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Response to the Financial System Inquiry Final Report

Cavendish Superannuation Pty Ltd (Cavendish) welcomes the opportunity to comment on the Inquiry's recommendations. As a leading provider of Self Managed Superannuation Fund (SMSF) administration and education, our submission makes specific comment on the Inquiry's recommendation to remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds.

For the reasons explained in this submission, we do not believe direct borrowing by superannuation funds under a limited recourse borrowing arrangement poses unacceptable levels of risk to the financial system. However we believe there are elements of these arrangements which do require attention to ensure the risks identified by the Inquiry do not materialise.

About Cavendish

Cavendish Superannuation Pty Ltd is an Australian company, wholly owned by the AMP group, providing specialist SMSF services to individuals, investment advisers, financial planners, stock brokers and accountants.

We are a leading industry provider with over $5 billion of funds under administration. We deliver our services through a variety of channels - direct to fund trustees, via financial advisers and accountants, or as a back-office providing fully-badged compliance administration outsourcing to external institutions.

Cavendish is committed to raising the standard of professional advice in the SMSF sector. In conjunction with the University of Adelaide’s International Centre for Financial Services (ICFS), Cavendish offers a SMSF specialist course for professionals wanting to provide accredited and competent SMSF advice. Since its inception in 2011, over 700 advice professionals have completed this course.

Formed in 1993, Cavendish, over the last two decades, has experienced the rapid growth of the SMSF sector first hand.

We would be happy to provide further information or to discuss any questions you may have about this submission.

Yours sincerely

Natasha Fenech
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Recommendation 8 – Direct borrowing by superannuation funds

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

This recommendation seeks to achieve two key objectives:

1. Prevent the unnecessary build-up of risk in the superannuation system and the financial system more broadly

2. Fulfil the objective for superannuation to be a savings vehicle for retirement income, rather than a broader wealth management vehicle

Quantifying the build-up of risk in the superannuation system and the financial sector

The use of leverage in the SMSF sector to finance asset purchases is embryonic but growing. Leverage magnifies investment risk on both the upside and the downside and we agree the excessive use of traditional style leverage investments could expose the SMSF sector, and the broader financial system, to unacceptably high levels of asset price volatility and systemic risk.

However, we believe there are important differences between "traditional style" leveraged investments and limited recourse borrowing arrangements (LRBAs). These differences mean the level of systemic risk posed by direct SMSF leverage is not the same as the level of systemic risk posed by direct leverage outside of superannuation.

The *Superannuation Industry (Supervision) Act 1993* (SIS Act), imposes a number of specific restrictions on superannuation funds which borrow to invest. As acknowledged by the Inquiry, these restrictions are designed to alleviate the risk of losses from assets purchased using a loan resulting in claims over the fund assets.

Personal guarantees

While the frequent use of personal guarantees to protect lenders against the probability of large losses can reduce the effectiveness of the SIS restrictions, this is unlikely to be the case in many scenarios involving LRBAs.

The Final Report refers to a scenario where there has been a significant reduction in the valuation of an asset that was purchased using a loan, requiring the trustees to sell other assets of the fund to repay a lender, particularly if a personal guarantee is involved. As a result, the LRBA has been ineffective in limiting losses from one asset from flowing through to other assets, either inside or outside the fund.

The SIS Act 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. The acquirable asset also must not be subject to any charge (including a mortgage, lien or other encumbrance). Therefore, under a LRBA, there can be no requirement for the trustees to sell other assets of the fund in order to repay the lender. In the absences of any requirement to do so, it is not entirely clear why a member would sell other fund assets in these circumstances.

Similarly, while the lender could obtain a personal guarantee and seek payment under that guarantee from the member in the circumstances outlined in the Final Report, this is only likely to affect other fund assets if the member has satisfied a SIS condition of release. Where the member has not satisfied a condition of release there could be no release of money from the fund to satisfy an obligation under a personal guarantee.

Given the criteria which must be met before the severe financial hardship or the compassionate grounds condition of release could be satisfied, it is unlikely members would qualify for this condition of release in most cases[1].

Even if the existence of personal guarantees reduces the effectiveness of the SIS restrictions, limiting the use of personal guarantees by SMSF members is a possible policy response. This could involve prohibiting personal guarantee in relation to LRBAs or restricting their use to situations where the member has satisfied a SIS condition of release.

Prohibiting or restricting the use of personal guarantees is likely to result in a lending institutions imposing lower Loan to Valuation Ratios (LVRs) on LRBAs. This in-turn would reduce the likelihood of property spruikers encouraging individuals to set up an SMSF with a small balance simply to purchase a property within an SMSF.

Reduced asset diversification

The Inquiry found that the use of LRBAs by superannuation funds is likely to result in lower levels of asset diversification and higher levels of investment risk. Given LRBAs typically involve the purchase of real property it is reasonable to conclude the growth of LRBAs could result in a more concentrated asset mix in the fund, particularly where the fund concerned has a relatively small balance.

However, the use of leverage in the SMSF sector to finance asset purchases is only embryonic with little substantive data available to support the above hypothesis. In fact our observations suggest the opposite may true, that is the use of LRBAs are enabling SMSF investors to reduce their exposure to asset classes which historically SMSFs have held over exposed positions (such as listed securities and cash).

Based on research undertaken by Multiport[2], the average LRBA property loan held by SMSFs is $263,000[3]. Anecdotal research suggests this is not dissimilar to the average LRBA loan provided by most other major lending institutions which is believed to be around $300,000. Given the average balance of an SMSF is now likely to be over $1 million, this suggests an average LRBA concentration of less than 30 percent[4].

In any event it is difficult to draw conclusions about the asset allocation of an SMSF, and the amount of risk in the fund's portfolio of assets without also considering the investments held by the SMSF investor outside their fund. Recent research undertaken by Investment Trends shows SMSF investors on average hold 50 per cent of their personal retirement funds outside their SMSF.[5]

Conservative lending practices

The legislative and capital adequacy requirements of an LRBA mean the LRBA lending practices of commercial lending institutions are typically measured and conservative. As is the case with any loan product, the lending institution is primarily concerned with counter party risk. With or without personal guarantees, given the higher risk associated with limited recourse lending, it is difficult to imagine a

[1] The severe financial hardship condition of release requires the person to be in receipt of Commonwealth income support and must be unable to meet reasonable and immediate family living expenses.
[2] Multiport Pty Ltd is wholly owned by the AMP Group. Multiport provides investment, SMSF and managed account administration services to a broad range of individuals, companies, trusts SMSFs and charitable foundations. The Multiport Investment Patterns survey covers just over 2,500 SMSFs, and is a sample of the SMSFs Multiport administers and the investments they held at the completion of each financial quarter. Funds are administered on a daily basis which ensures data is based on actual investments and is completely up to date. The assets of the funds surveyed represent approximately $2.7 billion
[3] Multiport Investment Patterns Survey, December quarter 2014.
[4] As at 30 June 2013, the average SMSF balance was $992,000. For the 5 year period ended 30 June 2013, SMSF average balances increased by over 22%.
[5] Investment Trends, Nov 2013 Retirement Income Report.

commercial lender entering into a LRBA without the SMSF trustees and the arrangement first satisfying a strict lending criteria.

For example, many institutions require investors to obtain independent financial advice before the loan will be approved and the limited recourse nature of the loan normally requires lower than normal LVRs. AMP Bank decline or cancel around 25% of all LRBA applications received because the applicant has failed to meet the bank's LRBA lending criteria. AMP Bank, and many other lenders, mitigates their own risks in a number of ways, including by limiting the size of the loan, LVRs and imposing rules on the security property type and location.

AMP Bank also require all originators (both advisers and brokers) to separately complete an accreditation program on their LRBA products before their LRBA applications will be accepted. Trustees are also required to obtain a formal legal review of their trust deed and other documents and provide AMP bank with certification of their legal and SIS Act compliance. We believe the LRBA lending practices adopted by AMP Bank are not that dissimilar to most other lenders who are active in the LRBA space.

The lending practices of commercial lenders provide an important check on unscrupulous sales practices, overzealous investors and ultimately the build-up of risk in the superannuation system. However to provide further safeguards, for capital adequacy purposes it would be possible for APRA to require lending institutions to classify LRBA loans as non-residential loans. Higher capital requirements would tighten the credit risk assessment by lenders resulting in higher LVRs and higher interest rates to reflect the higher cost of capital and risk.

Fulfil the objective of superannuation rather than a broader wealth management vehicle

As mentioned above the use of leverage in the SMSF sector to finance asset purchases is only embryonic. To date there is little substantive evidence that supports the hypothesis that investors are establishing SMSFs for the sole purpose of entering into a LRBA, or for reasons contrary to the core objectives of superannuation. There is also little evidence of high LRBA exposures or heightened investment risk due to a lack of asset diversification.

For the reasons outlined earlier we believe an equally credible argument is that LRBAs are enabling SMSFs to enhance their level of asset diversification and responsible lending practices are guarding against overzealous investor activity.

The case for LRBAs

Superannuation funds have for many years invested in instalment warrants. The borrowing amendments introduced in 2007 essentially legitimised these types of investments for superannuation funds and at the same time removed legislative barriers by enabling superannuation funds to invest in instalment warrants involving not only listed securities but any type of acquirable asset.

This approach is entirely consistent with the SIS Act which, aside from the rules prohibiting funds acquiring assets from related parties and restrictions on in-house asset investments, does not prescribe the types of assets that can be held by superannuation funds.

Repealing the LRBA provisions, with some exclusions for traditionally traded instalment warrants, would in all likelihood result in superannuation funds, including SMSFs, being permitted to invest in some assets at the exclusion of others. The primary purpose of the modifications to the SIS Act in 2007, which gave rise to LRBAs, was to legitimise investing in instalment arrangements in a manner which avoided these discriminations.

We believe the growing number of SMSFs is a positive sign that more Australians are actively engaging with their retirement savings and embracing greater levels of investment flexibility and control. By fostering greater levels of engagement and investment options like LRBAs, SMSFs have a positive impact on retirement incomes and ultimately drive better outcomes for consumers who choose this option.

Alternative measures

Licensing LRBA advice

Rather than repealing the LRBA provisions, we believe the perceived risks and vulnerabilities these provisions present could be more appropriately addressed by tightening some of the current legislative provisions and introducing consumer protection measures previously released in draft format by Treasury.

The purpose of the draft amendments to the *Corporations Regulations 2001,* released for public comment in February 2012, were to bring LRBAs by superannuation funds into the Government's financial consumer protection framework. The draft Regulations, if implemented, would make LRBAs a financial product under the *Corporations Act 2001* (the Act) and would extend the consumer protection available to investors under the Act to superannuation funds when purchasing LRBAs.

The primary intent of the proposed Regulations was to stamp out unlicensed and unqualified LRBA advice being provided to superannuation funds. The proposed Regulations, if implemented, would ensure superannuation entities, including SMSF trustees, would have access to consumer protections, such as product disclosure, indemnity insurance or dispute resolution mechanisms.

We believe a decision to repeal the LRBA provisions should not be made in the face of reported inappropriate and unlicensed overselling, without first implementing these proposed Regulations and then, some-time after, assessing their effectiveness.

Related party loans

While we believe the LRBA provisions in the SIS Act underpin an appropriate and measured approach to leverage by commercial lenders and SMSF trustees, the rules should be modified to prohibit related party borrowings as part of a LRBA. The ability of related parties to lend money to their SMSF on non-commercial terms is an overly generous concession which erodes the integrity and ultimately the confidence in the SMSF sector. Furthermore, we believe a requirement to engage an arm's length lender will ensure all LRBAs are subject to responsible and measured lending disciplines as explained earlier.