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RE: Submission – Financial System Inquiry Final Report

Thank you for the opportunity to make a submission in response to the final report of the Financial System Inquiry (FSI).

I would like to express support for the recommendation to extend choice of super funds to all employees, though this submission will concentrate on the recommendation of the FSI to:

“Remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds.”

The interim report of the FSI noted that “leverage in APRA-regulated funds is small, with total borrowings of under \$2 million reported each quarter over the past year.” As such this submission will be limited to consideration of borrowing by SMSFs under Limited Recourse Borrowing Arrangements (LRBAs).

The most recent ATO statistics, which are subject to revisions, show SMSF LRBAs grew by 1,244.30% between June 2010 and December 2014¹, though from a low base. Despite this growth LRBAs accounted for only approximately 1.69% of total net SMSF assets in December 2014. However fast growth in a particular area of investment by SMSFs is not, of itself, concerning.

It appears that the concern expressed by the Financial System Inquiry panel was primarily that borrowing inside superannuation created risks to the financial and retirement systems, risks that would be exacerbated by continued high growth.

The Financial System Inquiry considered borrowing in superannuation from the perspective of risk to the stability of the financial system. Large amounts of unleveraged assets held in superannuation could provide stability to the rest of the financial system in a crisis. Though LRBAs are limited recourse to the fund, losses in superannuation could spread to other assets inside superannuation and to external entities, as described in the FSI final report.

The Super System Review considered the issue from a different perspective, but had similar concerns. However the Review panel thought it was too soon to assess the changes to the superannuation borrowing rules, and so recommended a review within two years.

1 https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Quarterly-reports/Self-managed-super-fund-statistical-report---December-2014/?page=2#Asset_allocation_tables_m

This recommendation was not implemented, though in light of the FSI recommendation it deserves further consideration.

I recommend a review be conducted to consider all the relevant aspects of borrowing by SMSFs, before implementing or rejecting the FSI recommendation.

The terms of reference of this review should be designed to answer two questions:

1. Should section 67A of the Superannuation Industry (Supervision) Act 1993 be repealed, prohibiting SMSFs from borrowing other than on very limited terms for cash-flow purposes?
2. If s67A should remain, are there changes which should be made to improve the system?

Factors the review should consider include:

- Is SMSF borrowing compatible with the purpose of superannuation?
- Risks to the financial system
- Risks to the superannuation and retirement systems
- Risk to the retirement savings of individual superannuants
- Do SMSF LRBAs lead to a lack of diversification and liquidity?
- Impact of LRBAs on housing affordability
- Adequacy of consumer protections
- Should LRBAs be Financial Products, under the Corporations Act?
- Appropriateness of licensing requirements, or lack thereof, including for financial advisers and real estate agents, dealing with LRBAs
- Appropriateness and cost of the holding trust requirement
- Should related party borrowings be restricted or banned?
- Should personal guarantees be restricted or banned?
- Should there be maximum loan-to-valuation (LVR) ratio?
- The structure of grandfathering provisions if LRBAs are banned

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