Submission to the Financial System Inquiry

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Should SMSFs be allowed to borrow?

About the writer

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In 2001, Graham's first book, Naked Among Cannibals, *an analysis of the evolution of Australian banking, featured in the Top 10 Business Books in Australia for several months. He wrote a monthly column on banking and funds management for* CFO Magazine, *and his articles have appeared in* Euromoney, International Financing Review *and* Money Management *magazines, as well as websites* Crikey *and* Banking Day.

Graham has an honours degree in economics from the University of NSW and a Diploma from the Securities Institute of Australia (now the Financial Services Institute of Australasia).

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Introduction

An irresistible combination of four massive numbers is causing a headache for financial regulators but a gold mine for many financial advisers and real estate agents: $4 trillion in residential housing, $1.9 trillion in superannuation, $600 billion in SMSFs and one million trustees. And Australians love property.

Reigning in the grab for a piece of this action is rightly in the sights of the Financial System Inquiry (FSI): *"This Inquiry shares the Super System Review Panel's view that leverage should not be a core focus of SMSFs — or any superannuation fund — and is inconsistent with Australia's retirement income policy."*

This paper provides more background for the Inquiry's review.

The returns and losses to expect from gearing

Borrowers often underestimate the consequences of borrowing money to invest. The results of gearing are not intuitively obvious, and the asymmetry of returns can shock investors. For example, an investor who borrows 60% of an asset's value (asset value $100, debt $60) would typically lose 35% if the market falls 10%.

How can this be true? It's the effect of costs plus the 250% ($100/$40) exposure. Consider the exact dollars. An investor puts in $100,000 and borrows $150,000 to invest $250,000. The portfolio falls 10% or $25,000. Assume costs of 1% on gross assets or $2,500 and an interest cost of 5% or $7,500. That's a loss of $35,000 or 35% on the original $100,000.

By the same reasoning, many investors with margin loans in 2007 lost 100%, even when gearing ratios were lower. They put in $100,000 and borrowed $100,000, and then their shares fell in value by 50%. Their loss was not 50%, it was 100%. All their capital was gone. In good times, when investors are optimistic and often entering the market near its peak, it's easy to overlook the downside. If the market is down 20%, the geared return will be down about 60%.

For the formulas for calculating the returns from gearing and a table showing various scenarios, see: http://cuffelinks.com.au/the-returns-to-expect-from-gearing-into-shares/.

Cash flows from residential property are often misleading

There are few investments with the emotional appeal of residential property, and when price rises are strong, there is a 'fear of missing out' which drives prices even higher. News stories abound of properties selling well above reserve and auctions attended by hundreds of potential buyers.

A confluence creates competitive forces which drive residential property prices beyond the fundamental of the returns that can be expected over time, including:

- various first-home buyer schemes and stamp duty exemptions
- investors moving money out of cash and term deposits into the growth asset class they believe they understand and is not volatile
- Asian buyers, especially Chinese who are restricted in owning property in their own country. Asians love property and Australia is seen as more stable than Europe or the United States. They often have children studying here
- SMSFs are the new players, and although the amounts are not high in absolute terms (only about 3% of SMSF assets are residential property and three-quarters of SMSF property assets are commercial), it's a new competitive influence
- other residential property investors (local non-super) who have regained confidence at a time when unemployment remains low and financing has never been cheaper.

It’s only when the off-the-plan property settles a year later, or time comes to select an agent and a decent tenant, that many investors face a harsh reality check. The costs are always greater than expected. Table 1 calculates the yield to expect on two common forms of residential investment:

Table 1. Illustrative returns from a 2-bedroom apartment

Cost item	Up front cost	Annual short-term	Annual long-term
Purchase price	$700,000		
Stamp duty	$27,000		
Legal, inspections, etc	$5,000		
Furniture package (only for short-term rental)	$40,000		
Rental income (short-term 365 X $180 X 75%, long-term 48 X $700)		+$49,275	+$33,600
Apartment leasing agent (Gross rental X 13% or 7%)		-$6,406	-$2,352
Body corporate administration fee		-$8,000	-$8,000
Sinking fund fee		-$1,000	-$1,000
Council rates		-$2,000	-$2,000
Water, electricity, gas services		-$2,000	-
Apartment cleaning (short-term, assume 90 times pa)		-$10,800	-
Travel agent/online commissions, 10% on 50% of rent		-$2,464	-
Other costs (linen, pay TV, maintenance and repairs)		-$2,000	-$1,000
Purchase cost short-term	$772,000		
Purchase cost long-term	$732,000		
Net income (ignoring interest cost on loans)		$14,606	$19,248
Net income/purchase cost		**1.9%**	**2.6%**

Ignores tax and depreciation effects which vary by buyers, including land tax.

The returns without factoring in repairs and maintenance will be somewhere around 2%. For a complete set of assumptions and illustrations of the range of costs involved, see: http://cuffelinks.com.au/property-returns/. In most cases, the investment merit of investing relies heavily on capital gains exceeding inflation rates over the long term.

On an apartment valued at $700,000, an SMSF may borrow 80% or $560,000. With an interest rate of 5%, the annual borrowing expense is $28,000, plus fees. In NSW, the stamp duty on a $700,000 apartment is about $27,000. There are many annual costs which new property buyers often overlook, such as body corporate fees, agent leasing fees and council rates. By the time these bills are paid, an SMSF trustee will need to find at least $10,000 a year from within the SMSF (plus at least $30,000 up front to buy this property, and probably a lot more on furnishings and fittings). What happens when interest rates rise, or the property has a long vacancy period, or a major repair is required? What if the SMSF trustee loses their job and is not making other contributions to super? It’s not possible to sell the bathroom, and the SMSF trustee may be forced to sell the apartment at the worst time in the property cycle.

Residential property investing and spruiking

Most of the one million SMSF members have not read their 70 page trust deed, but every deed says something like: *The Trustees must ensure that each investment strategy is appropriate at all times for Members of the Fund.* The thousands of people attending property seminars aimed directly at SMSFs have additional risks to consider that are rarely, if ever, mentioned during the presentations.

For example, is it appropriate to use high leverage to invest in a single, illiquid asset worth many times more than the SMSF itself? Or in pension phase, how will minimum pension payments be met if the property is untenanted? And where will the money come from for major repairs if all the funds are in the property?

Peter Kell, ASIC Commissioner in charge of the SMSF taskforce, spoke at a CPA Australia conference and attempted to clarify the requirements for property purchased through an SMSF. To quote him:

"In the past you may have seen ASIC comment that we do not regulate direct property investment. This is the case except where the investment is made through an SMSF. Let me be very clear – a person requires an AFS licence if they recommend that an existing or proposed member of an SMSF purchase a property through their SMSF. This is because the vehicle through which the underlying investment is made is an SMSF and an interest in an SMSF is a financial product."

I attended a property seminar aimed at SMSFs, organised by one of the highest profile agents in the country, and was shocked at the material presented. It contained many half-truths and exaggerations, and the audience seemed to lap it up. Most of the presentation was made by an SMSF administrator whose fee for the complete package of putting together an SMSF and arranging the property loan was $7,995.

Consider three of the messages from this seminar:

- If you don't have enough money for a deposit, four people can pool their money to fast track to wealth.
- You can reduce the purchase price of the investment property by 40% using concessionally-taxed superannuation compared to after-tax salary for loan repayment.
- If you don't have enough money in super but you have equity in your house, you can borrow against your house and lend the money to your SMSF.
  Anyone who defends SMSF borrowing should attend one of these seminars for a real eye-opener. Imagine the future problems if four people own one illiquid asset requiring ongoing management as they head to retirement at different times.

If one of the largest and most reputable real estate companies in Australia can oversee a presentation like this, there is a strong case to protect superannuation money from property spruikers. For a complete explanation of what happened at this seminar plus some unwanted consequences, see: http://cuffelinks.com.au/smsf-property-spruikers-on-borrowed-time/

Doubts about compliance by property promoters and advisers

The main problem in allowing SMSFs to borrow is that the unwary are targeted. Unscrupulous agents sell off-the-plan apartments at inflated prices paying big commissions to advisers. A few years later when the rental return guarantee has finished the SMSF trustee realises the initial property price was overvalued. There have been many examples in Australia, including the Gold Coast, Melbourne's Docklands and various backwaters, where resales have been 50% of the original purchase price.

In another speech to CPA Australia, ASIC Commissioner Greg Tanzer also warned the regulator is monitoring websites and media for evidence of misleading conduct, and attending SMSF seminars. He said that making a recommendation to set up an SMSF to buy property is financial advice, for which a person must be properly licenced, even though the underlying investment – the property – is not itself a financial instrument. *"The promoter may not be complying with the law."*

In a poll conducted on the Cuffelinks website on 24 July 2014, we asked the question: Should SMSFs be allowed to borrow to invest in property? We received 119 responses:

- 60% said, 'No, need to protect retirement savings from such leverage'
- 22% said, 'Yes, it's a legitimate asset class and borrowing is fine'
- 18% said, 'Yes, but only when SMSFs buying related business premises.

Given our target audience is predominantly SMSF trustees and market professionals, Australians have a love affair with residential property and many people make money from encouraging borrowing, it was surprising to see only one in five in favour of such borrowing.

The first priority for any financial adviser meeting a new client should be an explanation of investment risk. Only by determining risk appetite can a portfolio be constructed. Those who start with fund or property selection have the wrong foundation.

This is where problems with borrowing start, especially for superannuation and SMSFs. SMSFs can usually borrow up to 80% of the value of a property, requiring the fund to have capital of at least 20%. If the value of the property falls 10%, the SMSF will lose half its capital.

There is too much price complacency among residential property buyers. The Reserve Bank Governor, Glenn Stevens, recently warned on property prices, especially in Sydney, "… in forming expectations about future price gains and deciding their financing structure, people should not assume that prices always rise. They don't; sometimes they fall." The Reserve Bank issued a paper entitled "Is Housing Overvalued?", which quotes research by The Economist (2013) and the OECD (2013) that Australian house prices are 24% and 21% 'overvalued'.

How can borrowing be restricted?

A major issue facing the Inquiry is the extent to which borrowing can reasonably be restricted. Any super fund that buys a share is taking on some level of gearing, since nearly all investee companies borrow. There are geared funds where the borrowing is built into the structure of the fund itself, although the SMSF is buying a unit in a fund and not borrowing in its own name. It is exactly the same leverage effect if an SMSF gears itself at 50% (borrows $100 to buy $200 of assets) or the SMSF invests in a fund that leverages at 50%.

In fact, during the GFC, even some ungeared property funds lost 70% of their value, because the listed property companies in their portfolios were heavily geared and fell significantly. The geared version of the same fund fell almost 97%. In both these cases, there was no borrowing within any SMSF itself.

How this happened is explained here: http://cuffelinks.com.au/best-worst-managed-fund/

It is also problematic to change SMSF rules to prevent business owners borrowing to put their own business premises into an SMSF. This has become an entrenched part of many business plans, and at least it has the security of the owner controlling the asset, knowing its cash flow potential and no being subject to the vagaries of a tenant. An estimated 85% of borrowings for property by SMSFs are for commercial premises, and the valuation and cash flow issues are less of a problem than aggressively-marketed residential apartments.

The other possibility is to continue to allow SMSFs to borrow, but to place a cap on the borrowing amount, perhaps 50% of the asset value. This requires the SMSF to have at least as much capital as debt and therefore it controls leverage and downside risk to some extent, although clearly all capital can still be lost (as it can in an ungeared investment).

Conclusion

Leverage increases risk, and when this is widespread across an asset class, financial crises can be exaggerated by forced sellers. The best example is margin lending, where banks have the right to force investors to sell assets to maintain margin ratios. In troubled times, assets look for buyers but everybody is trying to preserve liquidity.

Given so much leverage in our system outside of superannuation, do we need to add more potential risk and volatility into the system generally, and superannuation in particular? Our retirement savings are supposed to reduce the future drain on pension payments, and an investor who loses money from a poor leveraged investment may become a long-term drain on public resources.

Property differs from shares as it is usually a single indivisible asset, which cannot readily be sold brick by brick. The sole purpose of superannuation, and the reason it is given favourable tax treatment, is to fund a retirement, and to do this, it must generate income. Leveraged investments usually carry an interest cost, and unless the revenue exceeds this cost, there is a net cash outflow. What happens when interest rates rise, or the property has a long vacancy period, or a major repair is required? What if the SMSF trustee loses their job and is not making other contributions to super? The SMSF trustee may be forced to sell the apartment at the worst time in the property cycle.

This paper has demonstrated:

- the dramatic downside of leveraged returns in a falling market
- the low net yields generated by many residential properties when all costs are considered
- the spruiking techniques some agents use to target SMSFs
- the role that superannuation plays in funding a retirement.

Many highly leveraged SMSFs would lose all their own equity if there is a decent residential property price correction. Anyone who doubts the potential problems should attend a property seminar aimed at SMSFs and listen to the techniques used.

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