AUSTRALIAN INSTITUTE of SUPERANNUATION TRUSTEES

24 January 2018

Mr Robb Preston
Manager
Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: superannuation@treasury.gov.au

Dear Mr Preston,

Re: Superannuation Taxation Integrity Measures

In brief:
AIST supports these measures which will reduce the ability of LRBAs to circumvent restrictions on contributions. We point out that fund leverage adds to systemic risk in the financial system, and point to the opportunity that exists to prohibit these, as recommended by the Financial System Inquiry.

Thank you for the opportunity to comment in relation to this consultation paper. Our comments in this submission are made at a high level, and we do not plan to respond to the questions proposed in the paper. In addition, we do not plan to respond in detail to the exposure draft or draft explanatory memorandum.

AIST supports the measure which will restrict the degree to which a Limited Recourse Borrowing Arrangement (LRBA) can be used to circumvent the Total Superannuation Balance (TSB) restriction on contributions. AIST also supports the changes to the non-arm's length income (NALI) rules which will extend the NALI rules to expenditure.

The consultation paper discusses measures related to superannuation fund borrowings. AIST has long held significant concerns in relation to borrowings in superannuation, given that the tax environment of superannuation is designed for retirement savings through accumulation, rather than borrowings.

AIST supported the Financial System Inquiry (FSI) recommendation to remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds. This was for a number of reasons.

Firstly, the key objective of superannuation is to provide income in retirement. We agreed with the conclusion of the FSI Final Report that the essence of a savings vehicle for retirement income,

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together with the “strengths and benefits the superannuation system has delivered to individuals, the financial system and the economy” could be lost if the original prohibition on borrowing was not restored[1]. The report further noted that the prohibition of borrowing would limit the risks to taxpayers.

In the last decade, a case was made for direct, albeit limited, leverage in superannuation. This was cemented in 2007, when the *Superannuation Industry (Supervision) Act 1993* (the “SIS Act”) was amended to allow investment in instalment warrants, a type of derivative that allows for piecemeal investment in assets. Previously, these were limited to shares, however, since these were allowed under the Act, a variety of funding solutions have been created, most notably over real property. Leverage itself was generally only allowed in previous situations where liquidity in the form of very short-term cash flow was required to be addressed.

The Final Report also points to the fact that risk is magnified across the financial system by leverage. The submission of the Reserve Bank of Australia (RBA) drew special attention to this, singling the low level of leverage in superannuation out as being a stabiliser on the Australian economy[2]. This was due to the fact that low leverage reduces the chance of defaults and subsequent “wealth shock[s]” to households.

The RBA also drew attention to the role of superannuation in national savings, noting that compulsory superannuation now forms 35% of gross national savings today. However, the submission noted elsewhere that savings are undermined by debt, noting that household savings in the decade following the Wallis Inquiry dropped nearly as low as 5% of GDP[3] due to household borrowing.

Types of financial risk impacted by leverage include market risk, credit risk, manager risk, and liquidity risk and are increased at both an investor level, as well as a macroeconomic level. The interconnectedness of our financial system means that should failure in the form of defaults by borrowers become widespread, the spill-over effect of contagion may be unable to be contained by ordinary provisioning. This type of risk was noted in the Final Report, and – we argue – falls within the definition of systemic risk.

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[1] Murray, D., Davis, K., Dunn, C., Hewson, C. and McNamee, B. (2014). Financial System Inquiry Final Report. [pdf] Canberra: Commonwealth of Australia The Treasury, p.88. Available at: http://tinyurl.com/n7wl3lb [Accessed 23 Feb. 2015].

[2] RBA, (2014). Submission to the Financial System Inquiry. [pdf] Sydney: Reserve Bank of Australia, p.184. Available at: http://tinyurl.com/mhp599v [Accessed 23 Feb. 2015].

[3] RBA, (2014). Submission to the Financial System Inquiry. [pdf] Sydney: Reserve Bank of Australia, p.114. Available at: http://tinyurl.com/mhp599v [Accessed 23 Feb. 2015].

We point to the fact that the size of the superannuation industry – currently $2.53 trillion in assets under management, with only $35.7 billion in liabilities in 2017 – is so large that exogenous shocks, such as the global financial crisis, or shocks created within Australia, may be cushioned to a large extent by passive investment in unleveraged assets. Unfortunately, this stabilising influence is reduced as leverage increases.

Superannuation's unleveraged nature meant that the impact of the GFC was not as pronounced in superannuation. This, in turn, acted as a stabilising influence on Australia's financial system and the effect of interconnectedness was not magnified. However, with an increase in borrowings in the superannuation sector, this stabilising influence is not guaranteed to be as effective in the next financial crisis. We contend that since a largely unleveraged superannuation sector assists management of systemic risk, AIST supports a return of a prohibition on leverage in superannuation.

We additionally note that the second measure in this consultation relates to the assessment of non-arm's length income (NALI). While we welcome the measure, which will see the consideration of non-arm's length expenditure included in assessment of NALI, we question why these situations are able to occur. We point out that NALI itself would not be an issue if transactions at commercial rates involving unrelated third parties were entered into and that there would therefore be no need for measures such as this, if related entities who are also able to contribute into the fund were limited in their ability to enter into such arrangements with the fund.

For further information regarding our submission, please contact Richard Webb, Policy & Regulatory Analyst at 03 8677 3835 or at rwebb@aist.asn.au .

Yours sincerely,

Eva Scheerlinck
Chief Executive Officer

The Australian Institute of Superannuation Trustees is a national not-for-profit organisation whose membership consists of the trustee directors and staff of industry, corporate and public-sector funds.

As the principal advocate and peak representative body for the $700 billion profit-to-members superannuation sector, AIST plays a key role in policy development and is a leading provider of research.

AIST provides professional training and support for trustees and fund staff to help them meet the challenges of managing superannuation funds and advancing the interests of their fund members. Each year, AIST hosts the Conference of Major Superannuation Funds (CMSF), in addition to numerous other industry conferences and events.