

# **A better model for borrowing in Self-Managed Superannuation Funds (SMSF)**

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This is a private submission and does not necessarily reflect the views of his employer

The below is a submission regarding the public policy surrounding borrowing in superannuation to the Financial System Inquiry. It is not advice to any party and should not be read as such. **NO liability is accepted to any reader and they should seek their own independent advice on any topic discussed below.**

## **1.0 What is the borrowing in superannuation “model” currently?**

In essence it is a legal structure that allows a SMSF to borrow to acquire assets permitted under the SIS act with the key requirement being the loan is non-recourse. A so called Limited Recourse Borrowing Arrangement (LRBA).

The effect being that the lender, in the event of default, has recourse only against the asset acquired using the funds of the loan. If the SMSF does indeed own other assets the lender cannot make claim over those other SMSF assets. However the other practical feature of lending inside SMSF is it is very common, indeed virtually a universal practice for lenders to insist on personal guarantees from the members of the fund.

The great bulk of the lending has been for residential investment properties. The banks typically lend 70% of the value of the property (Loan to Value Ratio or LVR) although some do lend up to 80% on residential property. All banks apply strenuous tests to ensure the high likelihood of the SMSF being able to service the loan. Their preference is for the SMSF to be able to do this from its own resources, but it is also quite common for banks to factor in the Super Guarantee (SG) payments or personal contributions of the members if they are believed to be sustainable.

It is also quite common for many SMSF's to have as their primary or even sole asset, the residential property acquired under the LRBA.

## **2.0 Does the model need to change?**

Borrowing in superannuation unfortunately had something of an accidentally birth, being originally a set of rules cobbled out of legislation to enable funds to acquire Telstra instalment receipts in the final “float” of that enterprise. The legislative changes served that purpose and many accountants and lawyers in the SMSF industry soon recognised those changes could be customised to enable SMSF's to borrow to acquire other assets.

Hence the borrowing regime for SMSF's is not a carefully crafted purpose designed system. The Australian Taxation Office (ATO) and Treasury has since 2007, made quite sensible amendments to the legislation but the point still stands this is not a system designed from the outset for SMSF's and particularly investment into property. We should now “draw breath” and take the time to make the

changes we would have made, had the system been deliberately and carefully brought into existence.

In the recent Financial System Inquiry (FSI) and in general commentary in SMSF industry circles a number of criticisms have been made about LRBAs. Some are genuine and sensible criticisms, some are self-serving propaganda from those who stand to lose further funds under management. The main criticisms are outlined below

**2.1 A great many SMSFs are being set up specifically to initially buy a single property under a LRBA.**

Many of the SMSFs do not have the resources to acquire more than one asset hence they are not particularly diversified.

Some diversification is always sensible, even the very finest investors advise as much, but the very first line of defence in minimising investment risk should be investing in what you know and understand which we discuss below.

**2.2 SMSF's using LRBAs are fuelling a property boom.**

This looks to be the criticism with the least credibility. There is little empirical evidence to support this and it appears the property "boom" is essentially quarantined to Sydney. Given the rest of Australia's SMSF owners have access to the same loans as Sydney-siders it seems very implausible SMSF's are causing some nation-wide unsustainable property boom, yet it is only manifesting in Sydney property prices.

**2.3 Members will liquidate other SMSF assets to avoid personal guarantees**

Whilst the loans are non-recourse, given in almost all instances the SMSFs members have provided a personal guarantee (PG) it is highly likely that they would liquidate other SMSF assets first to reduce any shortfall the bank would require them to make up personally.

Further the FSI /Murray review made the claim that the legislative changes required to fix this would be too complex. A very surprising conclusion as I will discuss below, but to be fair there is some merit to this overall concern.

**2.4 If a SMSF/LRBA fails, it is likely it could eliminate all or nearly all the SMSF's wealth.**

This will see the members needing to live off the public purse in retirement. The FSI also made this point, but as we will discuss below it curiously only focussed on the negatives of gearing and completely ignored those who will now be able to create enough wealth to be self-sufficient thanks to gearing. Likewise there will be another class of retiree who may not succeed in being truly self-reliant for their entire retirement but due to gearing will be able to put off their needing to draw upon the public purse till much later in life.

**2.5 It seems to have attracted "property spruikers" and property "sharks".**

There appears to be some truth to this also. However given ASIC has been conducting a very well resourced surveillance program, combatting this for some time it would be interesting to hear an update from them. This problem almost certainly exists but whether it remains

out of control is not clear. As I will discuss below the proposed replacement model will help alleviate this problem to a significant degree.

(The real issue here is the legality and practice of some accountants and planners accepting commissions. Remove the incentive and you will remove the behaviour.)

### **3.0 Why borrowing in SMSF's is worth preserving**

There are a couple of significant advantages to enabling borrowing in SMSFs; we will discuss the main ones below

**3.1** What a great many of SMSF's and LRBA's opponents fail to understand or acknowledge about borrowing in superannuation is that there is not some widely held desire in "average" Australians to speculate in property inside their super.

Rather it is people's risk averse nature and conservativeness that drives them to this product. The greatest investor the world has witnessed, Mr Warren Buffett, implores investors to invest within their "circle of competence" or more plainly "invest in what you know and understand". This is what the overwhelming majority of SMSF LRBA investors are doing. They know and understand residential property, they do not know and understand the share market or vehicles investing in them such as managed funds. Nor do many of them, rightly or wrongly, have any remaining faith in the ability of the "experts" picking shares on their behalf for a considerable fee.

So in fact what LRBAs are to most people, particularly people typically around 40 years in age who together with their spouse have about \$200K in super, is it provides the other \$200K plus required to set up a SMSF and buy a property chosen by them. It enables them to do what they have always wanted to do, take control of their superannuation and invest it in what they prefer to invest in. It is therefore more akin to a finance bridge to being able to do what they want sooner.

The "average" Australian opening a SMSF and acquiring a property via a LRBA is NOT a property speculator and typically intends to hold the property to at least when they retire. Most are very aware of the possibility of selling it tax free upon reaching age 60 and retirement. So in summary the advantage is it enables people who wish to take control of their super and invest in property to do so much sooner.

**3.2** The author does not have any independent empirical evidence to support his next claim but he believes it stands to reason that if you give people control over how their money is invested they are far more likely to invest more into it. SMSFs are of course a perfect example of this and I see this anecdotally all the time. Indeed it is a generalisation but in broad terms people in APRA funds generally begrudge every dollar of their SG going into super whilst our SMSF clients bemoan how little they are allowed to contribute. It would be very curious for people not to be more willing to invest more into those things that they have direct control over versus those they don't. Hence SMSFs and LRBAS greatly encourage people to contribute more than their bare SG into superannuation. SMSFs are where superannuation succeeds most powerfully in getting people to save more to provide for their own retirement.

**3.3** The FSI was critical of gearing pointing out the chief negative of a geared investment failing and quite possibly eliminating or dramatically reducing a person's superannuation balance. This would see them needing to fund their retirement from the public purse. This cannot be denied and there will inevitably be examples of this. However this completely overlooks the beneficial effects of gearing to both the SMSF members and the Federal Treasury.

If we examine geared property investment outside SMSFs for a moment we can observe that banks have been entirely happy to lend to people to acquire residential investment properties for perhaps centuries. If there were significant continuous failures this practice would have ceased long ago or the LVRs being offered would have been sharply curtailed. Likewise it is hardly a secret that many Australians have made their fortune or certainly meaningfully provided for their retirement via geared residential investment properties. Indeed the ATO advises there are approximately 1.8m residential landlords in Australia with about two thirds incurring a negatively geared loss. Whilst there is no doubt a broad mix in the quality of these investments it clearly indicates a wide confidence in residential property investment which could not be sustained if most suffered a poor result. Both investors and banks would have altered their behaviour long ago.

Indeed delinquent loan rates for Australian banks are typically a fraction of just one per cent. Those failure rates include first home buyers on mortgage insurance. This suggests that for say every one thousand LRBAS perhaps at most 5 to 10 might fail.

If we examine a simple and "typical" example where we assume the underlying property value grows on average approximately 5% pa, then a SMSF with a balance of \$200K acquiring a \$400K property with a \$200K LRBA will in approximately 15 years have a property that has doubled in value to \$800K. The loan would have almost certainly been paid off. If the SMSF did not enter this investment and remained ungeared earning the same 5%pa it will have approximately \$400K in superannuation 15 years later. The implications for the members ability to be self-sufficient in retirement are plainly obvious. Please remember too we only required a 5% growth rate to achieve this, a good but hardly aggressive rate of growth.

There will of course be a far greater number of SMSFs who have a favourable investment experience than a poor one for the reasons outlined above and hence the gearing engaged in will magnify this already positive result. This means there will be people who would have needed to rely on the public purse for some of their retirement who now will not. Certainly they will be able to put off needing to come on the welfare system until much later in life. Therefore this brings us to the crux of this entire document. The truly intelligent response to borrowing in super is to ascertain what level of borrowing results in the maximum number of positive outcomes and the minimum number investment failures. We will discuss further below.

## **4.0 The Proposed New Model**

Given the above issues and concerns counter balanced against the outlined advantages of borrowing in SMSF's what then is the best approach? The author submits the below

### **4.1 Ban personal guarantees**

This directly addresses the FSI's primary issue. The danger is could this result in banks withdrawing from the LRBA market altogether? The author has at his local level approached local bankers to inquire will they lend on a good residential property to a couple who have a good credit history and good jobs where they borrow only 50% of the value of the property but minus personal guarantees? It appears as much as banks greatly desire to receive personal guarantees they will lend at these safe levels with so much surplus equity to protect their position. This simply removes the entire concern of the FSI of SMSF members using other SMSF assets to reduce any personal guarantee they will now have to fulfil because it simply does not exist. This obviously would NOT be difficult to legislate. The greatest issue is ensuring that banks will indeed lend under these circumstances. Anecdotal evidence and commercial logic says "yes".

### **4.2 Restricting LVRs to 50%.**

In line with the above point about banks being prepared anecdotally to lend at 50% LVR's without PGs the author also suggests deliberately and explicitly restricting LVRs to this sensible conservative level. It means that even if personal guarantees were allowed to continue the probabilities of any large number of them ever being called in would be miniscule. The "margin of safety" to quote Mr Buffett again within the entire LRBA system would be so strong that one could safely suggest the number of LRBA's guarantees being called in would be a tiny fraction of one per cent. Not only does this mean personal guarantees are rendered almost redundant if they are allowed to remain, but the other issue of SMSFs suffering an investment failure are vastly reduced. Indeed more than focussing on personal guarantees not being called in, surely our primary focus should be to design a system that results in the smallest number of failures occurring in the first place, without restricting the wonderful wealth building effects of gearing.

Having 50% LVRs also has other excellent prudential advantages. It creates the very high probability of the property in question being cash flow positive. This means if the SMSF members fall ill, lose their job etc. then the property can look after itself indefinitely. There will be no commercial pressure from the bank to sell at a disadvantageous time.

### **4.3 Ideally both 1) and 2) are adopted.**

If for instance we just ban PGs then this raises the prospect of probably a non-bank lender entering the market and offering LVR's far greater than 50%. This raises the possibility, particularly in buoyant property markets of people borrowing too much on what will prove to be overpriced property. We are aiming to design a system where we get the maximum number of positive gearing outcomes to the minimum number of negative outcomes. Likewise if we lower LVRs and don't ban PG's, whilst at the suggested 50% LVR there will be very few PG's acted upon it is still sensible to eliminate even the few occasions this might happen. This will force banks to be even more careful in their lending and pushes the cost of investment failures back on to the private sector and off the taxpayer.

#### **4.4 LVR's calculated over the borrowed asset's cost not SMSF's total asset base.**

I also strongly suggest the criteria restricting borrowing capacity of the fund should be applied to the asset being borrowed NOT the funds overall asset base. This is for administrative ease. If we apply it to a SMSF's entire asset base and those other assets are either listed shares rising and falling in value even by the second, ascertaining the SMSF's borrowing limit will be a constant moving target and an administrative nightmare. Likewise if the SMSFs other assets are in illiquid assets such as collectibles again ascertaining the current total asset base of the fund could be difficult, subjective and expensive requiring expert's reports. It would be reasonable to speculate that banks would be also very uneasy about lending on the basis of values ascribed partly to collectibles.

#### **4.5 Grandfathering of existing loans.**

Just as the FSI suggested all loans drawn down before any changes are made should have their terms and conditions grandfathered so does the author believe so for the same and typical reasons any legislation grandfathers prior contracts, ie grossly unfair to do otherwise.

### **5.0 Advantages and issues solved by new model**

**5.1** It continues to enable people who wish to take control of their superannuation and if they wish to buy a property to do so.

**5.2** By enabling more people to establish their own SMSF we have also in all likelihood greatly increased the number of people who will make significant voluntary contributions to their super, further reducing the likelihood they will end up on the welfare system to fund their retirement. Exactly what the superannuation system was set up for!

**5.3** By directly banning PG's it absolutely ensures other SMSF assets will not be sacrificed to reduce PGs owed by SMSF members

**5.4** By restricting LVRS to 50% or thereabouts, it ensures there will be vastly greater numbers of positive gearing outcomes in SMSFs than failures, meaning the overall effect on the superannuation and welfare system will be massively to the benefit of all.

**5.5** By restricting LVRS to 50% or thereabouts we make the possibility of the property being cash flow positive or very near too very high and hence in the event of a job loss or illness the property can service its loan and other operating costs by itself.

**5.6** Whilst it is not a perfect defence by restricting LVRS to 50% it will make it much harder for property "sharks" to pressure younger, more gullible members of the public into a SMSF and a LRBA to acquire typically an overpriced apartment as their borrowing capacity has been restricted back to a level to which they will not be able to afford such a property even with a LRBA.

**5.7** In line with 5.6 it will assist in discouraging people establishing a SMSF with a low balance as they will need more equity to acquire a property that they currently do. This will also prevent such people entering into property deals that are significantly negatively geared. This prevents investment

failures if members lose their jobs or suffer ill health and can't contribute the necessary SG or sacrificed contributions to ensure the loan is serviced.

**5.8** To the extent there could be some truth to the claim SMSF's are materially inflating property markets this has obviously been greatly restricted due to the LVR being reduced to 50%. This will see the SMSFs that can buy a property have less funds to invest and reduce the SMSF's who can enter the property market currently.

## **6.0 Disadvantages to new proposed model**

**6.1** the greatest disadvantage to the proposed model is there are currently sensible people quite capable of understanding and dealing with property purchases at 80% LVRs and this system will greatly restrict their investment options. SMSFs are about enabling people to exercise their right to control their own superannuation investment decisions. This model will unfortunately infringe on some people's rights when they were perfectly capable of dealing with the added risk of 80% LVRs. It regrettably is a reduction in economic liberty.

**6.2** It is also possible with the absence of PGs that banks may also charge a higher interest rate but if LVRs are 50% or less it would be difficult to argue that there was greater risk to the bank. In conversations with bankers inquiring would they lend to good quality borrowers at 50% LVRs with no PGs no bank raised the possibility of higher rates.

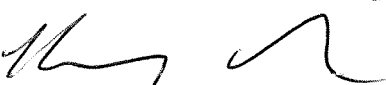
## **7.0 Conclusion**

The author believes that borrowing in SMSF's is in fact a very beneficial public policy provided it is done at safe conservative levels. The rational response to borrowing in superannuation currently is to take the opportunity to deliberately design the system such that it reduces investment failures to close to zero but empowers those many thousands who choose too so they can materially increase their superannuation balances. It will enhance a huge number of citizen's final superannuation balances, without any material risk to their retirement funds. Anecdotally I have seen many people increase their voluntary contributions to superannuation once they are set up in a SMSF and investing in the asset class or classes they prefer and understand. As stated above I also believe the above model and changes could be easily legislated, there are many things in the SIS act more complex than the above proposal.

There is the very real opportunity to build a safe and strong borrowing in superannuation system that will deliver overwhelming positive outcomes to the members SMSF's and Federal treasury now and into the future.

I commend the proposed changes to you and would be delighted to discuss any queries you may have.

Yours Sincerely

  
Kingsley Smith CA

