS estimates the total value of residential real estate in Australia to be circa $5.4 trillion comprising 9.5M dwellings with an average price of $571,500[19].

The 2011 Census Report from the ABS shows 29.6% of all residential dwellings are rented (up from 28.1% in 2006 and 26.3% in 2001).[20]

Based on ATO 2011 statistics this indicates a total rented property market of 2.78M residential properties. The total market value of these properties is estimated to be in excess of $1.3 trillion; not far off the total value of all companies listed on the ASX.

In the period from 2006 to 2011 the ABS Census shows that Australia's population grew by a significant 1.65M people or an average of 330,000 per annum; and the total number of dwellings in the country increased by more than 720,000 or an average of 144,000 per annum.

Significantly, the 2011 Census also shows that the total number of rented dwellings increased by more than 287,000 or an average of 57,400 per annum.

Leading economist Shane Oliver published a detailed analysis[21] recently that indicates residential property has provided a similar long term return as Australian shares, with both returning between 11 to 11.5% pa (income and growth) on average since the 1920s.

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[16] http://www.apra.gov.au/Super/Publications/Documents/Revised%202013%20Annual%20Superannuation%20Bulletin%2005-02-14.pdf

[17] https://www.ato.gov.au/super/self-managed-super-funds/in-detail/statistics/quarterly-reports/self-managed-super-fund-statistical-report---june-2014/?page=2#Asset_allocation_tables___m_

[18] https://www.ato.gov.au/uploadedfiles/content/cr/research_and_statistics/in_detail/downloads/cor00345977_2011taxstats.pdf

[19] http://www.abs.gov.au/ausstats/abs@.nsf/mf/6416.0

[20] http://www.censusdata.abs.gov.au/census_services/getproduct/census/2011/quickstat/0?opendocument&navpos=220

[21] http://www.switzer.com.au/the-experts/shane-oliver/shares-property-bonds-or-cash/

Like almost any market, investing in residential real estate is not without risks and prices can rise and fall over any given 12-month period or multi-year cycle. Even with Australia's significant population growth, the supply-demand curve varies from one year to the next with periods of undersupply and periods of oversupply impacting capital prices and rental yields.

However, in the experience of the companies and individuals endorsing this submission, real estate investors have a longer range investment horizon (7-10+ years) and invest in the asset class for its performance over the longer cycle.

6 CONCLUSION

The Financial System Inquiry is welcome and long overdue. While many of the FSI considerations are provocative, they have provided an opportunity for all stakeholders to stand back and think, discuss, and respond. That 6,500 submissions were received demonstrates this wide consideration by many.

We believe there is enormous opportunity for Australia's financial services sector to demonstrate leadership through this process.

What concerns us is the potential for 'ad hoc', reactive, or short-term populist reform.

This would have real impact on the sector, at a time of low confidence and economic uncertainty for investors. We urge decision-makers to avoid such moves at all costs, and to tread carefully through the minefield of unintended consequences on this financial service reform pathway.

We understand the FSI desire to manage risk in the system. We would ask government to caution against interpreting "a need to manage collective risk in the system" as meaning further policy favouritism to the four-pillar banks.

These banks already have substantial competitive advantages and do not need further policy support to assist their ability to attract wealth management fees – considered some of the highest by cross-jurisdictional comparison.

One of the key drivers of SMSF growth is concern about wealth management fees. SMSFs therefore play a legitimate role in providing competitive pressure, and to the overall efficiency of the sector.

Evidence is also weak that tries to position individual risk management as 'riskier' than bank risk management. On the contrary, based on exposure during the GFC period of 2008-2010, SMSFs proved themselves as no more risky than alternate options.

It is agreed that compensation is available for non-SMSFs through different legislative instruments, which is not available for SMSFs, when issues of fraud or illegality occur. The Trio Capital case has highlighted these differences.

Compensation is provided because of legislation however. Risk exposure was the same for both SMSFs and non-SMSFs in the Trio Capital example. It is policy that has chosen to treat them separately at this stage.

This is not an argument against risk in SMSFs, but an argument for consistent policy settings in superannuation. It is consistent policy settings that will assist with smoothing out risk in superannuation, and this includes consistent policies across all of government legislation/considerations.

As the government statistics above demonstrate, as a cohort SMSF members and trustees are not unsuspecting, unsophisticated investors who need to be shielded from their own logical decisions. It should not be assumed that they are less capable of managing the risks associated with gearing (or investing generally) than trustees and investment managers running retail and industry funds (and the myriad of sub-funds in which they invest) are.

There is no systemic risk to the system through the use of LRBAs.

Growth is sensationalised by the FSI Report through the use of "percentages" rather than proper analysis of the relativity of the debt levels to the total value of assets.

The prudent use of investment debt is a legitimate strategy both inside and outside a retirement savings environment.

As such it is irrational to suggest that "indirect" gearing should be allowed to prevail whilst "direct" gearing should be allowed to continue.

Under such a scenario SMSF trustees would be prevented from buying say a $400,000 property using modest borrowings of say $250,000 (using $150,000 of cash) yet they (or any retail investor) could invest their entire superannuation savings into a geared share fund like the Commonwealth Bank's Colonial First State Geared Global Share Fund[22] that has provided a negative return since its inception 10 years ago (and at times has been negative greater than 50%) yet continues to charge its investors 2.6% pa for the privilege.

SMSFs simply should not be penalised versus their retail and industry fund peers.

Further as a leading economist and former Director of the Menzies Research Centre, Christopher Joye, pointed out in a recent article written for the Australian Financial Review[23]:

> *The FSI's inconsistencies are acute in the case of self-managed super funds (SMSFs) using leverage.*
>
> *Today, banks permit SMSFs to borrow up to 80 per cent of the value of an investment property on a "limited recourse" basis. Specifically, the bank only has recourse to the property asset that secures the loan – it cannot touch the rest of your super savings or go after your non-super wealth.*
>
> *The saver therefore gets access to investment property returns with a maximum of five times leverage (given a 20 per cent deposit). If the $600 billion SMSF sector allocates 30 per cent of its cash to housing equity, that would translate into $900 billion of potential housing demand. With Australia's population expected to expand by 15 million people over the next 35 years, we are going to have to underwrite the construction of 6 million to 7 million additional homes. SMSFs could be one important solution.*
>
> *The fundamental question for Murray, however, is how investing in housing equity with five times leverage is any riskier, or a greater financial stability problem, than investing in major bank equities that carry 22 times leverage?*
>
> *The former exposes you to substantially less leverage and could help fund vital housing supply. The worst case in either scenario is you simply lose 100 per cent of your equity.*
>
> *If Murray wants to ban SMSF investments in leveraged housing, he should in theory ban all forms of leveraged equities, including bank shares.*
>
> *A better approach would be to simply mandate a minimum level of non-leveraged SMSF holdings.*

Arguments that property does not belong in superannuation because it is a relatively illiquid asset miss a vital point. This 'illiquidity' creates a stable asset class and stable income streams (unlike more volatile 'liquid' assets such as shares or managed funds that have shares as their underlying investments).

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[22] http://www.colonialfirststate.com.au/prospects/FS1636.pdf

[23] http://www.afr.com/opinion/murray-should-leave-smsfs-alone-20141202-11yqiq

The most important factors in residential real estate investing versus share market investing are the lack of volatility and the lack of a 'panic button'. Investment in stable, income-producing assets that have a history of stable asset value appreciation should be encouraged within retirement savings plans, not discouraged.

Investment in Residential Property is not a risky folly – it is Vital to Australia's Economic Stability and Social Fabric.

As ASIC has noted an estimated 85% of financial advisers are associated with financial product issuers so effectively act as a product pipeline (for the issuer)[24].

Perhaps because of consumer dissatisfaction with this model, retail and industry funds are losing many of their best members as they move to the lower-cost direct-control environment offered by SMSFs.

To put it in perspective, in FY2014 retail and industry funds lost 63,000 members or around $11.7Bn of funds outflow to SMSFs. This loss also cost them an estimated $2Bn plus pa of future new inflows.

Perhaps most significantly, over the average 'revenue life' of those departing members retail and industry funds will miss out on an estimated $4Bn of superannuation administration and asset management fee revenue.

This number is important because (based on modeling using ATO and APRA data) all things being equal those members departing to SMSFs will save an incredible $1.3Bn in fees over that same period. That is the difference between what they were paying and the cost of running their SMSFs. That is money they, not the retail and industry fund managers, will retire with.

This loss of revenue for the retail and industry funds; and gain to SMSF member retirement savings, is being repeated every year.

Policy setting should be such to foster this completive environment as it is likely to lead to more competitive behaviour in the retail and industry fund sector, therefore potentially improving retirement savings outcomes for all Australia's not just those moving to SMSFs.

Allowing the prudent use of leverage within SMSFs is good policy that can improve retirement outcomes for many Australians.

Government concerns relating to LRBAs can, and should be, readily addressed through means other than a ban.

[24] http://download.asic.gov.au/media/2125918/rg175-ris.pdf

APPENDIX A – WHO WE ARE AND THE REASONING FOR OUR SUBMISSION TO GOVERNMENT

We are a diverse group of company's and individuals who collectively provide products and services to more than 30,000 property investors as well as SMSF trustees and members; many of whom have investments in residential and commercial real estate and many of whom have used LRBAs to assist in acquiring those assets. Our individual contact details are provided below.

At the urging of many of our customers and clients we have held several round-table meetings over the past 12 months to discuss the current superannuation and housing reform agenda.

Following that process we are assisting our clients and customers to fully consider the ways in which they can collectively have a voice in critical national debates of this nature. One such consideration is the establishment of a new national residential property investors association to represent the interests of, and advocate for, the 1.76M Australians who collectively own 2.78M residential investment properties (that provide housing for more than 7 million Australians).

As the foundation stones for such an association are yet to be laid for we make this submission at this stage in its place.

We do not claim to be specialists in any broader national policy debate. Our specialties are in maximizing wealth accumulation for retirement investors, portfolio diversification, legal, accounting, taxation services and in the development of residential property.

The main reason we have felt the need to organise and make a submission is concern that some issues raised in the FSI process may impact on existing wealth management, superannuation, retirement planning and property investment strategies, which we believe would be detrimental to the financial system, and the national interest.

We acknowledge the national interest reasons behind the FSI, the Tax Reform White Paper, the Inter-Generational Report, and the Future of Federation White Paper, and offer to work in partnership with government to establish a strategic and long-term approach to all these issues, and to give due consideration to all these processes in the development of stable, secure, competitive policy for investors and the nation.

Because of this, we endorse the FSI suggestion of feeding tax and transfer recommendations into the separate Tax Reform White Paper process.

We would go a step further, and strongly encourage government to combine considerations of the Financial Services Inquiry, Tax Reform and Future of Federation White Papers, and Inter-Generational Report. ***All four processes of inquiry must 'talk to each other' if we are to maximize this reform agenda***. Each needs to feed into the other. No reform decision should be made in isolation, as this is not the reality of how the marketplace works now, or in the future.

The opportunity exists for a roadmap to be developed based on combining the four separate strands of government work - the Financial Services Inquiry, the Inter-Generational Report, the Tax Reform White Paper, and the Federation White Paper. The key to reform would be an encouragement of long-term investment strategies.

We would welcome engaging with government on this long-term agenda, and would assist where possible.

Such a sensible, longer-term approach stands in contrast to current investment uncertainty created by a Financial Services Inquiry perception that a ban on Self-Managed Superannuation Funds borrowing capacity will be re-introduced, that negative gearing on rental investments is in doubt, along with an unexpected decision to introduce a charge on foreign residential property investment. These are each examples of isolated decisions in the short-term that could be addressed through a much more strategic process, and in partnership with the investment community.

We look forward to being involved in such a process.

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Spring FG Limited (Spring FG) is an ASX-listed (ASX:SFL) diversified financial services company with products and services encompassing financial planning and investment advice; insurance and superannuation; finance; and tax & accounting services.

Spring FG's advice and product offerings are broad and include a specialisation in self-managed superannuation funds (SMSFs); and direct and SMSF residential real estate investment.

Spring FG's clients hold more than $250M in residential property investments.

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McInnes Wilson is one of Queensland's largest privately-owned law firms. It is a full service firm with a wealth of experience in a broad range of specialised legal services.

This includes advising investors, owner-occupiers and developers on private residential acquisitions and sales as well as major residential developments, including existing community title structures and off-the-plan sales for projects.

It has advised on hundreds of millions of dollars of residential and commercial property asset purchases and sales and also has extensive experience in SMSFs.

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Tessa Residential is a full service property and building management company managing residential property assets valued in excess of $300M.

Its team of specialist managers are highly experienced and extremely knowledgeable, having collectively over thirty successful years in the property industry.

Tessa's mission is to maximise investor returns by implementing efficient property management systems and best practice building management procedures. 100% privately owned and operated, Tessa Residential is a market leader in property and building management services.

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Metro Property Development is one of the most active developers in inner city Brisbane with more than $2.5 billion worth of projects in the development pipeline, while its Melbourne, Adelaide, Perth and Sydney operations are rapidly expanding their housing and master planned communities business.

Its knowledge and expertise was gained through its directors being the founding directors of Devine Limited for over 25 years, guiding the business from a small southeast Queensland company to one of Australia's leading publicly listed property organisations.

Metro's directors have delivered more than 30,000 homes and apartments for Australian families.

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BPM Corp is a Melbourne-based boutique developer with a track record that extends over two decades and is synonymous for delivering architecturally iconic developments that are truly inspired.

Founded by Jonathan Hallinan in 1995, BPM has emerged as one of Australia's most acclaimed property developers with an uncompromising attitude to both quality and design with exclusive projects extending from Melbourne's prestigious inner city suburbs through to Queensland's West End.

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Oliver Hume is a multi-disciplinary Australian property services company with over 60 years of success in residential and mixed-use property developments. Organised into specialist divisions, its people specialise in the delivery of corporate advisory services, project marketing, asset management, project management, development site sales or acquisitions and strategic research to and on behalf of public and private organisations throughout Australia.

Acclaimed as Australia's leading residential project marketer, Oliver Hume is the marketing force behind an enviable list of some of the nation's most reputable residential communities and residential development companies. Backed by a research division that provides the Oliver Hume network with real time intelligence into the state of the Australian residential property market, Oliver Hume has grown to become a multi-office organisation with operations in Victoria, Queensland and New South Wales.

Submission in Response to Financial System Inquiry Final Report
25 March 2015

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Established in 1983 the ASX-listed Devine Group (ASX: DVN) has become a widely respected and trusted home builder, meeting the needs of homebuyers in Queensland, Victoria and South Australia. As an Australian brand Devine proudly stands by its record for quality and value in delivering superior housing solutions to more than 30,000 Australian families. Its property experience portfolio extends across large-scale master planned community development, home building, inner-city high-rise apartment buildings, commercial and retail property as well as establishing a major construction company.

David Kortlang
Associate Director
Colliers International – Residential

Colliers works with investors, developers and occupiers across all sectors of the Queensland property market including office, industrial, retail, hotels, healthcare and retirement living, residential project marketing and site sales and rural and agribusiness. It offers a range of specialised services such as valuation and advisory services, real estate management, project services and tenant representation.

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