SELF-MANAGED INDEPENDENT SUPERANNUATION FUNDS ASSOCIATION

31 March 2015

Senior Advisor
Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email – fsi@treasury.gov.au

Dear Sir/Madam,

Financial System Inquiry – Submission in relation to the Inquiry's recommendation 8

SISFA is pleased to make a submission to Treasury in relation to the Financial System Inquiry Final Report (**Report**). SISFA has limited its response to recommendation 8 contained in chapter 1 of the Report in the section titled "Direct borrowing by superannuation funds".

SISFA is the Self-managed Independent Superannuation Funds Association. It was established in 1998 as Australia's first self managed superannuation fund (**SMSF**) advocate association, and since then has grown to be the national voice for SMSFs in the superannuation policy debate. SISFA provides an important link between fund trustees, the superannuation industry, authorities and the community though its regular liaison on matters such as policy, proposed legislation and rulings impacting on SMSFs.

The topic of SMSF and borrowing is an important topic that continues to attract a significant amount of (often passionate) comments in newspapers and from various persons in and out of the superannuation industry. Some of these comments suggest that the concept of borrowing in a SMSF is at odds with the savings purpose of the SMSF, and that SMSFs that borrow are taking unfair advantage, or at least compromising, the system. Other criticisms of borrowing in the superannuation system claim there is a potential for such borrowing to overheat the property market or to create a systemic weakness in the superannuation system. SISFA is concerned that some of these comments may be driven, or encouraged, by certain vested interests within the financial services industry as an attack on SMSFs rather than as an objective discussion of the merits of leverage in the superannuation system.

There has long been a goal of Governments and the superannuation industry to encourage members to take an active interest in their own superannuation, wherever it may be held. Many of the initiatives to foster this interest have failed. However, in the view of SISFA, one of the most significant areas of member engagement in the superannuation system has been the development of the SMSF sector. This has resulted in the superannuation sector moving from one dominated by large institutional funds with low member engagement to a sector that now has a very significant number of SMSFs with direct member engagement in their own superannuation savings. This level of engagement is a highly desirable outcome as SMSFs have been enthusiastically adopted by Australians as a way to grow their personal retirement savings. The superannuation system already has many safeguards to ensure SMSFs are not abused by members. As a general rule legislation does not restrict or dictate how an SMSF can invest (subject to certain conditions such as not providing financial assistance to members), provided the investment is within the fund's stated investment strategy. This is consistent with policy outcomes that apply across all types of superannuation funds, including the current borrowing provisions.

In general, it is not contentious to borrow to invest in assets. Australians borrow to invest in real property and financial assets such as shares to increase wealth and provide for an income in non-working years. Borrowings are also used at times to smooth cash flows (a point noted within the super regulations covering situations such as borrowing to pay a beneficiary or cover the settlement of security transactions). Prudent leveraging is a common and effective growth strategy regularly undertaken within the overall investment framework of larger superannuation funds and wholesale investment funds it. This is not a tax driven approach to investment, rather a mechanism to increase exposure to a wider range of assets and to increase fund returns.

SISFA submits that the current review of borrowing by superannuation funds more broadly provides an appropriate opportunity to make borrowing by SMSFs under limited recourse borrowing arrangements function better. SISFA has identified the following areas for improvement:

1. Simplify the financing structure
2. Ability to modify assets
3. Flexibility and refinancing
4. Risk management through a cap on loan to value (**LVR**) ratio
5. Consumer protection
6. Personal guarantees

1. Simplicity of financing structure

The limited recourse borrowing arrangements had an unusual genesis in the Telstra instalment warrants, and these origins produced overly clumsy structural requirements. The current "bare trust" or "instalment warrant trust" arrangement is complicated artificial and costly. SISFA recommends this mechanism be replaced with standard limited recourse loan documentation to remove uncertainties and unnecessary costs generated by the existing security structure and associated compliance complexities.

2. Ability to modify assets

The current arrangements are limited to the acquisition of a 'single acquirable asset' and prevent some improvements from being made to an asset.

This allows for anomalous results in cases where an SMSF cannot borrow to acquire vacant land to build a house, but can acquire a ready-made "house and land package". Difficulties also arise for renovations and improvements to existing valid fund investments.

SISFA believes in the spirit of providing SMSFs with freedom to choose how to invest and manage their money and consequently such artificial restrictions should be removed. Our risk management comments under item 4 below would provide an appropriate safeguard to enable this provision to take effect. It would also facilitate more efficient fund management and better compliance.

3. Flexibility and refinancing

The existing rules do not clearly define a loan or borrowing and the availability of refinancing. This can be an issue for loans from related parties and the ATO's view of the application of the non-arm's length income rules to "uncommercial loans".

SISFA believes that there should be a statutory safe harbour under which loans from related parties will not trigger adverse outcomes. This could include a minimum interest rate, a maximum loan to value ratio, a maximum loan term, etc. to ensure such related party arrangements are not open to abuse.

4. Risk management through a cap on LVR

A sensible legislative cap on the LVR could be considered for SMSF borrowings to address concerns that SMSFs can currently take too much risk. This would be a significantly simpler test to assist trustees administer funds within the rules as well as facilitate annual reporting for ongoing compliance and audit assessment.

5. Consumer protection

If there is a problem with inappropriate SMSF investment schemes being promoted, then the reform should focus on providing SMSF trustees with better consumer protection and directly addressing the problem of rogue promoters, rather than a blanket legislative ban on borrowing.

6. Personal guarantees

Currently a member can provide a personal guarantee to a bank to enable the SMSF to secure a lower interest rate for the borrowing or a higher LVR. There has been much criticism of such arrangements on the basis that the existence of guarantees undermine the "limited recourse" nature of the arrangements.

In SISFA's view the existence of guarantees is no different from other commercial arrangements and in light of some of the comments above should remain. Therefore, SISFA believes that ways to enable personal guarantees to work within the SMSF context can be considered and managed effectively.

Concluding comments

SISFA submits the recommendation 8 contained in chapter 1 of the Report to restore the general prohibition on direct borrowing by superannuation funds on a prospective basis should not be implemented. Instead SISFA recommends a more sophisticated approach that improves the circumstances in which SMSFs (and indeed all superannuation funds) can borrow. Borrowing is not the core focus of SMSFs. However, borrowing is a standard mechanism to build investments (and sometimes enable investment projects to be undertaken at all). SISFA submits that the ability to look after your own superannuation savings within your own fund (SMSF) should extend to having the ability to utilise all available investment tools, including borrowings, to maximise your final retirement benefits (obviously within appropriate legislative controls). Legitimate concerns regarding appropriate risk management and advice with regard to superannuation savings more broadly needs to be addressed consistently across all related sectors – not simply with a blanket ban in one specific area.

SISFA is ready and available to discuss these issues further. Please contact:

Michael Jones
Chair of the SISFA policy committee
03 9252 0800
mjones@cfmc.com.au

or

Phil Broderick
Chair of the SISFA technical committee
03 9611 0163
pbroderick@sladen.com.au

Yours Sincerely

Phil Broderick
CHAIR OF TECHNICAL COMMITTEE