Australian
Banking & Finance
Law Bulletin

Financial System Inquiry: Part 2 — A lending industry perspective on SMSF lending

Leonie Chapman *LAWYAL SOLICITORS and* ***Tim Brown*** *MORTGAGE AND FINANCE ASSOCIATION OF AUSTRALIA*

Background

This is the second article in our two-part series covering a lending industry perspective on the Financial System Inquiry (FSI). In Part 1,[1] we explored the findings by the FSI panel as they apply to the mortgage broking and lending industry and in particular, heard the views of Tim Brown, Chairman of the Mortgage and Finance Association of Australia (MFAA) on the Final Report's findings in relation to competition in the banking sector. In this second article, we explore the FSI's recommendations to prohibit self-managed superannuation fund (SMSF) lending, and the lending industry's response[2] as expressed by MFAA.

To recap, in late 2013 the Treasurer released draft terms of reference for the FSI, charged with examining how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth. The intension of the FSI is to establish a direction for the future of Australia's financial system. In July 2014 the committee produced its Interim Report (Interim Report), dealing with issues relevant to credit advisers such as the substantial regulatory reform agenda, and relevant to this article, the restoration of a ban on SMSF lending. In November 2014 the FSI Final Report[3] was published (Final Report) taking into account industry and expert responses, including from the MFAA.[4] In this article we explore the Final Report recommendation for a prohibition on SMSF lending through Limited Recourse Borrowing Arrangements (LRBAs), which MFAA and other industry participants challenge for the reasons outlined below.

Interim Report on SMSF leverage risk

The Interim Report documented findings that the number of SMSFs has grown rapidly, now making up the largest segment of the superannuation system in terms of number of entities and size of funds under management, which are expected to continue to grow. The use of leverage in SMSFs to finance asset purchases is also growing, with the proportion of SMSFs, while still small, increasing from 1.1 percent in 2008 to 3.7 percent in 2012. The Interim Report observes that, allowing the use of leverage in SMSFs to finance assets to grow "may create vulnerabilities for the superannuation and financial systems", as leverage magnifies risk "both on the upside and downside."[5] While leverage was originally prohibited in superannuation in most situations, in 2007 the Superannuation Industry (Supervision) 1993 (SIS Act) was amended to allow all SMSFs to borrow.

The key policy option put forward by the FSI's Interim Report was to restore the general prohibition on direct leveraging of superannuation funds on a prospective basis. It argues the general prohibition was put in place for sound reasons, including one highlighted during the Global Financial Crisis (GFC) where it demonstrated the benefits of Australia's almost entirely unleveraged superannuation sector, which the Interim Report claims resulted in minimal losses in the superannuation sector. This had a stabling influence on the financial system according to the Interim Report,[6] one of the key objectives of the FSI.

MFAA Submission in response to FSI's Interim Report

While Mr Brown and the MFAA acknowledge the Interim Report's comments that borrowing in SMSFs are often associated with poor advice by credit and financial advisers and accountants related to establishing an SMSF as part of a geared investment strategy,[7] in its submissions to the Interim Report MFAA expresses a view that rather than prohibit direct SMSF leveraging, training and education of advisers and accountants is a better alternative, including continuing initiatives such as the MFAA SMSF Lending Accreditation. This would help ensure consumers are better protected by qualified advice from all the professionals in the SMSF process, including SMSF lending. The introduction of MFAA's new SMSF Lending Accreditation program was motivated in 2012 after it recognised the gap in understanding of SMSF lending by quality advisers, and a desire to ensure they were properly educated in understanding its risks and pitfalls.[8] Mr Brown describes one of the key

outcomes of the program is to develop credit advisors to be competent in relation to LRBAs, to better be able to advise on the appropriateness and suitability of this type of lending from a credit perspective.

Mr Brown describes how at an institutional level, lenders have also been diligent in creating SMSF lending products that will protect SMSF trustees and beneficiaries, while at the same time providing the flexibility to achieve SMSF objectives. For example, most major lenders require a Financial Advice Certificate by financial advisers or accountants to certify that the lending is appropriate for the trustee, and have started to introduce a minimum fund balance. Lending criteria is also tightening, with lenders mortgage insurers requiring properties to be funded with LRBA's to be at least 12 to 18 months old, which reduces the risk of off-the-plan property sales from property developers and therefore reduces asset value. All lenders require property valuations and many a maximum loan to value ratio of 80% for residential property, to help improve the SMSF cash flows and improve liquidity within the fund. Finally, responsible lending guidelines are followed by lenders, when assessing suitability of SMSF lending products.

Final Report recommendations on direct borrowing for LRBAs

In the Final Report,[9] despite submissions from industry arguing against it, including the above arguments from MFAA, the FSI recommended the removal of the exception to the general prohibition in direct borrowing by SMSF from LRBAs under the SIS Act.[10] The section the FSI seeks to remove, currently allows SMSFs to borrower to purchase assets directly into the SMSF using LRBAs. The Final Report lists objectives including preventing the "unnecessary build-up of risk in the superannuation system and financial system more broadly" and to fulfil the "objective for superannuation to be a savings vehicle for retirement income, rather than a broader wealth management vehicle."[11]

In essence, the Final Report is concerned that borrowing even with LRBAs will magnify gains and losses from fluctuations in the price of assets held within SMSFs, and particularly so soon after the GFC. This could increase the risk of large losses in funds, where lenders can charge higher interest rates and require more personal guarantees from trustees. In this particular example, with a significant reduction in value of the asset and personal guarantees, the Final Report describes a likely outcome that the trustee would sell other assets in the fund to repay a lender, which could mean ineffective limiting of losses flowing from one asset to others, either inside or outside the SMSF.[12]

In many cases, SMSFs were set up to achieve a diversity of assets, mostly in the form of shares, money and real estate.[13] As such, the Final Report believes that selling other assets to pay a loan might concentrate the asset mix of a small fund, which reduces the benefits of diversification and increases risk to the SMSF. The ultimate end result of a failure of superannuation like this, the Final Report believes, will be a transfer of downside to taxpayers, through the provision of the Age Pension. Finally, the FSI is not keen on borrowing by SMSF where it allows members to circumvent contribution caps and accrue large assets in the superannuation system in the long run.[14]

Industries views on banning SMSF lending

Predictably the recommendation to ban SMSF LRBAs has been attacked from many sectors, with some pointing to the current low volumes, and others, like MFAA, stating that lending standards should be tightened and advice requirements toughened. Many Accountants and Financial Advisers join the voice of MFAA in disagreeing with the FSI's recommendation to ban direct borrowing in SMSFs, predicting intense lobbying for and against LRBAs in 2015 and strong resistance to the recommended ban.[15] In a joint submission to the Final Report by MFAA, Association of Financial Advisers, Financial Planning Association of Australia and Commercial Asset Finance Brokers Association of Australia, MFAA reminds the FSI of the heavy government regulation and self-regulation over the SMSF industry and outlines that the sector has been assessed favourably by ASIC and the ATO, with no hint of any systemic risk having been raised in relation to SMSF lending.[16]

Regarding personal guarantee risk

Regarding the Final Report's comments that there is a frequent use of personal guarantees to protect Lenders against the possibility of large losses and this could potentially reduce the effectiveness of the SIS Act[17] restrictions, this is unlikely to be the case in many scenarios involving LRBAs, according to Mr Brown. The SIS Act[18] prohibits any legal right of recourse against the assets of the fund should the trustees default on the loan. The rights of the lender against the fund as a result of default on the borrowing are limited to rights relating to the acquirable asset.[19] Some industry submissions even call for a ban on personal guarantees, however MFAA's joint submission highlights that the removal of personal guarantees will result in Lenders lowering LVRs for LRBAs, meaning that SMSFs will need to contribute more of the purchase price for the property, impacting the ability of SMSF to diversify its asset mix and restricting the availability and cost of finance. Given the very low default rate of LRBAs, MFAA does not believe that the removal of member personal guarantees is justified.[20]

Regarding diversification

To the Final Reports comments on diversification, most in the industry, including Mr Brown and the MFAA, agree that there are some dangers of SMSF lending, and in particular if the weighting of property in SMSFs is too heavy then this could reduce the diversification benefit of leveraging. An SMSF is essentially about having liquid assets to fund retirement, and therefore having assets tied up in property could result in SMSF portfolios that are predominantly based in real estate rather than cash or some other form of greater.[21] However, MFAA also believes that a restriction in maximum LVR to 80% will help address the diversification risk the FSI has raised. In fact, without gearing, a lot of SMSFs may be forced to access real estate exposure through managed funds and their portfolios could be restricted only to shares and money.[22] Some submissions describe a key differences between "traditional style" leveraged investments and LRBAs, claiming a lower level of systemic risk posed by direct SMSF leverage compared with direct leverage outside of superannuation.[23]

Many in the industry, including Mr Brown, believe that the use of LRBAs is likely to result in higher, and not lower, levels of asset diversification and lower, and not higher, levels of investment risk, as they enable SMSF investors to reduce their exposure to asset classes which historically SMSFs have held over exposed positions, such as listed securities and cash.[24] For example, according to MFAA's joint submission in response to the Final Report, due to the long term performance and stability of property, if SMSF borrowing is banned, SMSFs with moderate balances will still invest in direct property using cash and such investments will be at the expense of fund diversification.[25]

Further, banning LRBAs, according to MFAA's joint submission, will simply channel SMSFs into less regulated, riskier structures that also use leverage, such as unit trusts, warrant products and derivatives. To the contrarily, LRBAs are within the oversight of the ATO and must comply with strict rules set out in the SIS Act. Despite any ban, SMSFs would also still be able to invest in management investment funds holding direct property. As superannuation is compulsory in Australia, individual should have the discretion regarding where and how to invest those savings and SMSF lending is essential to consumer choice and competition, to allow people to build their retirement savings in a manner that suits their needs and preferences. Finally, banning SMSF lending could also have a significant impact on small businesses that use leverage to assist their SMSF to purchase their business property, which is then leased to a related trading entity.[26]

Possible alternative solutions suggested by industry

As demonstrated, Mr Brown believes the impact on banning SMSF lending will be significantly felt, and he and the MFAA believes that better education and training for those involved in the SMSF lending industry, measures to protect and license LRBA advice, and the continue restriction of lending parameters for SMSF lending, are better alternatives to prohibiting SMSF lending completely. He also believes that in order to give Australians confidence in superannuation it is important that regulation in the industry is stable. Many trustees enter into long-term investments, and making regular changes to the superannuation laws means that trustees lack the necessary certainty to make such long term, stable investments.[27] At the very least, Mr Brown believes, the LRBA provisions should not be repealed without first implementing proposed regulations and protection measures, and after some time, assessing their effectiveness. MFAA also believes banning borrowing from related parties could assist reduce the risk, and require borrowing to be from a licenced lender, with sound credit policies and a requirement for independent financial and legal advice for the trustee.

Unfortunately for industry, however, there is a risk that it may face a difficult task lobbying to retain SMSF lending against the FSI's recommendations to ban it. Many submissions put forward by industry wish to improve the superannuation system and seek to weigh up the costs versus benefit of SMSF funding, however according to some, very few have responded directly to the actual concern of the FSI.[28] The terms of reference of the FSI are to promote a competitive and stable financial system that contributes to Australia's productivity growth, and to consider the threats to stability of the Australian financial system, including superannuation. The review did not consider the potential benefits to superannuation leverage or the inappropriateness of advice. It was set up to ensure the prevention of unnecessary build-up of risk in the superannuation and financial system and to fulfil the objective for superannuation to be a savings vehicle for retirement income.[29] The Final Report noted some of these alternatives to address the risk surrounding SMSF borrowing and the industry goal to provide funds with more flexibility to pursue alternative investment strategies, however found that some alternatives would impose additional regulation, complexity and compliance costs on the superannuation system.[30]

Despite this, according to MFAAs joint submission to the Final Report, the FSI has not provided any evidence of risk, damage or loss arising from LRBAs. The evidence cited in support of the ban is anecdotal at best, according to Mr Brown. In any case, as mentioned

above the MFAA believes that a ban on SMSF lending to avoid leveraging will be ineffective because SMSFs will still be able to invest in derivatives and other traded products with built in leverage, and if the underlying company or investment scheme fails, there is no residual value on the asset. This, however, is not the case with real property, which is the primary asset acquired through the use of LRBAs. Even if property values fall, the asset itself is still a residual value and it is often hard for yields to be materially adversely affected, even during the GFC. MFAA's joint submission explains how real property has an added benefit of providing capital growth as well as an income stream during retirement (for example, rental income on investment properties), where dividends are not and therefore shareholdings may need to be sold when the fund moves into pension mode.[31]

Conclusion

The government is currently considering the recommendations of the FSI and is accepting consultations, with plans to respond sometime during 2015.[32] In summary, the FSI panel was mostly concerned that leverage in the superannuation system, combined with leverage in the banking sector, will weaken the financial system and limit the ability to respond to the next GFC. As leverage cannot be removed from the banking sector, the only response is to ban it in the superannuation system.[33] In making its recommendation, the FSI believes that the ability for SMSFs to borrower funds may, over time, erode the strength of the Australian superannuation industry, and could contribute to systemic risks to the financial system if allowed to grow at high rates.[34] According to FSI, prohibiting direct borrowing by SMSF would be consistent with the objectives of superannuation being a savings vehicle for retirement income, and would in the views of the FSI, preserve the strengths and benefits of the superannuation system for individuals, the system and the economy.[35] In particular, they expressed concern that if SMSFs do not meet the retirement objectives the government hopes for, they will then have to fall back on the public purse to fund retirement through taxes.[36]

So far many of the banking and advisory industries appears to disagree with the ban and it will be interesting to see how hard MFAA and other industry bodies will lobby for LRBAs in 2015. Mr Brown and the MFAA believe that Credit Advisers and Lenders are acutely aware of the potential negative implications of LRBAs and have introduced policies to substantially reduce the risk presented to clients, and ensure that trustees have success with SMSF lending. With the work being undertaken by the MFAA to up skill members on LRBAs, and the proactive initiatives undertaken by Lenders to ensure responsible Lending, the restoration of the general prohibition on direct leverage of superannuation funds in the views of the MFAA, is inappropriate. Given the broad number of stakeholders who would be impacted by a ban on SMSF lending, the potential risks to the financial system if it is not banned according to the Final Report, and the currently very low default rate of LRBAs according to MFAA, it will be interesting to see if the government pursues the prohibition, and if it does, the flow on consequences to the banking, advisory and superannuation industries.[37]

Leonie Chapman
Principal Lawyer and Director
LAWYAL Solicitors
leonie.chapman@lawyal.com.au
www.lawyal.com.au

About the author
Leonie Chapman's *experience extends to banking and finance, consumer credit and mortgage lending, contract negotiation, trade practices and fair trading legislation, intellectual property and trade marks, and corporate and financial services. After completing her Bachelor of Laws and Bachelor of Commerce in 2002, Leonie went on to work both in private practice and as senior in-house lawyer supporting a specialist lender, and then for six years with Macquarie Bank Ltd. Having achieved a Master of Laws in 2009 specialising in banking and finance law, Leonie's main focus now as Principal of LAWYAL Solicitors is on regulation and compliance for banking and financial institutions.*

Tim Brown
President
Mortgage Finance Association of Australia (MFAA)
TimB@vow.com.au

About the author
Tim Brown *is the Chairman of the Mortgage and Finance Association of Australia (MFAA). He has worked in the banking and finance industry for over 30 years and has held senior management positions in organisations such as Macquarie Bank, LJ Hooker, Suncorp, Aussie Home Loans and AVCO Finance (now GE Capital). Tim's industry experience has seen him successfully establish and own LJ Hooker Home Loans as a master franchise which was acquired by LJ Hooker in 2003. Tim is currently the CEO of Vow Financial, Australia's sixth largest mortgage aggregator. He has an MBA and also completed a Diploma in Mortgage Lending and Business Management and a Diploma in Financial Planning.*

Footnotes

1. L Chapman and T Brown, *Financial System Inquiry: Part 1 — A lending industry perspective on competition*, LexisNexis *Australian Banking & Finance Law Bulletin*, (2015) 31(1) *BLB* at p 4.
2. Submission by Mortgage Finance Association of Australia in response to Financial System Inquiry, dated March 2014.
3. Financial System Inquiry, *Final Report*, Treasury, November 2014.
4. Mortgage Finance Association of Australia, submission in response to Financial System Inquiry, *Interim Report*, August 2014.
5. Financial System Inquiry, Interim Report, Treasury, July 2014, at p 2–116.
6. Above, n 5, at p 2–117.
7. Australian Securities and Investments Commission (ASIC) 2013, SMSFs: Improving the quality of advice given to investors, Report 337, ASIC, Sydney.
8. Mortgage Finance Association of Australia, submission in response to Financial System Inquiry, dated August 2014.
9. Above, n 3, at p 86.
10. Superannuation Industry (Supervision) Act 1993 (Cth), s 67A.
11. Above, n 3, at p 86.
12. Above, n 3, at p 86.
13. N Bendel, *Finance broking associations at odds over SMSF borrowing*, SMSF Adviser, 8 January 2015.
14. Above, n 3, at p 86.
15. M Masterman, *Accountants reject ban on SMSF borrowing: poll*, SMSF Adviser, January 2015.
16. Joint Submission by Mortgage Finance Association of Australia, Association of Financial Advisers, Financial Planning Association of Australia and Commercial Asset Finance Broker Association of Australia in response to Financial System Inquiry Final Report, dated March 2015.
17. Above, n 10, s 67A.
18. Above, n 10, s 67A.
19. K Taurian, Cavendish disputes FSI stance on borrowing, SMSF Adviser, 9 April 2015.
20. Above, n 16.
21. Above, n 13.
22. Above, n 13.
23. Above, n 19.
24. Above, n 19.
25. Above, n 16.
26. Above, n 16.
27. Above, n 16.
28. L Smith, Have people got the FSI SMSF LRBA recommendation wrong? Sole Purpose Test, 2 April 2015.
29. Financial System Inquiry's terms of reference dated 20 December 2013.
30. Above, n 5, at p 2–116.
31. Above, n 16.
32. Above, n 28.
33. Above, n 29.
34. Above, n 5, at p 2–116.
35. Above, n 3, at p 88.
36. Minter Ellison Lawyers, FSI must focus on SMSF risks, News, accessed in April 2015.
37. Above, n 16.