CONFIDENTIAL

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SMSF ASSOCIATION SUBMISSION ON LIMITED RECOURSE BORROWING ARRANGEMENTS

The SMSF Association (SMSFA) welcomes the opportunity to make a confidential submission to Treasury regarding the Council of Financial Regulators' review of Limited Recourse Borrowing Arrangements (LRBAs).

Our historic position regarding direct borrowing by superannuation funds has been to oppose a prohibition on borrowing on the basis that SMSFs use LRBAs to fulfil the objective of superannuation to generate retirement income. LRBAs used appropriately as a genuine retirement strategy can help build savings and also allow small business owners to utilise their business real property as a superannuation investment.

However, LRBAs have been under recent heightened scrutiny and as an Association we have regularly reviewed their impact relating to risk areas such as their use by property spruikers, lack of SMSF diversification, risk to SMSF and economic integrity, LRBA growth and impact on the property market.

The SMSFA has specific concerns regarding the unscrupulous provision of LRBA and SMSF advice through one-stop property shops. This was highlighted as a concern in the Australian Securities and Investment Commission's (ASIC) Report 575 SMSFs: Improving the quality of advice and member experiences.

Furthermore, the access to finance from the major banks is becoming further restricted for SMSF trustees.

Based on the current available statistics and feedback from our members who advise on and implement LRBAs, we do not believe that the use of LRBAs is occurring in an excessively risky manner.

As part of this submission we have provided a summary and analysis of current LRBA statistics and trends, as well as the results from a survey of our professional members.

We recommend that it is appropriate that further consumer protections are placed upon LRBAs, rather than a ban. As we highlight, the ability for individuals to access this genuine retirement strategy and domestic property, particularly for small business owners, is an important component of the flexibility, choice and control of SMSFs.

Key points we make in this submission are:

- We do not believe that LRBAs are creating systemic risk in the SMSF sector or broader superannuation sector.
- We are concerned by property spruikers or "one stop property shops" which unscrupulously and inappropriately target investors with SMSF LRBA strategies.
- We oppose an outright ban of LRBAs.
- The use of LRBAs to transfer business real property to an SMSF is crucial to the retirement savings plans of many small business owners.

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- If the Government is concerned by risks associated with LRBAs, we believe that these can be mitigated by banning the use of personal guarantees supporting LRBAs and increasing SMSF education requirements for advisers.

Summary and analysis of current statistics and trends

The most recent Australian Tax Office (ATO) statistics *'Self-managed super funds: a statistical overview 2015–2016'* released in January have provided the latest source of LRBA statistics for this submission. These statistics and trends are compared throughout with the same statistics contained in the ATO's 2013-14 SMSF annual report.

SMSF limited recourse borrowing arrangements asset allocations, 2016					
LRBA investment by asset type	**($m)**	**Proportion of total SMSF assets**	**Proportion of SMSF population holding those assets**	**Mean* ($)**	**Median* ($)**
Australian residential real property	12,212	1.92%	4.18%	516,403	430,000
Australian commercial real property	11,483	1.81%	1.79%	1,139,462	650,275
Overseas real property	43	0.01%	0.02%	483,662	226,823
Australian shares	548	0.09%	0.43%	228,834	113,220
Overseas shares	256	0.04%	0.40%	123,699	18,872
Other	814	0.13%	0.30%	489,011	100,000
Total	**25,355**	**3.99%**	**^6.92%**	**650,295**	**435,000**

Asset allocation

As at 30 June 2016, LRBAs made up 4% of all SMSF assets ($634 billion) at $25.4 billion. This has risen from 2.71% and $15.1 billion at 30 June 2014 and 0.15% and $497 million at 30 June 2009. This represents 68% growth in two years, compared to 18% growth for total SMSF assets in the same period.

Of this $25.4 billion, 93% relate to Australian residential and commercial property. There is almost an even split in the amount of assets allocated to either with residential at $12.2 billion and commercial at $11.5 billion. This split is consistent with statistics at 30 June 2014.

The growth in property related LRBAs has doubled since 2014. Interestingly, the total growth in LRBA size has been hidden by a large fall in overseas shares LRBAs since 2014. We believe SMSFs utilised these LRBAs to invest in distressed American properties post the Global Financial Crisis. These LRBAs need to be structured through a limited liability company.

Amount of SMSFs

6.92% of SMSFs have an LRBA, but importantly 5.97% of SMSFs or 33,900 SMSFs have an LRBA that relates to Australian property. The total amount of SMSFs with an LRBA used to acquire Australian property has risen from 3.6% in 2014 or 18,800 SMSFs (total SMSFs with LRBAs were 5.72% then).

As at 30 June 2016, over twice as many funds invest in residential LRBAs compared to commercial LRBAs. This is approximately 23,750 SMSFs and 10,170 SMSFs respectively. This is potentially an area for concern, whereas the proportion of SMSFS with commercial LRBAs remained steady, the amount with residential LRBAs almost doubled in two years from 2.43% (12,700 SMSFs) to 4.18% (23,750 SMSFs) at 30 June 2016.

Despite the growth rate, this is still a relatively small proportion of SMSFs. In addition, given the restrictions on finance and softening of property market prices, we do not expect to see a continued rise at this rate in future.

Diversification

It has been stated that SMSFs investing in LRBAs do so without proper diversification. This is also an area for concern depending on the interpretation of the statistics. The statistics show that only 3.9% of SMSFs have over 80% of their fund invested in an LRBA. A similar percentage was highlighted in our submission to the Financial System Inquiry in 2013. The ATO statistics indicate that SMSFs investing predominately in a single geared asset is a rare situation.

Although, if you consider that 3.9% of SMSFs have over 80% of their funds invested in an LRBA and consider that with the fact only 6.92% of SMSFs have an LRBA, this may be concerning. It can be interpreted that over half the SMSFs that do have an LRBA may not be properly diversified. This needs to be considered in the context of property spruikers who encourage individuals to set up SMSFs with single asset strategies and gearing.

This may be a conscious or rational decision rather than a failure of advice or trustee decision making. Given property is a large asset with average values well in excess of $400,000, we would expect an LRBA to make up the majority of the assets inside the SMSFs that use LRBAs during the accumulation phase when members are building for retirement. The decision to have a concentrated portfolio does not follow retirement savings orthodoxy but is open to SMSF trustees and is a unique feature of the SMSF sector, which allows greater choice and flexibility around investments.

In addition, it is also important to note that diversification and asset allocation of an individual's superannuation must be considered holistically and as a part of their total wealth. There may be many situations where a SMSF may be considered undiversified in isolation but the member may in fact be adequately diversified with cash, equities and other like products through other superannuation or non-superannuation investments. Furthermore, a restriction on LRBAs would not provide certainty that individuals will satisfactorily diversify their superannuation with other inappropriate assets (e.g. using "member direct" investments in large superannuation funds).

Accumulation funds vs Pension funds

Statistics have also indicated that members using LRBAs are responsible with the strategy and how it relates to their proximity to retirement. SMSFs in the pension phase only have a 1.5% asset allocation to LRBAs compared to 9.4% for SMSFs in accumulation phase. The December 2017 Class Benchmark data[1] also shows that only 1.3% of their SMSFs have an LRBA relating to property in the retirement phase compared to 10.9% in the accumulation phase. This indicates that SMSF trustees are considering their investment needs and are reducing risk as they approach retirement.

[1] https://cdn2.hubspot.net/hubfs/2621735/Benchmark%20Report/Benchmark_2017_Dec_FINAL.pdf

Total SMSF Growth

It may also be important to consider LRBA growth in the context of total SMSF growth and property increases since 2009.

- In the 7 years from 2009, SMSF (direct and indirect) commercial property has grown from $36 billion to $66 billion and residential property from $11 billion to $28 billion.
- The whole SMSF sector has grown from $332 billion to $701 billion.
- Extensive LRBA growth can be attributed to robust property price growth and LRBAs starting from such a small base.

Furthermore, 47% of recent establishments have been from members aged under 44. These members would be more likely to be attracted to LRBAs given the longer investment timeframes.

Finance lending

The Association is also aware that Australia's large banks (ANZ, NAB, Westpac, CBA and AMP Bank) will not offer new LRBA lending. This may mean that the majority of growth or new LRBAs will be financed from second tier lenders or related party loans. There is potential for these loans to be offered on 'riskier' terms than those loans which were previously offered by the large financial intuitions.

However, current lending requirements have become increasingly stringent on aspects such as loan-to-value ratios, serviceability, and assets to be covered. This mitigates the risk that SMSFs are being offered on inappropriate grounds. However, we note that non-authorised deposit institutions (ADI) that lend to SMSFs are not subject to the same restrictions as ADIs.

Furthermore, SMSFA member feedback suggests that funding has become extremely difficult to obtain, also supporting our view that growth rates will slow.

Fuelling the housing market boom

Negative sentiment towards LRBAs has changed recently from a notion that LRBAs were fuelling the housing market boom to a focus on irresponsible lending to SMSF trustees and risks to Government of "bailing out" SMSF trustees with the Age Pension. It is still important to detail that the $12.2 billion of SMSF LRBAs residential property must be put in the context of the $6.05 trillion housing market as at June 2016. This comprises 0.20% of the housing market.

Government and regulator positions

We also note that the Australian Labor Party has signalled their intent to ban LRBAs if elected based on David Murray's FSI recommendation. This is based on a view that LRBAs could pose a systemic risk for the superannuation and broader financial system. We do not agree with this assessment.

The Coalition Government has stated they do not wish to ban LRBAs. Despite this, their recent LRBA integrity provisions relating to the transfer balance cap and total superannuation balance will ensure that LRBAs will become increasingly complex to administer. This will make them a less viable strategy and will remove some of their appeal.

We also note ASIC's concerns regarding poor quality advice to SMSFs on LRBAs and property spruikers targeting SMSFs.

The Productivity Commission found they were confident that LRBAs are unlikely to pose a material systemic risk based on their review into the superannuation system.

Any policy changes should consider these factors.

Gaps in statistics

Current ATO statistics regarding LRBAs are not perfect and as a result can be misinterpreted. For example, the 2016 SMSF Annual Return does not clearly direct that the LRBA asset recorded should be on the basis of the gross value with the borrowing amount entered separately under the liabilities section. Therefore, there is the potential for the net value of LRBAs to be recorded in these returns.

Accordingly, we are unaware of the full extent of the LRBA picture, the amount of related party LRBAs and if personal guarantees are prevalent. We need to better understand what is driving LRBA growth, especially in the residential sector, and if that growth is excessive.

Fortunately, the 2017 SMSF Annual Return will provide most of this information and we look forward to its publication in due course, as well as information from an LRBA survey conducted by the ATO in late 2016.

SMSF Association membership view

The SMSFA has surveyed our professional members (158 responses) and they have reinforced our view that LRBAs can be a suitable strategy for building retirement savings when used appropriately. However, the survey highlighted a changing sentiment towards introducing certain policy safeguards.

Overall LRBA prevalence statistics from our members were:

- 16% of professional members' client bases had an LRBA.
- 15% of those LRBAs were related party LRBAs.
- 22% of those LRBAs were financed by second-tier lenders.
  - With comments suggesting that related party and second-tier lenders were increasing, due to recent financing restrictions by the major banks.

The following responses were provided in relation to certain policy options:

- 52% of LRBAs used a personal guarantee.
  - 61% of professional members supported limiting the use of these, 22% did not and 17% were undecided.
- 34% of professional members supported a maximum LRBA allocation to improve diversification, 55% did not and 11% were undecided.
- 30% of professional members supported a restriction on residential property, 60% did not and 10% were undecided.
- 12% of professional members supported a restriction on commercial property, 82% did not and 6% were undecided.
- 29% of professional members supported a restriction on related-party LRBAs, 58% did not and 13% were undecided.

We therefore believe any significant change in policy would need to undergo significant consultation and be supported by persuasive research that LRBAs could pose an unjustified risk to SMSFs and the financial system.

The SMSF sector would be more accepting of greater integrity protections on LRBAs such as a personal advice requirement or limiting personal guarantees as detailed below, rather than an outright ban, which would preclude the use of LRBAs as a genuine strategy and stifle flexibility and choice.

SMSFA current policy position

With respect to LRBAs, the SMSFA believes greater regulatory scrutiny is required for one-stop property shops who spruik inappropriate properties to susceptible individuals and fully supports ASIC's efforts to stamp out any unlicensed and unethical marketing behaviour.

The strategy promoted by one-stop property shops to establish an SMSF and purchase a property through gearing, often off the plan properties located in a different state, is a commonly used strategy and is most likely to cause financial detriment. Of particular concern to the SMSFA is the commissions which are available to advisers in these schemes.

However, we are not aware of any case studies where significant financial detriment has occurred and are anecdotally aware from lenders that the credit performance of LRBAs has been exceptional compared to standard prime owner-occupied residential loans.

We believe that gearing is an appropriate strategy for individuals to build their retirement savings and therefore should remain a legitimate investment option. We do not believe that use of LRBAs is occurring in an excessively risky manner – notwithstanding the potential risks in the one-stop property shop sector if that continues unchecked – and note that SMSFs are required to consider diversification under the SIS Act.

We believe the notion that the downside risk associated with LRBAs will be a significant risk to the taxpayer funded Aged Pension is unfounded and note that the benefits LRBAs have provided to SMSF trustees has in fact reduced the reliance on the Aged Pension.

The SMSFA does not deny that LRBAs have become a more widely used financial instrument. However, evidence from SMSF administrator Class shows that most of this debt is held in the accumulation phase, with SMSFs being 10 times more likely to have a geared investment in accumulation phase than in pension phase. We therefore believe the sector is capable of using LRBAs responsibly to build their retirement savings.

Furthermore, recent tightening of lending standards by banks has made the provision of loans to SMSF increasingly difficult. Banks will now only lend on established properties, and SMSFS are now required to have substantial minimum balances, loan-to-value (LVR) ratios of no more than 70%, and strong evidence of loan serviceability.

As such, we continue to oppose a prohibition on borrowing on the basis that SMSFs can use LRBAs to fulfil the objective of superannuation acting as a savings vehicle to generate retirement income.

We believe investment in commercial properties that are the small business premises of the SMSF trustees are the most important use of LRBAs. This allows small business owners the opportunity to transfer their most significant business asset to their SMSF which increases their ability to save for retirement. This is particularly important for small business operators who do not have the ability to contribute as easily as other individuals as they tend to reinvest in their business rather than contribute to superannuation. Business real property LRBAs provide certainty that rental income is paid, access to superannuation taxation benefits for many self-employed persons and more flexibility in ownership and succession planning.

LRBAs when used appropriately, also provide access to residential property as an asset class. A ban of LRBAs will deny SMSFs the access to a traditional asset that is extremely familiar to individuals and has provided strong historic gains to support retirement incomes. This is particularly important when you consider the long term aspect of property investment and superannuation, where regulators should ensure policy changes are not overly influenced by short term volatilities. However, we note that residential property is the most susceptible asset class to property spruiking.

The SMSFA strongly recommends that in the first instance, the following two safeguards are implemented post the Treasury review to ensure that LRBAs remain appropriate: a prohibition on personal guarantees and raising SMSF education levels amongst advisers.

Prohibition on personal guarantees

Limiting the use of personal guarantees by SMSF members is a policy measure that could minimise any build-up of systemic risk arising from LRBAs. In effect, a restriction on personal guarantees ensures that limited recourse loans remain limited. As highlighted in our member survey, the majority of LRBAs include a personal guarantee.

Personal guarantees given by SMSF trustees allow the SMSF to undertake larger borrowings with higher LVR ratios. While the SMSFA is comfortable that the vast majority of SMSF borrowing is being made within sensible LVR limits, prohibiting SMSF members from providing a personal guarantee for their SMSF's borrowings would make it more difficult for lenders to make risky, high LVR borrowings to SMSFs.

Lenders would also need to be certain that the SMSF is able to adequately service the loan based on the financial circumstances of the SMSF members within the superannuation system, rather than looking at circumstances and assets outside superannuation.

This would also limit the ability of property spruikers to use SMSF LRBAs as an investment vehicle for promoting speculative property investments and, in particular, would reduce the ability for property spruikers to encourage individuals to establish an SMSF with a small balance simply to purchase a property. It is unlikely that a property spruiker would be able to facilitate a loan without a personal guarantee, unless the superannuation assets and serviceability were adequate.

Furthermore, any default on an LRBA, without a personal guarantee, would ensure that other assets are not available as security to the lenders. For example, the risk to 'silent partners' that their personal property is used as guarantee for an LRBA would no longer exist.

The limit on personal guarantees would therefore increase the integrity of the SMSF sector and ensure borrowing is more appropriate.

We note there is a risk that limiting the use of personal guarantees may restrict some sources of commercial financing. Nevertheless, this may be the appropriate impact of ensuring LRBAs meet their policy intent.

Raising SMSF education levels amongst advisers

A second measure which we believe is essential to the appropriate provision of LRBAs is to raise the specific SMSF education level for licensed SMSF advisers. The SMSFA believes that advisers who provide advice to individuals about SMSFs should have specific SMSF education and qualifications that underpin their advice. This notion was also reflected in ASIC's Report 575 in regards to raising education and a specific SMSF qualification for advice providers wishing to provide SMSF advice.

We believe this policy measure would further limit the ability for property spruikers to establish SMSFs and sell properties. Tightening licensing requirements around LRBA advice and increased scrutiny of this type of advice could assist in ensuring the integrity of LRBAs.

Introducing an SMSF education requirement would limit advisers, who are licensed but have poor knowledge of SMSFs and LRBAs, from advising on the product. It would also discourage property spruikers from entering the SMSF advice market as the education barrier to entry would be higher.

Significantly, the Financial Adviser Standards and Ethics Authority (FASEA) is the new education standards-setting body which is currently determining the education and training requirements for advisers to give advice under a 'new' financial advice profession. We believe it would be unfortunate for advisers to be able to reach a required FASEA threshold to give financial advice and then be able to give specific SMSF LRBA advice without specific SMSF knowledge being part of the required learning outcomes. Furthermore, we support and encourage further ASIC monitoring and enforcement of this type of advice.

Understandably, the SMSFA notes that education cannot entirely prevent poor and misleading advice but these two-pronged policy measures should provide a safeguard to those members who could be given poor advice.

Other policy options - restrictions on assets, asset allocations or funding type

The SMSFA explored the option of a restriction on the use of LRBAs, with respect to the type of asset that can be held under an LRBA (particularly residential property), diversification allocations and funding type. We note that residential property has experienced the most growth and is the asset typically used when poor financial advice regarding LRBAs has been given, and that commercial property is utilised most appropriately with business real property being an exemption to the in-house asset and related party acquisition rules.

As stated, based on the above analysis of available current statistics and trends, the SMSFA does not believe it is appropriate to legislate for a restriction on the type of asset, diversification limits or funding type if policy safeguards are introduced.

Furthermore, increased regulatory scrutiny should not extend to the prudential standards for SMSFs or asset class limitations as this would be contrary to the flexibility and choice of SMSF trustees taking control of their retirement savings.

We believe a limit on asset allocations would add complexity to the existing legislation and prevent funding for younger trustees with appropriate smaller balances who are building for retirement.

We also believe recent amendments to the ATO related-party safe harbour rules have ensured the related party LRBAs are occurring appropriately. In addition, with the large institutions pulling out of the SMSF market, related party loans are becoming a more prominent use of funding. This is common and normally utilised for business real properties by SMSF trustees.

However, if the Government decides to implement restrictions on borrowing via LRBAs, it is essential solutions are put in place with regard to commercial and small business property strategies, indirect borrowing strategies, and transitions for existing strategies.

The use of LRBAs to purchase commercial property can be an extremely important retirement savings strategy for small business owners, who accumulate most of their retirement nest-egg through their small business. Any loss to the flexibility of business real property CGT exemptions through the funding of LRBAs, which allows small business owners the opportunity to work on premises owned by their SMSF, would significantly impact the ability for those individuals to save for retirement.

This was highlighted in our member survey, where members were very averse to restricting commercial property LRBAs. Feedback from the survey further reinforced our view that commercial property LRBAs are a prominent strategy and asset for SMSF trustees, where loans are repaid in smaller time frames due to the high yields.

We therefore believe that an alternative solution would need to be designed to ensure that SMSF trustees can encompass their business real property in their SMSF.

Furthermore, if LRBAs are restricted, indirect borrowing strategies and schemes could be developed to fund domestic and commercial property acquisitions. These schemes which may include unit trust structures would have the potential to provide unscrupulous advice to SMSF trustees, regardless of a direct restriction on LRBAs. This is an important consideration for any policy change. Indirect borrowing through unit trusts is already common in APRA regulated superannuation funds, especially where property investment is conducted through geared property unit trusts but also via geared investments in equities and other asset classes. From a competitive neutrality perspective, it would be detrimental to restrict borrowing within the SMSF sector while allowing extensive indirect borrowing in the APRA regulated superannuation sector to continue.

We also note that SMSFs which are currently seeking funding for potential LRBAs would need an appropriate transition to avoid possible financial detriment from possible regulatory changes.