

Anthony Cahill: Submission to Federal Treasury Financial System inquiry

Response to Financial System Inquiry – Gearing in Superannuation

I, Anthony Cahill, have prepared the following submission with respect to the Final Report's Recommendation 8 to "Remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds."

Summary of Submission

In response to the Inquiry's Recommendation 8, I submit:

1. A review of gearing within superannuation needs to consider all forms of gearing, not just direct gearing i.e. consider leverage in all its forms. This should encompass indirect borrowing and also leverage created via the use of exchange traded and over the counter (OTC) derivatives. Indirect gearing and leverage is already a systemic risk which dwarfs the impact of direct gearing.
2. Direct gearing in superannuation funds, particularly SMSFs, provides benefits to the small and medium sized enterprise sector of the economy, particularly with regard to certainty of retirement planning and business stability;
3. In my view, the potential risks associated with direct gearing in SMSFs result from the lack of minimum standards for the establishment of SMSFs and the failure to licence the real estate industry in the same way as others providing financial advice. Addressing those areas would provide the greatest protection against inappropriate use of leverage.
4. Adopt minimum standards for the establishment of SMSFs including a net asset threshold, advice requirements prior to establishment of an SMSF and trustee training.
5. Advice with respect to real estate should be licensed in the same way as any other financial advice. There is no valid reason for advice with regard to real estate being treated differently to any other investment. It would also significantly curtail the provision of "disguised" advice on SMSFs packaged up with real estate purchases.

1. Direct Leverage

The use of direct leverage has increased since the introduction of LRBA arrangements in 2007. But, as acknowledged in the Final Report, direct leverage is at a very small level.

Estimated total assets within the SMSF sector are \$553 billion¹. Estimated borrowings in the SMSF sector are \$9.38 billion² which means borrowings represent 1.7% of SMSF assets. The ATO statistics quoted are estimates using lodgement data for the year ended June 2012. The estimates may not have captured recent growth in SMSF borrowing. Even assuming an underestimation error of 50%, SMSF borrowing would only represent 2.7% of total SMSF assets.

The prohibition on superannuation funds borrowing was based on protecting the security and integrity of the superannuation system as the basis for retirement savings. It was devised at a time when the ability to leverage was almost solely confined to loans or borrowing and

¹ ATO Self Managed Super fund statistical report – December 2014

² ATO Self Managed Super fund statistical report – December 2014 comprised of Limited recourse borrowing arrangements and Borrowings per the Asset Allocation Tables.

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investing in leveraged vehicles (companies and trusts). At the time the Superannuation Industry (Supervision) Act (SIS Act) was enacted, derivative markets were embryonic and were beyond the reach of all but the most sophisticated investors.

Prior to 1999, SMSFs were effectively able to gear investments via the use of subsidiary unit trusts. Due to concerns about the use of such vehicles, the ability to indirectly gear was prohibited by treating controlled trusts as “in-house assets”.

SMSFs can leverage investments indirectly by investing in non-controlled vehicles with embedded geared or leverage (e.g. unit trusts, property trusts, hedge funds). APRA regulated superannuation funds invest in similar vehicles and some also have controlled subsidiary trusts with significant leverage via derivative exposure.

The introduction of LRBA in the SIS Act was in 2007 via Section 67(4). The provisions were amended in 2010 via sections 67A and 67B which currently apply. The provisions are designed to provide an exception on regulated funds borrowing (per Section 67 of the SIS Act). The existing LRBA provisions, which apply to all regulated superannuation funds, provide an environment where debt can be used to assist investment strategies. But recovery of the debt must be quarantined, or ring fenced, to the specific asset acquired with the debt. The asset must be held in a special purpose trust as a further protection regarding recourse. No other assets of the fund can be used to secure the loan.

The Benefits of Direct Leverage

I submit that sensible use of direct leverage has potential benefits to Australians' retirement savings, particularly small and medium sized business owners. The use of direct leverage provides smaller funds the ability to access investments that might not otherwise be available. Direct property is one of those asset classes.³

Typically the property acquired by an SMSF is the commercial premises from which small and medium sized enterprises conduct their business.⁴ The ability for SMEs to acquire their own business premises via their SMSF is beneficial to the economy. It provides SMEs with a source of capital and provides a measure of creditor protection for the SME owners (and SMSF members). It also accelerates the growth in the key retirement asset for most SMEs – their business.

Commercial property represents the large majority of direct real estate investment made by SMSFs. Estimates indicate that SMSFs hold \$69.8 billion of non-residential property (12.6% of SMSF assets) and \$21 billion of residential property (3.8% of SMSF assets).⁵ In addition, the rate of growth of non-residential property within SMSFs has been higher than residential property. In the period from June 2010 to December 2014, the value of non-residential property increased by 69% versus the increase in residential property of 55%.⁶

Residential property exposure in SMSFs is increasing. Appropriate investment in that sector can also provide a valuable part of a long term investment strategy to support retirement benefits (income and capital growth) as well as forming part of retirement funding.

I acknowledge that there has been increased residential property investment by SMSFs. And there is clearly an element of the property development market targeting consumers to use existing superannuation balances as the means to acquire an investment property. There is

³ RSM Bird Cameron's thinkBIG 2014 study

⁴ ATO Self Managed Super fund statistical report – December 2014

⁵ ATO Self Managed Super fund statistical report – December 2014

⁶ ATO Self Managed Super fund statistical report – December 2014 and ATO 2010 SMSF asset allocations

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the prospect that a segment of the SMSF market will be exposed to losses from those activities. In my view, the main reasons for this trend is the lack of minimum standards for SMSF establishments and the failure to regulate advice with respect to real estate in the same way as other financial advice.

The factors that support the use of direct leverage via LRBA's are:

1. Direct borrowing in SMSFs is of economic benefit for small and medium sized enterprises. It helps many SMEs secure a stable business environment (via effective control of their business premises and creditor protection) and also provides a retirement outcome with a high degree of certainty (via clarity about their superannuation strategy);
2. The borrowing exposure is transparent to SMSF trustees and regulators. The ATO receives annual reporting on LRBA's and APRA receives monthly and quarterly statistics from ADIs on lending to SMSFs;
3. The amount of possible loss is known in advance i.e. the loan amount and accrued interest. Movements in underlying asset prices do not have the potential to significantly increase liabilities as is the case with derivative based leverage;
4. Only the specific SMSF asset acquired with a LRBA can be used to satisfy debt obligations. Other SMSF assets are quarantined from any recovery action under the structure of LRBA's. This is not the case with respect to derivative based leverage used by superannuation funds.

Consistent Treatment of Leverage

In my view, the approach to the use of leverage must be consistent across APRA regulated funds and SMSFs, and should include direct and indirect forms of leverage. Regardless of the manner in which leverage is used, it still has the same impact of greater losses in periods of stress.

The reality is that many funds make significant use of leverage via interposed trust and company vehicles. Many larger funds also use derivative based exposure to enhance investment returns or to balance out equity risk (directly or via mandates outsourced to investment managers). Whether the exposure is direct or indirect, the leverage impacts still exists.

The Final Report notes with the stability of Australia's financial system was assisted by the largely unleveraged nature of Australia's superannuation system (e.g. page 87).

The Interim Report noted that "*The catalyst for the crisis was the deterioration of the United States housing and mortgage market*". That is true, but the causal factors were:

1. Poor and deceptive lending practices; and
2. The financial structuring of subprime mortgages via complex derivative structures which increased the actual exposure to many multiples of the base exposure.

Credit ratings agencies, investors (naïve and professional) and regulators all largely failed to understand the risks involved with derivative exposures and the magnitude of those risks.

Significant steps have been taken to control derivative use and make trading more transparent (e.g. central clearing), but these measures only currently extend to "vanilla" instruments and cover a small component of the derivatives market.

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Higher governance requirements have been imposed on superannuation funds regarding derivative use and APRA has increased its monitoring of this area. Both are positive steps.

But, exposures created by derivatives are still largely opaque, particularly where the exposures are used to enhance investment returns e.g. long/short equity portfolios, relative fixed income strategies, credit default swaps. Given the complexity and range of instruments used as well the vehicles via which they are held, it is difficult to identify the potential for loss within a fund.

With the global economy in a low growth period, investment yields have declined to low levels. This environment has spurred the search for yield and the increased use of leveraged and structured investments to enhance yields. Significant risks to the superannuation system now exist as a result of the “search for yield” and that impact dwarfs the risks with direct borrowing by superannuation funds.

Larger funds report on financial instruments on an annual basis as part of their annual financial statements. For certain instruments, a sensitivity analysis (possible gain or loss) is provided based on the relevant fund’s expectations of market movements (e.g. impact of currency movements due to hedging policy, interest rate risk on bond exposures). The expectations are most typically derived from past price movements in normal environment. They do not show the outcome in a worst case or “what if scenario” which is what occurs in a crisis situation such as the GFC.

In addition, larger funds also have other exposures in financial instruments classified as Level 2 and Level 3 instruments as defined in AASB 7 Financial Instruments: Disclosures. Level 2 instruments are typically valued by reference to price impacts of quoted markets (i.e. derivatives) and Level 3 instruments where there is no quoted market to reference pricing (i.e. unlisted markets such as private equity holdings and infrastructure).

I have not been able to identify any superannuation fund which has disclosed the extent of leverage within its investment program, or parts of investment program.

Another factor impacting derivative use is counterparty risk. This risk comes in two parts:

1. Counterparty failure or default (e.g. Lehman Brothers); and
2. Counterparty risk tolerances.

Counterparties can default and do fail. This was a feature of the GFC with Lehman Brothers the most notable example. Many superannuation funds sustained losses in the GFC as a result of the failure of Lehman Brothers and the inability to recover collateral and margin balances. While Central Clearing of derivatives is reducing some of that risk, it still exists.

Unlike LRBAs, super funds which use derivatives to enhance returns do effectively pledge other fund assets to meet margin requirements and losses on settlement of the instrument involved. Undoubtedly, larger funds, and their investment managers, all have risk systems and risk mitigation measures in place. But the nature of counterparty relationships (centrally cleared or over the counter) is that the funds agree to meet whatever the obligation is under the derivative contract from whatever fund assets are liquid. As witnessed in 2008, the extent of losses and margin requirements can spike significantly when market volatility increases, liquidity reduces and counterparties become risk averse.

I acknowledge and appreciate the risk framework provided by APRA and the risk and governance frameworks for larger funds. But I am simply identifying that even with responsible and risk controlled use of derivatives for investment purposes:

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- Leverage within the fund is created i.e. the exposure of the fund to an asset class or strategy is increased, even if a shorting strategy is used;
- Losses can be magnified due to derivative use;
- Counterparty risk becomes a significant issue;
- The exposure, and risk of loss, is not transparent and cannot be understood by fund members.

My Recommendations on Direct Leverage

To protect the integrity of the superannuation system while still allowing SMSFs access to a wider range of assets, I recommend the following:

1. Direct leverage should remain available to all regulated funds;
2. Minimum requirements should be introduced on the establishment of SMSFs including:
 - a. A minimum net asset size could be considered before an SMSF could be established. This will provide a solid base for future growth and promote the economic establishment of SMSFs. I suggest that a \$200,000 would be adequate;
 - b. Independent advice on the establishment of an SMSF must be obtained as a pre requisite to an SMSF being established;
 - c. Basic trustee training requirements should be imposed so that trustees understand the obligations of operating a superannuation fund;
 - d. A requirement to document the SMSF's investment strategy and formally review the strategy at regular cycles.
3. No restrictions should be imposed with regard to the maximum allocation to an asset class within an SMSF:
 - a. Such a restrictions would constrain SMSFs in their early life, particularly those which want to make use of the real business property exemption within the SIS Act. Access to direct property exposure is one benefit of establishing an SMSF;
 - b. It is the trustees' responsibility to set and implement investment strategies on their own SMSF;
 - c. It would be inconsistent with the ability of members of larger funds to allocate all, or the major part of their superannuation to single asset class (e.g. international shares, cash);
 - d. Such a restriction would also put SMSFs at a competitive disadvantage to larger funds and artificially restrict the ability of members to take control of their own superannuation.

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2. Quality of Advice with Regard to SMSFs

I agree with need to improve the standards of advice with regard to more complex products and administration solutions such as SMSFs.

As a first step, I believe that licensing requirements for all assets and investments should be under the same structure i.e. an Australian Financial Services Licence, or authority is required.

My own observations are that the bulk of poor practices involving leverage and SMSFs comes from the residential property development sector. That is, developers targeting people to roll smaller superannuation balances into an SMSF, to be used as a deposit for a residential property purchase.

I highly recommend that the provision of advice on the purchase of real estate, other than for owner occupiers, be included in the definition of financial advice.

Real estate purchases by consumers represent significant investments of wealth and almost always involve some element of debt. It is an anomaly that advice provided on such significant investment decisions is not regulated in the same way as advice on similarly significant investments e.g. superannuation, managed funds, margin lending.

There no is valid reason for the financial services licensing system not to apply to advice with respect to real estate investments. Inclusion of real estate advice would provide a consistent framework for advice standards across all major asset classes.

I also see that the lack of regulated advice in the real estate sector is one of the driving factors in consumers establishing SMSFs which are not appropriate for those consumers e.g. fund too small to be economic, consumer is not equipped to be a trustee.

Mr Anthony Cahill