Leverage and Risk in The Superannuation System

Council of Financial Regulators Report to Government

September 2022

Council of Financial Regulators

Executive Summary

The first report to Government on leverage and risk in the superannuation system was published in February 2019. The report was commissioned by the previous Government in response to the 2014 Financial System Inquiry (FSI) which recommended prohibiting the use of limited recourse borrowing arrangements (LRBAs) by superannuation funds. At the time, the then Government did not consider the data sufficient to warrant prohibiting LRBAs and instead asked the Council of Financial Regulators (CFR) and the Australian Taxation Office (ATO) to monitor leverage and risk in the superannuation system and report back to it after three years.

The 2019 report found that LRBAs were used almost exclusively by SMSFs and that while the level of SMSF borrowing was not significant enough to pose a material systemic risk to the superannuation system or broader financial system, some individuals were putting their retirement savings at significant risk by using LRBAs in inappropriate ways. Absent reforms to prohibit the use of LRBAs to reduce the risks identified, the report recommended continued monitoring of LRBAs and a further report to Government by the CFR and the ATO in another three years, including to allow an assessment of recent regulatory changes and of several more years of improved data. The then Government agreed to this recommendation and commissioned a further report by the CFR and the ATO in three years. As such, this new report has been prepared, and as in 2019, contains analysis by the CFR agencies and ATO.[1]

Borrowing by superannuation funds can have implications for the financial system and for the retirement income of individual members. The key findings of this report are set out below.

Financial system

► The use of LRBAs remains almost entirely restricted to self-managed superannuation funds (SMSFs). The number of funds with LRBAs has increased since the FSI and the 2019 report. Assets held under LRBAs form a relatively low but not insignificant proportion of SMSF assets overall. These arrangements are most common in lower balance funds, which as a result tend to have lower levels of asset diversification.

- The proportion of SMSFs using LRBAs has grown from 2.9 per cent to 11.8 per cent between 2013 and 2020, with more modest growth occurring in the period from 2017 comprising 2.2 percentage points of this total growth.

- LRBA assets represent 71.0 per cent of total assets for those SMSFs with LRBAs. The value of assets held under LRBAs increased from $8.8 billion in June 2013 to $45.8 billion in June 2018 and to $59.7 billion in June 2021. As at June 2021, LRBA assets represented 7.2 per cent of total SMSF assets, up from 6.6 per cent in June 2018, and 1.9 per cent in June 2013. The total borrowing amount outstanding for SMSFs was around $27.8 billion as at June 2021. The leverage ratio (total LRBA borrowings divided by total LRBA assets) for SMSFs with LRBAs has declined from 34.6 per cent in 2017 to 32.0 per cent in 2020 as asset prices have risen.

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[1] The report has been authored by Treasury with input and analysis from CFR agencies and the ATO. NB: The ATO is not a policy agency and therefore makes no recommendations on the findings of the research in this report.

- Real property continues to represent a significant proportion of the assets held by SMSFs with LRBAs. SMSFs remain a small, but not insignificant, driver of growth in the lending for property market investment. A change in the property cycle or rising interest rates could increase incidents of default or personal guarantees being called upon.

► Australian Prudential Regulation Authority data shows lending to SMSFs comprised less than 1 per cent of overall residential mortgage lending by authorised deposit-taking institutions (ADIs) as at the March quarter 2022.

► The current levels of borrowing by SMSFs are unlikely to pose a material systemic risk to the superannuation or broader financial system at this time.

Superannuation members

► LRBAs can represent a significant risk to some individuals' retirement savings particularly where they have low-balance SMSFs with high asset concentration and/or personal guarantees.

- LRBAs are most common in SMSFs with a net fund size (total assets excluding the value of the amount borrowed) of between $200,000 and $500,000. In 2020 the average borrowing of SMSFs with LRBAs was $350,492 and the average value of LRBA assets was $778,600 of SMSFs with LRBAs.

- SMSFs with LRBAs assets remain highly concentrated in their investment strategies with 43.3 per cent holding over 90 per cent of their total asset value under LRBAs in 2020 (up from 41.2 per cent in 2017).

- Less diversified SMSFs with LRBAs are exposed to asset concentration risk, which in the event of a fall in the asset's price, could lead to a significant loss in value of the SMSF which could be magnified by borrowing. Further, this high degree of asset concentration could exacerbate risks to SMSF members if personal guarantees are involved, leading to a loss of personal wealth beyond superannuation.

► There continues to be evidence of conflicted and poor-quality advice being provided to individuals regarding the use of LRBAs which could potentially put their retirement savings at risk, including inappropriate advice provided through property one-stop-shops.

Regulatory and market developments

► There have been a number of changes in market conditions since the previous report that may influence the demand and supply of LRBAs going forward.

- Since the withdrawal of the major banks from new lending to SMSFs in mid-2018 (with the exception of National Australia Bank which currently offers loans to SMSFs for margin lending purposes but not for property investment), non-ADI lending to SMSFs has seen significant growth, representing around 36 per cent of total lending to SMSFs in mid-2022, compared to around 24 per cent of total lending to SMSFs in late 2020. While non-ADI lending to SMSFs has grown significantly in recently years, the sector is not considered to pose a systemic risk as it represents only a small share (less than 5 per cent) of total house lending and the exposure of banks to non-ADIs is limited.

- The initial shock of the COVID-19 pandemic in the first half of 2020 is likely to have softened growth in borrowing and asset values between June 2019 to June 2020. From mid-2020 accommodative monetary and fiscal policy settings in response to the pandemic, and rising house prices have supported increases in borrowing and asset values. However, since May 2022 the Reserve Bank of Australia has begun normalising monetary policy conditions to cool inflationary pressures in the economy.

► Since the previous report there have been several reforms to improve the quality of financial advice. These reforms include strengthening professional standards for financial advisers, requirements by financial services licensees to disclose a lack of independence and a new disciplinary system for financial advisers. Consistent with recommendations by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, an independent review into how the regulatory framework can better enable the provision of high quality, accessible and affordable financial advice is currently underway. The final report will be provided to Government by 16 December 2022.

► Since 1 July 2018, the outstanding value of an LRBA has been included in the total superannuation balance for some SMSF members. This improved the integrity of the system by reducing the ability for SMSFs to use related party loans to circumvent contribution caps. The extension of non-arm's length income rules to expenditure on 1 July 2018 also disincentivises third-party lending to a fund through an LRBA at below market and zero interest rates.

- Since the reforms commenced no new LRBAs have been established by SMSFs with very large balances ($50 million or more), suggesting the integrity measures have worked effectively in reducing the ability of SMSFs to circumvent contribution caps.

Conclusion

► This report and the previous 2019 report on leverage and risk in the superannuation system establish a clear baseline for monitoring risks relating to LRBAs in the superannuation system. They demonstrate that borrowing by SMSFs through LRBAs has not posed a material risk to the superannuation system or broader financial system since it was first permitted in 2007. This is notwithstanding evidence LRBAs are used in inappropriate ways by some individuals and can be a high risk to their retirement savings and, by extension, increase the risk of higher fiscal outlays through the Age Pension.

- The CFR considers that continued monitoring and reporting to Government on an as needed basis would be prudent to ensuring appropriate oversight of risks relating to financial stability from the use of LRBAs.

- Further, noting the evidence that LRBAs represent a significant risk to some individuals' retirement savings, the Government may wish to further consider current policy settings, particularly in light of the FSI's recommendation to prohibit LRBAs.

Table of Contents

1 CONTEXT 1
1.1 Background on limited recourse borrowing arrangements 1
1.2 FSI recommendation and response 2
1.3 Summary of the 2019 report 2
2 REGULATORY AND MARKET DEVELOPMENTS 4
2.1 Regulation of SMSFs 4
2.2 Regulation of lending 6
2.3 Regulation of financial advice 7
2.4 Changes in market conditions 8
2.5 COVID-19 and pandemic support measures 9
3 CURRENT USE OF LRBAS 11
3.1 Data sources 11
3.2 Use of LRBAs by SMSFs 12
3.3 Value of LRBA assets and total borrowings by SMSFs 14
3.4 SMSF investment by asset class 15
3.5 Asset allocation of SMSFs with LRBAs 15
3.6 Borrowing levels of SMSFs with LRBAs 16
3.7 Asset concentration 18
3.8 Lenders used by SMSFs 19
3.9 Compliance of SMSFs with LRBA rules 19
4 RISKS ASSOCIATED WITH LRBAS 20
4.1 Risks to SMSFs and individual members 20
4.2 Risks to the superannuation system 23
4.3 Risks to financial stability 23
4.4 Continued monitoring of leverage in the superannuation system 24
APPENDIX A – TIMELINE 25
APPENDIX B – GLOSSARY 27

1 Context

Superannuation funds are generally prohibited from direct borrowing, a long-standing feature of the investment rules in the *Superannuation Industry (Supervision) Act 1993* (SIS Act). However, there are some limited exceptions to this, the most commonly used being limited recourse borrowing arrangements (LRBAs).[2]

Superannuation is a significant component of Australia's financial system and the wealth of Australians. At June 2022, superannuation assets totalled $3.3 trillion,[3] or 144.2 per cent of gross domestic product (GDP).[4] The 2021 Intergenerational Report projected that superannuation assets will grow to around 244.0 per cent of GDP by 30 June 2061, as the superannuation system continues to mature.[5] Superannuation is now the second largest asset for many Australians and is of growing importance.

The 2014 Financial System Inquiry (FSI) recommended prohibiting the use of LRBAs by superannuation funds. In its response to this FSI recommendation in 2015, the then Government noted that while there were anecdotal concerns about LRBAs, it did not consider the data sufficient to justify any significant policy intervention. Instead, it commissioned the Council of Financial Regulators (CFR) (consisting of the Reserve Bank of Australia (RBA), Treasury, Australian Prudential Regulation Authority (APRA) and Australian Securities and Investment Commission (ASIC)) and the Australian Taxation Office (ATO) to monitor leverage and risk in the superannuation system and report back to it after three years.

The *Leverage and Risk in the Superannuation System* report was published in February 2019. The timing was set to allow improvements in ATO data collection to wash through the system to better inform the analysis of anecdotal concerns.

Absent reforms to prohibit or limit the use of LRBAs, the 2019 report recommended continued monitoring of LRBAs and a further report to Government by the CFR and the ATO in another three years' time to: allow an assessment of how regulatory changes either recently introduced, or still intended, at that time would influence the demand and supply of LRBAs going forward; allow the review of measures to improve the quality of advice to SMSFs; and allow several more years of improved data to be analysed.

As such, this new report has been prepared, which as in 2019, contains analysis by the CFR agencies and the ATO.[6] The current report builds on the 2019 report to provide updated data and analysis of risks relating to leverage and risk in the superannuation system.

1.1 Background on limited recourse borrowing arrangements

Although all superannuation funds can use LRBAs, LRBAs are used almost entirely by self-managed superannuation funds (SMSFs). Unlike SMSFs, APRA-regulated funds are governed by prudential standards, and their size means they can invest in asset classes such as property without needing to borrow. LRBAs

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[2] A timeline of the evolution of borrowing in the superannuation system is provided as Appendix A.

[3] APRA quarterly superannuation statistics June 2022.

[4] Australian Bureau of Statistics (ABS) Catalogue 5206.0 Australian National Accounts, Table 1, GDP at current prices for the year to June 2022.

[5] Treasury 2021 Intergenerational Report Chart 7.4.2.

[6] The report has been authored by Treasury with input from CFR agencies and the ATO. NB: The ATO is not a policy agency and therefore makes no recommendations on the findings of the research in this report.

were first explicitly allowed under the SIS Act in 2007 to permit SMSFs to invest in instalment warrants, following increased use of these warrants in earlier years.

1.2 FSI recommendation and response

The FSI final report released in November 2014[7] delivered a number of recommendations, including Recommendation 8 being the restoration of the general prohibition on direct borrowing by superannuation funds.

The FSI considered that restrictions in previous years on leverage in the sector had provided stability to the superannuation system, broader financial system and the economy and would be important for mitigating future build-up of risks in those systems. It would also fulfil the objective of superannuation to be a savings vehicle for retirement income, rather than a broader wealth management vehicle. The FSI's main concern was that borrowing, even in a limited recourse arrangement, would magnify the gains and losses from fluctuations in the market, and increase the probability of large losses within a fund.

The FSI noted that further growth in direct borrowing by superannuation funds would, over time, increase risk in the financial system. At the time of the FSI, ATO data illustrated that use of LRBAs was rising rapidly. By December 2014, assets held under LRBAs constituted around 3 per cent of total SMSF assets, up from around 0.1 per cent in June 2008.

1.3 Summary of the 2019 report

The 2019 report examined the implications of borrowing by superannuation funds for the financial system and for the retirement income of individual members, in particular focussing on LRBAs given the FSI's concerns about these arrangements. The report also focussed on SMSF use of LRBAs given that the ATO data indicated that the use of LRBAs was almost entirely restricted to SMSFs.

Findings

The 2019 report found that LRBAs did not present a material systemic risk given at the time the small number of SMSFs using LRBAs and that the level of SMSF borrowing and assets held under these arrangements comprised a relatively low (whilst not insignificant) proportion of overall SMSF assets. The Productivity Commission's 'Superannuation: Assessing Efficiency and Competitiveness' report in 2019 also found that the relatively small number of SMSFs using LRBAs meant that such borrowing was unlikely to pose a material systemic risk.

However, the 2019 report did note that LRBAs may present a significant risk to some individuals' retirement savings, particularly low-balance SMSFs with high asset concentration and/or personal guarantees. In the event of a fall in asset prices, this could lead to a significant loss in value of the SMSF and retirement savings, and in some cases also a loss of personal wealth beyond superannuation.

The report also noted that real property represented a significant proportion of the assets held by SMSFs with LRBAs. SMSFs were seen at that time as a small, but not insignificant, driver of growth in the property market for which a change in the property cycle or rising interest rates risked increased incidents of default or personal guarantees being called upon. The effect of expected market condition changes going forward,

[7] Financial System Inquiry – Final Report, 2014, p. 86.

for example non-ADI lenders making up a greater share of lending to SMSFs, was also of interest, but the report expected the ability and incentives for SMSFs to borrow would continue.

Recommendations

The report set out a number of policy options to reduce or eliminate completely the risks of LRBAs to individuals. In particular, regulator members of the CFR and ATO noted that no longer allowing LRBAs would address a number of significant risks which could be detrimental to SMSF members' retirement incomes, and also remove the risk that rising leverage in the superannuation system may pose to financial stability. However, the report noted that a number of reforms announced by the then Government in response to the recommendations of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission) went to these options, including prohibiting the hawking of superannuation products and a review of measures to improve the quality of advice in three years' time.

2 Regulatory and market developments

Summary

In 2019, a number of reforms were announced to address the quality of financial advice in response to the recommendations of the Royal Commission. The majority of these have since been implemented, including reforms to professional standards of financial advisors, disclosure of independence by financial services licensees and the introduction of a new disciplinary system for financial advisers. As recommended by the Royal Commission, an independent review into how the regulatory framework can better enable the provision of high quality, accessible and affordable financial advice is currently underway and due to be completed by the end of 2022.

Since 1 July 2018, reform to include LRBAs as part of an individual's total superannuation balance in certain circumstances has improved integrity in the superannuation system by reducing incentives to use LRBAs to circumvent contribution caps and accrue larger assets. Changes to tighten non-arm's length expense rules in 2019 may have increased the costs of utilising an LRBA for some SMSFs, and greater enforcement of diversification standards by the ATO may have contributed to a slight decrease in asset concentration amongst those SMSFs the ATO engaged with.

Market conditions have also continued to evolve since the previous report. The cessation by the major banks of new lending to SMSFs since 2018 (with the exception of National Australia Bank (NAB) which currently offers margin loans to SMSFs) has coincided with growth in non-ADI lending to SMSFs. Rising house prices and low interest rates have supported growth in demand for LRBAs since the 2019 report. The economic recession caused by the COVID-19 pandemic likely contributed to slower growth in SMSF borrowing and asset values between June 2019 and June 2020, including due to weak economic conditions and tighter lending in place during the initial market volatility in early to mid-2020.

Broad fiscal stimulus, regulatory interventions, and more accommodative monetary policy that was implemented in response to COVID-19 likely helped ameliorate any adverse impacts of the pandemic on borrowing and asset values. The ABS residential property price index indicated a 16.8 per cent increase in national house prices in the 2020-21 financial year. While this will have contributed to reductions in the ratio of borrowing to asset values for some SMSFs, it will not have benefited more recent investors. ATO quarterly estimates suggest there has been strong growth in leverage and asset values in SMSFs since the initial pandemic shock. Recent increases in the cash rate by the RBA to contain inflationary pressures may reduce demand for new LRBAs.

2.1 Regulation of SMSFs

Borrowing by SMSFs is regulated in three main ways: regulation of trustees, prudential regulation on lenders, and consumer protection regulation on financial advisors and product providers.

Total superannuation balance treatment

Since 2017, individuals have only been able to make non-concessional contributions or catch-up concessional contributions and access certain superannuation measures (e.g. the spouse tax offset) if their Total Superannuation Balance (TSB) for the previous financial year is below the general transfer balance cap ($1.6 million from 2017-18; $1.7 million from 2021-22).

As noted in the 2019 report, a member's share of the outstanding balance of any LRBAs commenced on or after 1 July 2018 must be included in their TSB where the LRBA is with a related-party, or the member has met a condition of release with nil cashing restrictions (e.g. when a member reaches age 65 or has retired and is over the preservation age). Prior to this reform, only the value of the superannuation interest in the asset held under an LRBA was required to be included in a member's TSB.

Including the outstanding balance of an LRBA in an individual's TSB was intended to prevent SMSFs using LRBAs to reduce their TSB to make non-concessional contributions they otherwise would not be eligible to make. In some cases, funds were removed as lump sums, reducing the TSB of a member, and then effectively recontributed as capital under an LRBA, resulting in a lower TSB.

Where a person is in the accumulation phase and the LRBA is borrowed from a commercial lender they are not required to include the outstanding value of an LRBA in their TSB. This means that there are still incentives to use LRBAs to help build retirement savings.

Non-arm's length arrangements

The 2019 report announced changes to extend non-arm's length income (NALI) rules to non-arm's length expenses. Since 1 July 2018, NALI has been expanded to incorporate expenditures incurred in deriving income for an SMSF which are less than would otherwise have been expected to be incurred if the parties were dealing at arm's length. Income with a sufficient nexus to expenditure incurred on a non-arm's length basis is deemed NALI and taxed at the highest marginal rate.

The measure means that trustees will be disincentivised from using non-commercial expenses to inflate their overall superannuation fund earnings. Consequently, interest expenses on assets supported by LRBAs will be assessed in comparison to market interest rates. This will, for example, disincentivise a third-party lending to a fund through an LRBA at below market and zero interest rates. In conjunction with the total super balance treatment, it will limit some SMSFs from making contributions to pay interest on an existing asset.

The ATO released the Law Companion Ruling (LCR) 2021/2 on 4 August 2021 which provided details as to the ATO's interpretation of the *Income Tax Assessment Act 1997* rules on NALI and their compliance approach.

Diversification standards

SMSFs are required to meet diversification requirements under the operating standards of the *Superannuation Industry (Supervision) Regulations 1994*. In response to identified risks in the 2019 report and ASIC report 'SMSFs: Improving the quality of advice and member experiences' in 2018 (which found that 1 in 3 trustees did not know they needed an investment strategy[8]) the ATO conducted a probe into the diversification level of SMSF investment portfolios in 2019.

The ATO sent letters to 17,700 trustees (approximately 3.0 per cent of all SMSFs), who had more than 90 per cent of their assets in a single asset class.[9] Of these SMSFs, 98 per cent had acquired a property under an LRBA.[10] These letters indicated there could be a $4,200 administrative penalty for failing to meet diversification standards.

A comparison between the 2018 and 2020 SMSF annual returns (SAR) for the funds in the cohort that were sent letters, and which reported on both occasions, shows a slight decrease in asset concentration. Of these funds, 83 per cent continued to have an asset concentration greater than 90 per cent, while 12 per cent of the cohort had reduced their concentration into the 80 to 90 per cent range and less than 5 per cent had an asset concentration of less than 80 per cent.[11]

[8] ASIC Report 575, SMSFs: Improving the quality of advice and member experiences, page 8, 28 June 2018.
[9] Unpublished ATO data, 2019.
[10] Ibid.
[11] Unpublished ATO data, 2021.

This high asset concentration population is most at risk to property fluctuations and rising interest rates when they are also highly leveraged. However, as noted in section 3.6, the number of funds in this category is reducing.

Reporting changes

Since 1 July 2021, there is no longer a requirement for SMSFs to obtain actuarial certificates when calculating exempt current pension income (ECPI) where all members of the fund are fully in the retirement phase for all of the income year. These funds will now be able to use the segregated method to calculate ECPI. Also, for the 2021-22 financial year onwards, trustees can choose their preferred method of calculating ECPI where the fund is fully in retirement phase for part, but not all, of the income year. These changes have been introduced to reduce administrative costs for superannuation funds.

If an SMSF has multiple members, the rules give flexibility to SMSFs using LRBAs to use the segregated method to designate the LRBA asset, and the outstanding loan balance to a particular member. The increase in flexibility may make LRBAs more attractive for some SMSFs with multiple members.

Other regulatory changes

The government has also announced and delivered several changes to rules which will significantly impact SMSFs. As announced in the 2018-19 Budget, from 1 July 2021 the number of members allowed in SMSFs and small APRA funds was increased from four to six.

In the 2021-22 Budget, the then Government announced that residency requirements for members of SMSFs and small APRA funds will be relaxed. The measure, which is yet to be legislated, will extend the safe harbour provisions of the central control and management test and remove the active member test. The measure will allow members to maintain their SMSF, including assets under LRBA arrangements, while overseas for up to five years.

2.2 Regulation of lending

APRA is responsible for the prudential oversight of authorised deposit-taking institutions (ADIs), which include a number of banks that lend to SMSFs. While APRA monitors aggregate trends in system-wide lending, it does not make rules for non-ADIs unless those lenders materially contribute to risks of instability in the Australian financial system. Non-ADI lenders are not currently considered to present a material risk to financial stability (see Section 4.3).

Non-ADIs must comply with the *National Consumer and Credit Protection Act 2009* when lending to SMSFs with a trustee who is an individual for the purposes of residential property investment. These laws prohibit credit licenses (including non-ADIs) from providing credit or a loan, where the credit arrangement is unsuitable for the consumer. To assess suitability, non-ADIs must consider the financial situation, requirements and objectives of the consumer. A loan is unsuitable for a consumer if they would be unable to comply with their obligations under the loan without substantial hardship, or if the loan does not meet their requirements or objectives.

2.3 Regulation of financial advice

Many consumers decide to set-up an SMSF after seeking financial advice. Financial advice regarding SMSFs represents almost a quarter of all revenue generated by the financial advice industry.[12] As noted in the 2019 report, there has been considerable legislative reform to address concerns about the quality of financial advice. Changes to the regulation of the financial advice industry have continued since 2019.

The professional standards reforms came into effect from 1 January 2019, with transitional provisions for existing advisers. The standards require financial advisers to have an approved qualification, pass an exam, participate in continuing professional development, and comply with a code of ethics.

In 2020 legislation passed giving existing advisers until 1 January 2022 (one additional year) to complete the exam; and until 1 January 2026 (two additional years) to meet the qualification requirements. Further, in 2021, legislation passed giving the responsible Minister the power to allow an additional extension of up to nine months in 2022 for existing advisers to pass the exam if they have had at least two attempts by 1 January 2022. In December 2021, the Hon Stephen Jones MP, then Shadow Minister for Financial Services and Superannuation, announced an election commitment to remove tertiary education requirements for financial advisers who had passed the exam, had 10 years' experience and a clean record of financial practice. In August 2022, Assistant Treasurer Jones reiterated this commitment and indicated consultation on the changes would commence shortly.

Since the release of the Final Report of the Royal Commission in February 2019, a range of reforms to the sector have been implemented:

- From 1 January 2021, ending the payment of grandfathered conflicted remuneration.
- From 1 July 2021, new requirements for the annual renewal of ongoing fee arrangements and a requirement for Australian Financial Services (AFS) licensees (including authorised representatives) to disclose a lack of independence.
- From 1 October 2021, reference checking and information sharing requirements for financial advisers, and new requirements around how breaches are reported to ASIC and how misconduct is managed internally in firms.
- From 1 January 2022, a new disciplinary system for financial advisers. In addition, the responsible Minister and ASIC have taken over the functions of the Financial Adviser Standards and Ethics Authority (FASEA). Financial advisers who provide tax (financial) advice services to retail clients are also no longer required to be registered with the Tax Practitioners Board. From 1 January 2023, financial advisers must be registered with ASIC.

As recommended by the Royal Commission, an independent review of how the regulatory framework could better enable the provision of high quality, accessible and affordable financial advice is currently underway. The terms of reference were released on 11 March 2022, and the final report will be provided to Government by 16 December 2022. The Review is considering whether measures that have been implemented by government, regulators and financial services entities have improved the quality of financial advice. The review is also considering how to ensure the regulatory settings support Australians getting access to affordable financial advice.

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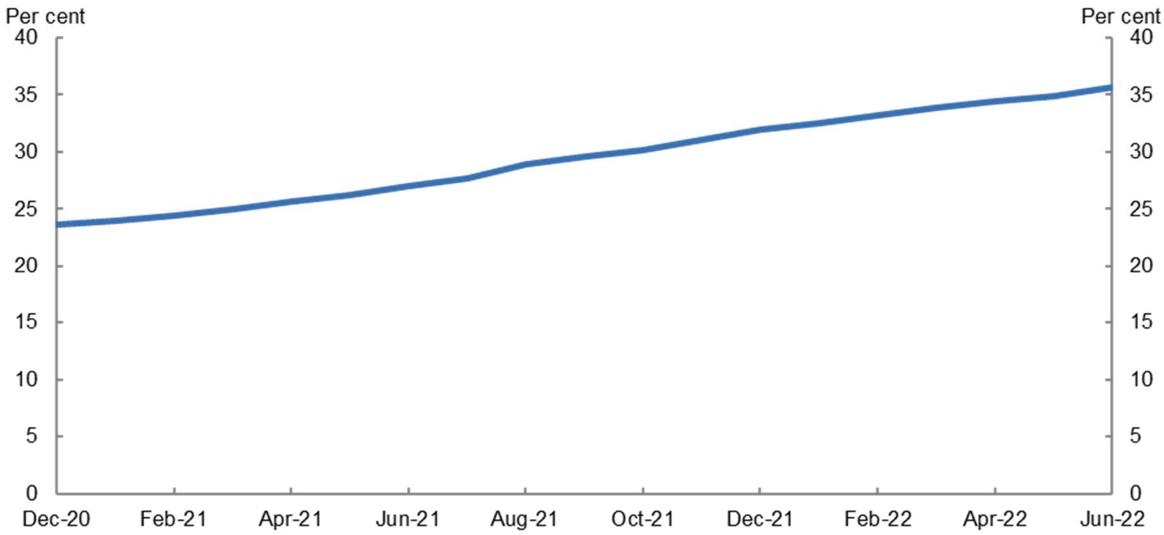
[12] IBISWorld, *Financial Planning and Investment Advice in Australia K6419b*, October 2020, p 8.

2.4 Changes in market conditions

As noted in the 2019 report, most major banks and a number of other lenders have withdrawn from providing LRBAs, although NAB currently offers loans to SMSFs for margin lending purposes but not for property investment. The major banks have noted a desire to simplify their business models, and with the introduction of new regulatory requirements, have chosen to move away from LRBAs. APRA data indicates that lending by ADIs to SMSFs that is secured by residential property has fallen steadily since the March quarter 2019.[13] Nonetheless, as of mid-2022, the major banks still hold around $8 billion (in aggregate) of outstanding loans to SMSFs on their balance sheets.[14]

APRA data show that non-ADIs represented around 36 per cent of total SMSF borrowings in mid-2022, compared to around 24 per cent of borrowings in late 2020 (Chart 1).

Chart 1: Non-ADI share of lending to SMSFs



Note: Non-ADIs are defined as finance companies and money market funds. To maintain confidentiality, data prior to September 2020 are not provided for these series. Data are gross of provisions. Non-ADI data does not include entities with <$400m total assets due to reporting differences.
Source: APRA unpublished data, 2022.

This growth in non-ADI lending to SMSFs is likely to be at least partly due to non-ADIs being drawn to the vacated field left by the major banks. A factor supporting non-ADI growth is that they do not have to comply with the prudential regulatory requirements applied to banks, which reduces their compliance costs of lending to SMSFs. While they generally tend to charge higher interest rates than banks, borrowers are attracted by their faster approval times and greater likelihood of approval compared to banks.[15]

[13] APRA Quarterly authorised deposit-taking institution property exposures, March 2022, Table 1b.
[14] Unpublished APRA data.
[15] RBA Financial Stability Review - April 2019, Box D: Non-bank Lending for Property.

The demand for non-ADI lending among SMSFs likely reflects the low interest rate environment and strong growth in property prices over the period.[16] Residential property prices rose 23.7 per cent through the year to December quarter 2021, the strongest annual growth since the ABS Residential Property Price Index began in September quarter 2003.[17]

2.5 COVID-19 and pandemic support measures

Borrowing by SMSFs is estimated to have fallen slightly from $25.2 billion to $24.9 billion between June 2019 and June 2020 (1.0 per cent reduction), while the value of LRBA assets rose from $50.0 billion to $52.6 billion (5.4 per cent increase). [18] This follows a slowdown in the growth of the value of LRBA assets and total LRBA borrowing over the previous two years. LRBA borrowing grew by 2.8 per cent between June 2018 and June 2019, and by 5.7 per cent between June 2017 and June 2018. Meanwhile, LRBA asset values grew by 9.0 per cent and 12.4 per cent respectively over those same periods. It is unclear whether, and to what extent, the moderation in borrowing and asset values between June 2019 and June 2020 can be attributed to the COVID-19 pandemic, but consistent with the impacts of the pandemic on the broader economy, it is likely to have had impacts on both the demand for LRBAs and the willingness of lenders to make new loans.

Growth in SMSF borrowing was likely constrained in the first half of 2020 by weak economic conditions and pandemic response measures which may have limited purchases of properties, including restrictions on auctions and open houses. Further, declines in property prices and weak rental returns may have disincentivised some SMSFs from investing in LRBAs and may have contributed to some SMSFs selling their LRBA assets. In response to these conditions, deferrals on housing loan repayments reached a peak of 8 per cent in June 2020,[19] and the value of new housing loan commitments in June were down 9.0 per cent compared to March 2020.[20] On the supply side, banks imposed a moderate tightening of lending standards in response to the economic uncertainty, further restricting the growth in LRBAs.[21]

There were a number of measures implemented by governments and lenders during 2020 that provided support to SMSFs. This included repayment relief offered by some lenders to SMSF trustees if they had suffered financial effects of COVID-19. In April 2020, the ATO also advised that this relief would not impact NALI provisions relating to SMSFs, if repayment relief reflected similar terms to what commercial banks were offering for real estate loans at the time and there was documentation showing an expectation that interest would continue to accrue on the loan during the period relief is given.[22] In addition to this, broad fiscal and regulatory interventions in response to the economic effects of the pandemic, and the recovery in financial markets, have provided support and are likely to have ameliorated the initial impacts of the pandemic on SMSFs.

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[16] Unpublished RBA research.

[17] ABS Media Release – March 2022, Strongest annual growth in property prices on record. (Referencing Catalogue 6416.0 Residential Property Price Indexes: Eight Capital Cities, Table 1).

[18] Estimates are extrapolations based on those SMSFs that have lodged their annual returns in the previous financial year (see Section 3.1 for more details).

[19] RBA Financial Stability Review - October 2020, 2. Household and Business Finances in Australia.

[20] ABS Catalogue 5601.0 Lending Indicators, Table 1, Seasonally Adjusted.

[21] RBA Financial Stability Review - October 2020, 2. Household and Business Finances in Australia.

[22] See ATO COVID-19 frequently asked questions for Self-managed super funds, Related party limited recourse borrowing arrangement relief (last updated on 17 April 2020) and QC 20439: COVID-19 limited recourse borrowing arrangement relief (last modified 15 July 2021).

Without actual data on SMSF annual returns for the 2019-20 and 2020-21 financial year, it is not yet possible to confirm with certainty how borrowing and asset values were affected in these years, and what impact the pandemic support measures had. However, the ABS residential property price index increased by 16.8 per cent in the 2020-21 financial year.[23] Indicative quarterly estimates modelled by the ATO also suggest strong growth in borrowing and asset values since June 2020, with borrowing increasing from $24.9 billion in June 2020 to $27.8 billion as at June 2021 and LRBA asset values increasing from $52.6 billion to $59.7 billion over the same period.[24]

[23] ABS Catalogue 6416.0 Residential Property Price Indexes: Eight Capital Cities, Table 1.

[24] Data for June 2021 is from quarterly statistical reports based on modelling of asset values. This modelled quarterly data is only used in this section in the context of asset and borrowing value trends with annual data for the 2019-20 financial year (latest available) based on SAR data used for analysis of SMSFs using LRBAs.

3 CURRENT USE OF LRBAS

Summary

The proportion of SMSFs with at least one asset under an LRBA has increased significantly from 2.9 per cent in 2013 to 11.8 per cent in 2020.

As at June 2021, the value of SMSF investments financed by an LRBA (LRBA assets) is estimated to be $59.7 billion or 7.2 per cent of total SMSF assets (up from 1.9 per cent as at June 2013). The value of LRBA assets as a share of total SMSF assets grew by only 0.6 percentage points from 6.6 per cent in 2018 to 7.2 per cent in 2021. Between June 2018 and June 2021, total SMSF borrowing (including LRBAs) rose 13.3 per cent from $24.5 billion to $27.8 billion, however borrowing as a share of total SMSF assets remains low at 3.4 per cent (down slightly from 3.5 per cent in 2018).

Real property continues to be the most popular asset class for LRBAs. In 2020, the value of LRBA assets invested in real property was 95.9 per cent of the total value of LRBA assets. A contributing factor is that the law allows SMSFs to purchase business real property from related parties. While 70.3 per cent of LRBA SMSFs held residential property, it represented only 51.8 per cent of the total value of LRBA assets in 2020. Non-residential property while being held by 26.6 per cent of LRBA SMSFs, represented 44.0 per cent of the total value of LRBA assets in 2020.

SMSFs with LRBAs are predominantly in the accumulation phase with most members of working age and total SMSF net assets below $500,000. The proportion of SMSFs with LRBAs in the accumulation phase has increased from 85.8 per cent in 2013 to 94.8 per cent in 2020. This proportion is much higher than the overall SMSF population, where only 55.1 per cent were in the accumulation phase in 2020.

Of SMSFs with LRBAs in 2020, 43.3 per cent had 90 per cent or more of their assets backed by an LRBA. In 2020, 36.9 per cent of SMSFs with LRBAs had a leverage ratio (LRBA borrowings divided by LRBA assets) above 60 per cent, although this proportion has declined since 2017. SMSFs with low levels of diversification and high leverage ratios could expose members to an increased risk of loss of superannuation savings from an economic or property market downturn. The use of personal guarantees by 30.9 per cent of SMSFs with LRBAs could potentially extend losses to wealth outside of superannuation (see Section 4 for further details on risks to individuals' superannuation savings from LRBAs).

3.1 Data sources

The ATO compiled published and unpublished data on completed and lodged SMSF annual returns (SARs) for the purposes of this report. The SMSF statistics in this report are primarily based on this unpublished SAR data and the ATO's published SMSF Quarterly Statistical Report which comprises estimates derived from extrapolations of actual SAR lodgements.

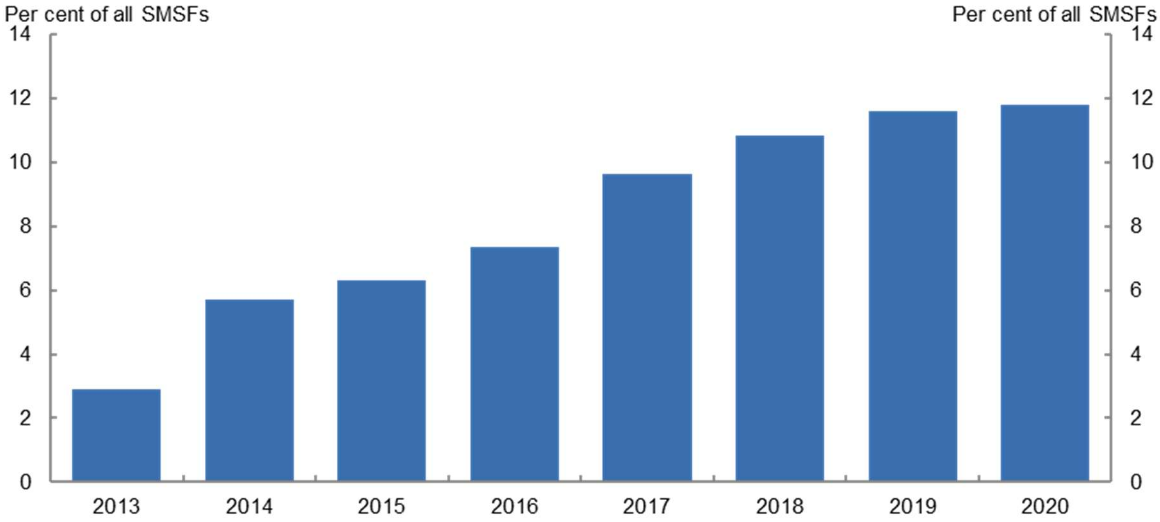
The 2019 report drew on data from actual reported SAR lodgements over the financial years 2013 to 2017. The current report covers SAR data from this period with an additional three years of data from 2018 to 2020.[25] As in the previous report, the value of SMSF assets and borrowing are drawn from published quarterly statistics. This report extends the quarterly series from the previously reported June 2018 figures to June 2021.[26]

The report also includes data from APRA on lending by financial institutions to SMSFs, and ATO data on auditor contravention reports lodged by SMSF auditors.

3.2 Use of LRBAs by SMSFs

The proportion of SMSFs with LRBAs has increased from 2.9 per cent in 2013 to 11.8 per cent in 2020 (Chart 2). The growth in the proportion of SMSFs using LRBAs has slowed since 2017 with a 2.2 percentage point increase between 2017 and 2020, compared to 3.9 per cent between 2014 and 2017.

Chart 2: Per cent of SMSFs using LRBAs



Source: ATO, 2021

The majority of SMSFs using LRBAs (64.4 per cent) had total net assets of under $500,000 in 2020. As LRBAs increase both the value of an SMSF's assets and liabilities, it is more appropriate to consider the net fund size of SMSFs using LRBAs, than their total assets. The predominance of funds in this net fund size range has remained stable at around 64 per cent between 2013 and 2020. The proportion with a net fund size in the lower range of $0 to $200,000 has decreased from 27.6 to 17.2 per cent over this period (Table 1), while those in the range of $200,000 to $500,000 has increased from 36.7 per cent to 47.2 per cent.

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[25] The 2020 SAR data is based on all SAR lodgements received at the time the data was compiled, accounting for approximately 86.8 per cent of all SMSFs in the 2020 financial year. As this data does not cover the entire SMSF population it is used to derive insights on distributional characteristics, rather than population aggregates.

[26] Quarterly SMSF asset allocation statistics are estimated based on SAR data from the previous financial year adjusted for non-lodging SMSFs, investment returns, SMSF establishments/wind-ups and other factors. These adjustments make the quarterly figures suitable for analysis of aggregate asset allocations. While asset allocation estimates for three further quarters to March 2022 were available at time of writing this report, June quarter 2021 was deemed more appropriate for presenting a consistent analysis on a financial years' basis.

Table 1: Proportion of SMSFs with LRBAs, by net fund size (%)

Net fund size	2013	2014	2015	2016	2017	2018	2019	2020
>$1–$50,000	1.4	1.0	0.9	0.8	0.7	0.7	0.8	0.8
>$50,000–$100,000	4.8	4.0	3.9	3.4	2.5	2.3	2.2	2.1
>$100,000–$200,000	21.4	19.0	21.7	21.3	20.6	17.8	15.9	14.3
>$200,000–$500,000	36.7	33.7	38.2	40.1	44.2	45.9	46.6	47.2
>$500,000–$1m	17.8	18.9	17.6	18.3	17.9	18.9	19.7	20.7
>$1m–$2m	10.3	12.1	9.9	9.3	8.4	8.6	8.9	9.1
>$2m–$5m	5.8	8.4	5.8	5.0	4.2	4.3	4.3	4.4
>$5m–$10m	1.4	2.2	1.4	1.3	1.1	1.0	1.0	1.0
>$10m	0.4	0.7	0.5	0.5	0.5	0.5	0.5	0.5
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Note: Discrepancies between totals and sums of components are due to rounding.
Source: ATO, 2021.

SMSFs are increasingly using LRBAs to purchase higher value assets. SMSFs with LRBA assets valued greater than $1 million have grown from 1,647 (11.7 per cent of all SMSFs with LRBAs) in 2013 to 9,175 (15.6 per cent of all SMSFs with LRBAs) in 2020 (Table 2).

Table 2: Number of SMSFs with LRBAs investing over $1 million in LRBA assets

LRBA asset value	2013	2014	2015	2016	2017	2018	2019	2020
>$1m–$2m	1,103	1,913	2,768	3,532	5,340	6,152	6,657	6,468
>$2m–$5m	432	703	972	1,182	1,828	2,118	2,274	2,180
>$5m–$10m	84	142	182	216	336	368	410	375
>$10m	28	46	61	93	163	150	154	152
Total >$1m	**1,647**	**2,804**	**3,983**	**5,023**	**7,667**	**8,788**	**9,495**	**9,175**

Source: ATO, 2021.

SMSFs using LRBAs are mostly in the accumulation phase with members of working age. Most members of SMSFs with LRBAs were between the ages of 25 to 59 years with 88.9 per cent in this age bracket in 2020, up from 79.5 per cent in 2013. The proportion of SMSFs using LRBAs which were in the accumulation phase has increased from 85.8 per cent in 2013 to 94.8 per cent in 2020 (Table 3). The proportion of SMSFs with LRBAs in either the full pension phase or partial pension phase has fallen from 7.8 and 6.5 per cent respectively in 2013 to 2.6 per cent for both pension phases in 2020.

These demographics are markedly different to the demographics of the total SMSF population, where 55.1 per cent were in the accumulation phase, and those in full pension phase and in a partial pension phase represent 35.3 per cent and 9.6 per cent respectively in 2020.[27] SMSFs with LRBAs were 20.3 per cent, 0.9 per cent and 3.2 per cent of all SMSFs in accumulation phase, full pension phase and in partial pension phase respectively in 2020.

[27] ATO 2021, SMSF overview 2019-20, Table 12: SMSFs by payment phase.

Table 3: Proportion of SMSFs with LRBAs, by SMSF phase (%)

Phase of the SMSF	2013	2014	2015	2016	2017	2018	2019	2020
Full pension	7.8	10.8	7.6	6.5	4.6	2.8	2.6	2.6
Partial pension	6.5	7.8	6.0	5.7	4.7	2.7	2.7	2.6
Accumulation	85.8	81.3	86.4	87.8	90.8	94.5	94.7	94.8
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

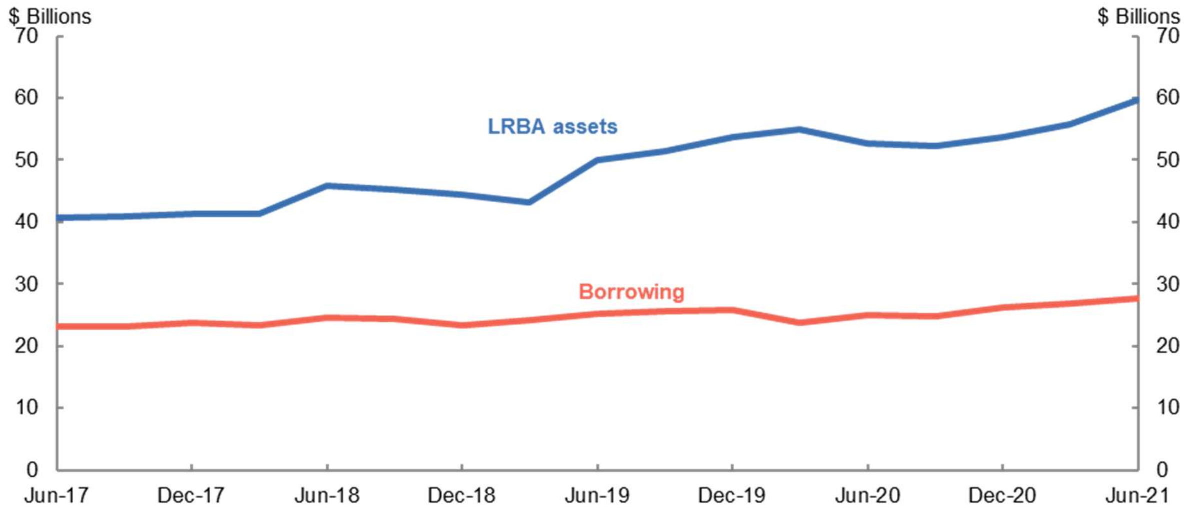
Note: Discrepancies between totals and sums of components are due to rounding.
Source: ATO, 2021

3.3 Value of LRBA assets and total borrowings by SMSFs

The value of LRBA assets was almost seven times larger as at June 2021 than as at 2013, increasing from $8.8 billion to $59.7 billion. As at June 2021, the value of LRBA assets was 7.2 per cent of total SMSF assets, up from 1.9 per cent in June 2013. The growth in value of LRBA assets reflects a mixture of increased leverage, rising asset values and improved data collection since 2017. Prior to 2017 there was some misreporting of borrowing for LRBA purposes, making it challenging to discern the contribution of leverage towards the growth in LRBA assets for that period.

Since June 2017, growth in LRBA assets has been faster than the growth in borrowing.[28] Since the 2019 report, SMSF borrowing has remained a small share of total SMSF assets at 3.4 per cent as at June 2021 (down slightly from 3.5 per cent in June 2018). In nominal terms, borrowing by SMSFs has increased by 13.3 per cent between June 2017 and June 2021 ($24.5 billion to $27.8 billion), while the value of LRBA assets has grown by 30.1 per cent over that same period (Chart 3). Notwithstanding challenges in discerning the factors driving growth in the value of LRBA assets, the data would suggest that recent growth in the total value of LRBA assets has been mostly driven by increases in the value of underlying assets rather than increased use of LRBAs by SMSFs.

Chart 3: Value of LRBA assets and total borrowings by SMSFs



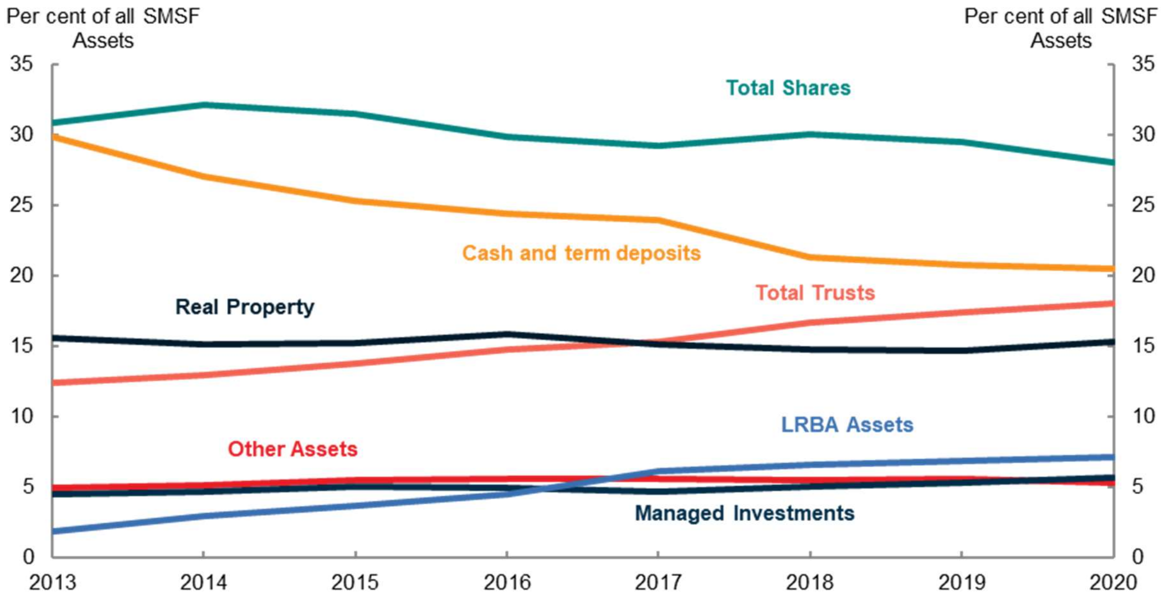
Source: ATO, 2021.

[28] Borrowing figures cannot be broken down between amount borrowed for LRBAs and other purposes. These figures are the sum of all borrowing by SMSFs with LRBAs for LRBAs and purposes other than LRBAs.

3.4 SMSF investment by asset class

LRBA assets have remained a relatively stable share of total SMSF investments in recent years, with this share growing by 1.0 percentage points from 6.2 per cent to 7.1 per cent between 2017 and 2020 (Chart 4). By comparison, investment allocations to cash and term deposits decreased 3.5 percentage points from 24.0 to 20.5 per cent between 2017 and 2020, and total trust investment increased 2.7 percentage points from 15.3 per cent to 18.0 per cent.

Chart 4: Composition of SMSF assets



Source: ATO, 2021.

The recent slow rate of growth in the share of SMSF assets held under LRBAs compares to a 3.2 percentage point increase over the four years prior from 2014 to 2017.

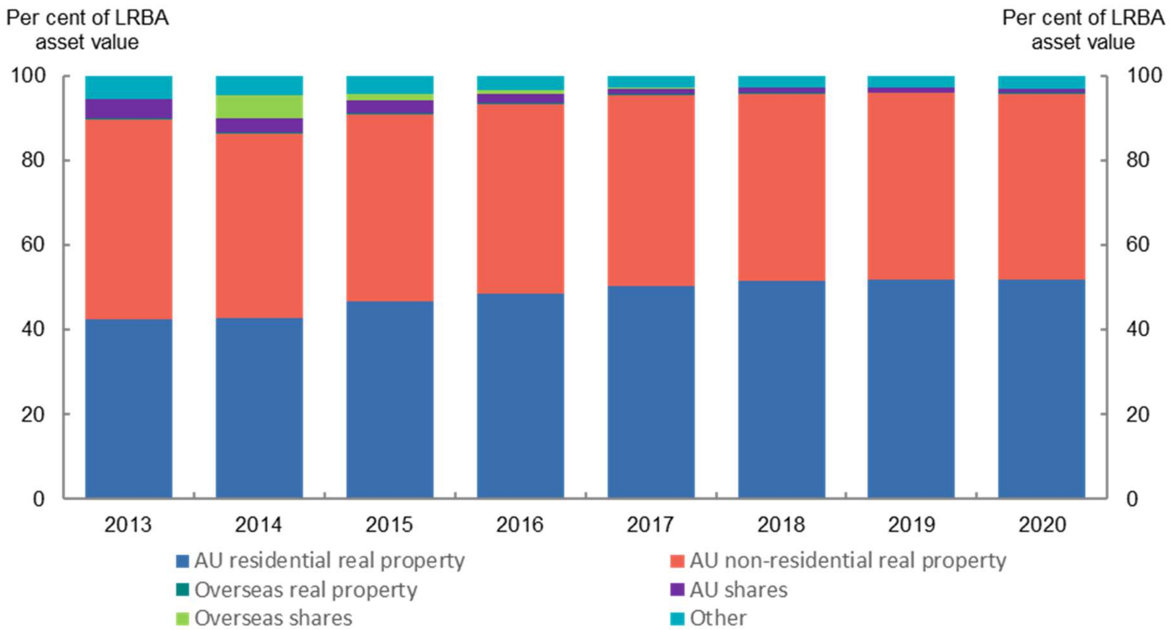
3.5 Asset allocation of SMSFs with LRBAs

A significant proportion of LRBAs are used to acquire residential and non-residential property assets, with only a small proportion of LRBA holdings in other types of assets. In 2020, real property assets collectively made up 95.9 per cent of the value of assets held by SMSFs under LRBAs. The proportion of LRBA assets invested in real property has remained around 96 per cent since 2017 (Chart 5).

The proportion of LRBAs being used for residential property has continued to grow since 2013. In 2020, 70.3 per cent of LRBA SMSFs held residential property, up from 52.1 per cent in 2013. Further, in the same year, the total value of residential property held under LRBAs was approximately 51.8 per cent of the total value of LRBA assets, up from 42.5 per cent in 2013.

The proportion of LRBAs invested in non-residential property has remained stable at around 27 per cent between 2013 and 2020, while the proportion of the total value of LRBA assets in non-residential property declined in its share from 47.0 per cent in 2013 to 44.0 per cent in 2020.

Chart 5: Value of assets under LRBAs by asset class (% of total LRBA assets)



Source: ATO, 2021.

For funds with total assets between $100,000 and $2 million, the highest value assets under LRBAs were mostly residential properties, whereas for SMSFs using LRBAs with more than $2 million in total assets the highest value assets under LRBAs were mostly non-residential properties. This suggests SMSFs using LRBAs with balances between $100,000 and $2 million have greater exposure to the housing market, while SMSFs with larger balances above $2 million are more exposed to non-residential property. The higher price point of non-residential property likely explains why funds with larger balances above $2 million are more likely to have this assets class as their highest value asset under an LRBA compared with lower balance funds.

3.6 Borrowing levels of SMSFs with LRBAs

In 2020 of SMSFs with LRBAs the average amount borrowed was $350,492 and the average value of LRBA assets was $778,600, representing an average leverage ratio (total LRBA borrowings to total LRBA assets) of 45.0 per cent. The share of SMSFs with LRBAs with a leverage ratio above 60 per cent declined between 2017 and 2020 from 48.9 per cent to 36.9 per cent (Table 4). As Section 3.3 notes, this likely reflects rising asset values exceeding largely stable borrowing levels over this period.

Table 4: Proportion of SMSFs with LRBAs by level of leverage (%)

Leverage ratio (LRBA borrowings/ LRBA assets)	2017	2018	2019	2020
>0%–20%	5.3	6.1	7.0	8.1
>20%–40%	15.0	16.3	17.6	19.3
>40%–60%	30.4	31.9	33.2	35.2
>60%–80%	39.2	36.1	32.7	28.7
>80%	9.7	9.3	9.2	8.2

Source: ATO, 2021.

Median leverage ratios for SMSFs with LRBAs tend to be lower for larger SMSFs (Table 5). SMSFs using LRBAs in all net fund size ranges above $200,000 saw median leverage ratios decline between 2017 and 2020. The median leverage ratio for funds in the most common range of $200,000 to $500,000 fell by 4.3 percentage points over this period from 59.0 per cent to 54.8 per cent.

Table 5: Median leverage ratio for SMSFs with LRBAs, by net fund size (%)

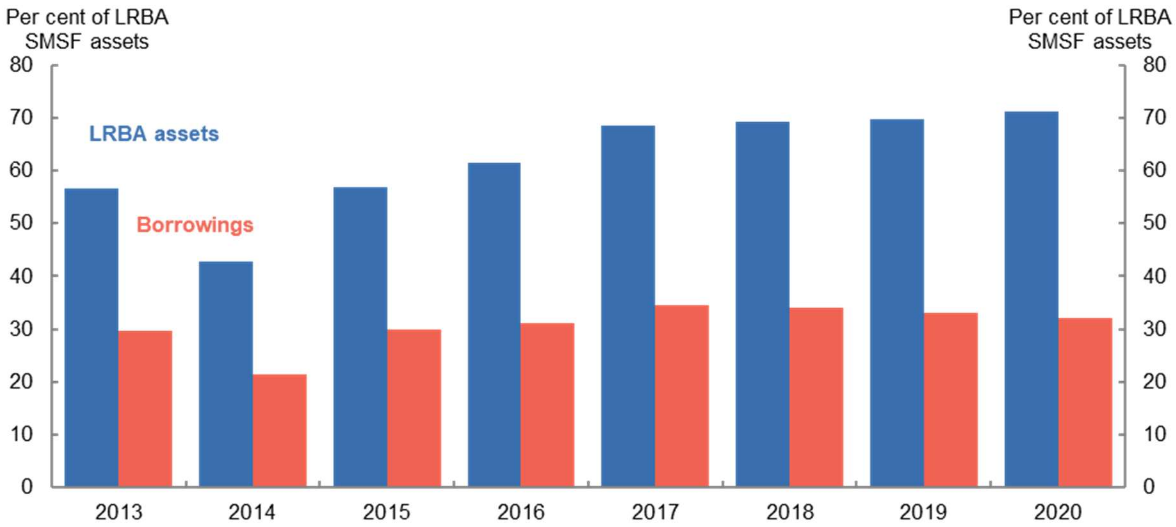
Net fund size	2017	2018	2019	2020
>$1–$50,000	99.4	99.2	98.9	99.8
>$50,000–$100,000	76.8	78.6	80.6	81.5
>$100,000–$200,000	67.0	66.4	66.2	66.0
>$200,000–$500,000	59.0	58.0	56.7	54.8
>$500,000–$1m	48.3	46.9	45.1	42.6
>$1m–$2m	44.4	40.8	38.4	36.1
>$2m–$5m	42.7	41.1	37.4	33.6
>$5m–$10m	40.5	36.9	32.6	30.0
>$10m	36.9	34.9	32.0	27.6

Source: ATO, 2021.

SMSFs with LRBAs over residential property tend to acquire those assets at higher leverage ratios compared to SMSFs with LRBAs over non-residential property. In 2020, 42.2 per cent of LRBA SMSFs holding only residential properties under LRBAs had a leverage ratio of more than 60 per cent. In comparison, 18.4 per cent of LRBA SMSFs holding only non-residential properties under LRBAs did so with a leverage ratio of more than 60 per cent.

For SMSFs with LRBAs, the ratio between the total value of LRBA assets and the total value of all SMSF assets has remained stable in recent years at around 70 per cent between 2017 and 2020 (Chart 6). Over the same period, for SMSFs with LRBAs the ratio of the value of total SMSF borrowing to total SMSF assets declined from 34.6 per cent to 32.0 per cent.

Chart 6: Ratio of LRBA assets and borrowings to all assets of SMSFs with LRBAs



Source: ATO, 2021.

3.7 Asset concentration

In 2020, 95.8 per cent of the value of assets held under LRBAs were real property (up slightly from 95.5 per cent in 2017). This large concentration of LRBAs in a single asset class, particularly if coupled with the concentration of all or a significant proportion of an SMSF's assets within a single asset in that asset class, raises the investment risks for SMSFs.

As borrowing magnifies gains and losses, using an LRBA to acquire assets can further increase investment risk, and imposes liquidity and credit risks. Of SMSFs with LRBAs in 2020, 43.3 per cent had 90 per cent or more of their assets backed by an LRBA - up from 41.2 per cent in 2017 and 28.8 per cent in 2014 (Table 6). The proportion of SMSFs with LRBAs with less than 50 per cent of their assets under LRBAs has declined since 2017 from 12.5 per cent to 10.6 per cent in 2020.

Table 6: Proportion of SMSFs with LRBAs at levels of LRBA concentration (%)

LRBA concentration (cumulative)	2013	2014	2015	2016	2017	2018	2019	2020
100%	1.4	1.2	1.5	1.6	2.1	2.1	2.6	2.2
>=90%	34.1	28.8	35.5	37.3	41.2	41.6	42.6	43.3
>=80%	49.6	42.4	53.3	56.3	62.1	62.5	63.1	64.2
>=70%	58.9	50.3	63.2	67.3	74.1	74.8	75.2	76.4
>=60%	66.0	55.8	70.0	74.4	81.8	82.5	83.0	84.1
>=50%	72.2	60.8	75.5	79.6	87.5	88.0	88.5	89.4

Source: ATO, 2021.

Viewed from the perspective of fund size, more than 90 per cent of SMSFs with LRBAs with total assets between $200,000 and $1 million had LRBA concentrations of 50 per cent or more in 2020 (Table 7). In particular, of SMSFs using LRBAs in the $200,000 and $500,000 range 90.1 per cent had LRBA concentrations of 70 per cent or more. Both smaller and larger funds tend to be less concentrated in LRBA investments.

Table 7: Proportion of SMSFs with LRBAs at levels of LRBA concentration in 2020, by fund size (%)

	LRBA concentration (cumulative)				
Fund size	**>=90%**	**>=80%**	**>=70%**	**>=60%**	**>=50%**
>$1–$50,000	25.0	37.5	37.5	37.5	37.5
>$50,000–$100,000	25.8	48.4	54.8	64.5	71.0
>$100,000–$200,000	44.1	65.8	75.9	81.6	87.4
>$200,000–$500,000	52.1	78.0	90.1	94.5	96.4
>$500,000–$1m	40.1	63.2	78.1	87.6	93.3
>$1m–$2m	36.5	52.0	62.4	71.2	79.8
>$2m–$5m	29.5	40.7	48.6	57.5	66.3
>$5m–$10m	21.6	31.6	39.3	48.2	56.1
>$10m	18.4	26.7	34.9	42.4	52.8

Source: ATO, 2021.

3.8 Lenders used by SMSFs

Lending to SMSFs secured by residential property represented approximately $7.5 billion (less than 1 per cent) of overall residential mortgage lending by ADIs as at the March quarter 2022. Lending to SMSFs has declined steadily from around $11.2 billion as at the March quarter 2019, when data was first published by APRA.[29]

Commencing in 2017, details of the financing arrangements used in LRBAs was added to the SAR reporting for SMSFs to capture whether borrowings are from a licensed financial institution. In addition, details of personal guarantees provided, or other securities offered to secure borrowings have also been required.

A comparison of years 2017 to 2020 indicates that financing from licensed institutions continued to increase slightly and continues to dominate lending sources. Similarly, the proportion of LRBA SMSFs securing loans with a personal guarantee has been little changed at around 30 per cent (Table 8).[30] Details of the personal guarantees offered, and related terms or lending arrangements are not captured in the SAR.

Table 8: Proportion of SMSFs with LRBAs borrowing from licensed institutions and using personal guarantees (%)

	2017	2018	2019	2020
Borrowing from a licensed institution	91.2	92.0	92.3	92.6
With a personal guarantee	29.6	30.2	30.5	30.9

Source: ATO, 2021.

The limitations around the data collected by the SAR means that it is not possible to use as a source to determine the proportion of lending met by smaller banks and non-ADIs since the exit of most major banks from lending to SMSFs.

3.9 Compliance of SMSFs with LRBA rules

Prior to lodging an annual superannuation return all SMSFs must be independently audited. Where the SMSF has been found to contravene the SIS Act or its Regulations an Audit Contravention Report (ACR) must be lodged with the ATO. The ACR, while identifying sections of the SIS Act that have been contravened may not identify cause or effects related directly to LRBAs.

Between 2013 and 2020, 17,234 ACRs were issued to SMSFs with LRBAs. While the types of contraventions reported in LRBA SMSFs are comparable in nature to those observed in the total SMSF, population a comparison of ACR incidence indicates the rate is higher in the LRBA SMSF population. In 2020, 5.4 per cent of LRBA SMSFs were issued an ACR compared to 4.8 per cent for non-LRBA SMSFs. As can be seen in Table 9, the greater incidence of ACRs in the LRBA SMSF population is observable since 2013, with 2014 being the only exception.

Table 9: Proportion of SMSFs issued with an ACR (%)

	2013	2014	2015	2016	2017	2018	2019	2020
LRBA SMSFs	5.1	3.3	3.7	4.0	4.5	5.7	6.3	5.4
SMSFs without LRBAs	4.7	4.2	3.6	3.3	3.7	5.2	5.8	4.8

Source: ATO, 2021.

[29] APRA Quarterly authorised deposit-taking institution property exposures, March 2022, Table 1b.

[30] These questions were first included in the 2016-17 SAR.

4 Risks associated with LRBAs

Summary

LRBAs can represent a substantial risk to many SMSF members and their retirement balances, particularly as most SMSFs with LRBAs have lower balances and are heavily concentrated in real property. In the event of a property market downturn, although recourse by lenders is in theory limited to the leveraged asset, in practice it can extend to other assets in the fund.

While there have been declines in the proportion of SMSFs with high leverage ratios since 2017 (see Section 3.6), this trend largely reflects increases in asset prices which may not be sustainable. The lack of asset diversification amongst SMSFs using LRBAs continues to remain a significant concern for the retirement savings of SMSF members, with around 96 per cent of the value of LRBA assets invested in real property since 2017.

ASIC continues to act on serious cases of poor quality and conflicted advice concerning SMSFs, including LRBAs and property 'one-stop shops'. The Australian Financial Complaints Authority (AFCA) reports that a significant share of the complaints it receives from SMSFs concern poor advice by one-stop shops to set-up an SMSF and invest in property using an LRBA. Consumers in some instances have been encouraged to invest all their superannuation savings in a single residential property.

As in the 2019 report, the systemic risks posed by LRBAs to the broader financial system continues to be low. Since the 2019 report, SMSF borrowing has remained a small share of total SMSF assets. Further, the reduced exposure of the major banks to LRBAs has limited systemic financial risks. While non-ADI lending to SMSFs is quickly growing to fill this gap (accounting for around 36 per cent of all lending to SMSFs in mid-2022), the RBA considers the financial stability risks from this lending to be limited, with only a small share of total banking assets (around 3 per cent in 2021) exposed to the non-ADI sector.

Continued monitoring and reporting to Government on an as needed basis in relation to leverage in the superannuation system would be prudent to ensuring risks are minimised.

4.1 Risks to SMSFs and individual members

Borrowing through limited recourse arrangements can be a risky investment for members. It has the potential to magnify both gains and losses from fluctuations in asset prices. Lenders also tend to charge higher interest rates on LRBAs to compensate for these risks and sometimes require personal guarantees from trustees.

Although in theory LRBAs limit recourse of lenders to a particular asset in the event of a default, in practice they can affect assets beyond those subject to the loan. If the leveraged asset does not produce sufficient returns to service the loan, trustees are more likely to sell other assets of the fund or make additional voluntary contributions to repay a lender rather than default, especially if personal guarantees are involved. In the case of illiquid assets such as property, it can also be difficult to sell assets quickly to meet repayments. Less diversified funds are at increased risk of default if they have fewer assets to rely on to meet payments. Furthermore, as the FSI noted, the selling of other fund assets to service the LRBA asset can further increase investment risk by reducing diversification in the fund.

Between 2017 and 2020, there has been a small increase in the proportion of SMSFs that had greater than 90 percent of their assets backed by an LRBA (see Section 3.7). While LRBA assets are making up a larger share of SMSF portfolios, SMSF borrowing as a proportion of total SMSF assets has remained largely stable since 2017 and leverage ratios have decreased. The proportion of SMSFs with leverage ratios greater than 60 per cent fell by 12.0 percentage points between 2017 and 2020, although this reduction in the proportion of highly leveraged funds largely reflects rising asset values, particularly for residential housing, which may not be sustainable.

There continues to be a lack of diversification in the investment choices of SMSFs using LRBAs (see Section 3.7). As most SMSFs using LRBAs have net asset values less than $500,000, the high purchase price of property relative to their fund balance can mean this asset class often makes up a large proportion of their portfolio and leads to high levels of asset concentration in an SMSF. Allocating a large proportion of a fund's assets into a single asset class can potentially endanger a member's retirement savings if the asset price declines. Depending on the age of the member, there may be little opportunity to recoup losses. Some of this downside risk is implicitly transferred to taxpayers who underwrite adverse outcomes in the superannuation system through the Age Pension[31] and costs may be incurred by government in the form of forgone tax revenue from superannuation tax concessions.

In recent years, low interest rates and rising house prices have made investing in property using an LRBA an attractive investment strategy for SMSFs. In May 2022, the RBA lifted the cash rate target for the first time since November 2010 to 0.35 per cent from 0.10 per cent to mitigate rising inflationary pressures in the economy. The RBA has since further increased the cash rate target which stands at 2.35 per cent as at September 2022. The increase in borrowing costs and its impact on the return to property investments may present risks to the retirement savings of many SMSFs using LRBAs. In particular, there is a risk that leveraged funds with smaller balances will sell assets to meet LRBA repayments, potentially exhausting their entire balance.

Financial advice

The Australian Financial Complaints Authority (AFCA) and ASIC remain concerned about inappropriate advice to SMSFs. An ASIC survey in 2017 found that in 40.8 per cent of cases, SMSF advice involved an explicit recommendation to use an LRBA, and another 10.0 per cent implied the use of an LRBA.[32] SMSFs advised to use an LRBA tended to have younger members and lower starting balances. ASIC identified concerns about SMSFs taking advice encouraging the concentration of investment in a single asset class (usually property) and high overall levels of gearing within funds.

ASIC has continued to act on cases of poor quality and conflicted financial advice to SMSFs, including involving LRBAs. ASIC typically focuses on breaches of an adviser's obligation to act in the best interest of the client in providing advice which may include recommending products (including SMSFs with LRBAs) which are not suitable or appropriate to the client's needs or financial circumstances.

Case study: ASIC action on conflicted remunerations to a financial advisor[33]

On 20 May 2021 ASIC advised they had commenced civil penalty proceedings in the Federal Court against a financial advice business for alleged breaches of the prohibition against conflicted remuneration and alleged failure to provide appropriate financial advice and discharge its best interests duty. It was alleged that the business paid three advisers' bonuses upon settlement of property purchases which they had recommended their clients purchase though a new or existing SMSF. On each of the 12 occasions subject to the proceedings, their advice to purchase these properties involved recommendations to establish an SMSF, purchase a property through the SMSF and borrow funds in order to do so.

[31] Financial System Inquiry – Final Report, 2014, Page 88.

[32] ASIC Report 575 SMSFs: Improving the quality of advice and member experiences, page 60, 28 June 2018.

[33] ASIC media release: 21-106MR ASIC issues civil penalty action against company formerly called Equiti Financial Services, 20 May 2021.

AFCA provides dispute resolution for complaints related to investments and financial advice for consumers and small businesses. In the 2020-21 financial year AFCA received 272 complaints related to SMSFs, a significant share of which concerned a conflict of interest in the advice given to consumers to start an SMSF to purchase a property with an LRBA.[34]

Almost all LRBA related complaints received by AFCA concerned instances of poor quality and conflicted advice provided in relation to SMSFs by groups of companies operating as property one-stop shops. Concerns about these arrangements were raised by ASIC in the 2019 report. These groups might consist of a financial advice arm that holds an Australian financial services licence (AFSL), an accounting arm, a brokering arm and a realty arm.

Property one-stop shops will most often provide a one-off service to set-up an SMSF to invest in residential property. In providing these services advisers often have a financial incentive to encourage consumers to purchase property, including by using an LRBA. This can be either directly (via a commission) or indirectly by being employed by a company within the group that would ultimately benefit from a loan being taken out or property being purchased. Frequently any advice given will be provided by a realty arm (non-AFSL) of the group to avoid regulatory oversight and AFCA's involvement. These realty arm recommendations often have all the characteristics of personal advice except for being provided by a non-AFSL and being written up in a "property strategy report" rather than in a statement of advice as required under law.

AFCA advises that complaints about property one-stop shops also involve instances of advisers failing to adequately inform consumers of risks, providing poor quality advice which could increase the risk of financial loss and not considering whether recommended financial products would be appropriate for the client's circumstances. There are instances where an advisor will purport to provide limited advice, and inappropriately limit their advice to merely setting up the SMSF. In these complaints consumers are encouraged to invest almost all of their superannuation savings in a single residential property, reducing their level of diversification and increasing the risk of loss of retirement savings.

Case study: Inappropriate advice to commence an SMSF and purchase property[35]

AFCA received a complaint brought by a couple claiming they were given inappropriate advice by a financial firm to establish an SMSF and purchase property using an LRBA. The financial firm, which is a member of a group of companies, including a realty arm, markets itself as providing comprehensive financial planning services and a range of financial products. The couple had a combined superannuation balance of just over $200,000. The advice resulted in the couple's superannuation being concentrated in a single property in addition to having significant property holdings outside of superannuation.

The financial firm argued they were merely facilitating the couple's goal of purchasing property and advice relating to setting up an SMSF was general in nature as it did not take their personal circumstances into account. The financial firm also argued they asked questions of the couple with the sole purpose of understanding their property preferences.

The AFCA panel considered the recommendations given by the financial firm were inappropriate as they increased the risk the couple would not meet their retirement goals and did not consider their willingness to take on SMSF trustee responsibilities. This risk was compounded by the unnecessary recommendation that the couple use an LRBA.

[34] Unpublished analysis provided by AFCA, 2021.

[35] AFCA Determination Case number 624981, 31 August 2021.

4.2 Risks to the superannuation system

LRBAs continue to not pose a material systemic risk to the superannuation system, being used almost exclusively by SMSFs and comprising only a small share of total SMSF assets (see Section 3.3).

As noted by the CFR in the 2019 report and the FSI, a build-up of borrowing within the superannuation system could shift the focus of superannuation away from its primary objective of providing for retirement incomes towards wealth creation. In 2020 there were 14 LRBA SMSFs with assets over $50 million. These funds held total SMSF assets of $1.7 billion of which $1.1 billion (67 per cent) were LRBA assets. Between 2013 to 2020 the size of the largest SMSF with LRBA assets had increased by more than 200 per cent from $87 million to $273 million, with the LRBA assets being 87 per cent of this value.

Evidence suggests that integrity measures introduced from July 2018 have curbed the use of LRBAs by some SMSFs to circumvent contribution caps and engage in non-arm's length lending arrangements. All LRBAs of LRBA SMSFs with assets over $50 million were established prior to 1 July 2018. While the amount of money held in the concessionally taxed environment by these high value funds has a direct cost to government due to forgone tax revenue, this risk is not limited to LRBA SMSFs but also other high value SMSFs.

4.3 Risks to financial stability

Risky and excessive borrowing in the superannuation sector could have potential flow on effects to the broader financial system. In theory, in the event of an economic shock, losses could be spread to the broader financial sector if funds defaulted on loans or banks did not have sufficient recourse to fund assets. The selling of assets to meet loan repayments could also potentially magnify fluctuations in asset prices, such as real property in which LRBAs are increasingly concentrated. The extent of these risks depends in large part on the level of SMSF borrowing and degree of exposure of financial institutions.

In the 2019 report the risks to financial stability from the use of LRBAs was assessed to be limited. With limited change in the use of LRBAs since then, the financial stability risks continue to remain low. The reduction in the proportion of LRBA SMSFs with high leverage ratios has lowered the likelihood of defaults in the event of a downturn. Furthermore, as most major banks have ceased lending to SMSFs, the risks of any losses from a widespread failure in LRBAs spreading to the broader financial sector has reduced. Lending to SMSFs by ADIs (including for LRBAs) as a proportion of total ADI lending has fallen from around 0.6 per cent to 0.3 per cent between mid-2019 and mid-2022, according to APRA data.

Non-ADI lending accounted for around 36 per cent of all lending to SMSFs in mid-2022, an increase of around 12 percentage points since late 2020, according to APRA data. RBA research indicates that the financial stability risks from this lending currently remain limited. Non-ADI debt financing represents less than 10 per cent of financial system assets and a similar share of new housing lending,[36] and given they are less integrated with other aspects of the financial system the risk of contagion from non-ADIs to the banking sector is low. Furthermore, the banking system's exposure to non-ADIs is small at around 3 per cent of total assets in 2021, having declined in recent years from a peak of just under 10 per cent in 2008.[37] APRA's reserve powers would allow it to regulate the lending activities of non-ADI lenders if their lending activities were to become large and risky enough to pose a material risk to the financial system.

SMSF investment in property could potentially exacerbate property cycles by increasing demand should investors behave in a procyclical manner. The value of assets backed by LRBAs, of which around 96 per cent

[36] Ibid.
[37] Ibid.

has been invested in real property since 2017, has grown by $18.9 billion between June 2017 and June 2021. Research by the RBA indicates that the nominal growth in LRBA investment in real property has had a modest impact on property prices in recent years, as SMSFs only make up a small share of overall housing credit. Between 2015 and 2021, SMSFs only accounted for 0.7 percentage points of the 32 per cent ($480 billion) growth in housing credit.

4.4 Continued monitoring of leverage in the superannuation system

As demonstrated by the findings of the current report and previous report in 2019, borrowing by SMSFs through LRBAs has not posed a material risk to the superannuation system or broader financial system since it was first permitted in 2007. This is notwithstanding evidence LRBAs are used in inappropriate ways by some individuals and can be a high risk to their retirement savings and, by extension, increase the risk of higher fiscal outlays through the Age Pension.

The CFR considers that continued monitoring and reporting to Government on an as needed basis would be prudent to ensuring appropriate oversight of risks relating to financial stability. Further, noting the evidence that LRBAs represent a significant risk to some individuals' retirement savings, the Government may wish to further consider current policy settings, particularly in light of the FSI's recommendation to prohibit LRBAs.

APPENDIX A – TIMELINE

Date	Details
1987	Regulation 16(1)(b) of the *Occupational Superannuation Standards Regulations 1987* prohibits borrowing in superannuation.
30 Nov 1993	**Section 67 of the SIS Act prohibits superannuation funds from borrowing money**, with certain exceptions to address short term cash flow needs.
24 Sep 2007	**LRBA exception legislated** Schedule 3 of the *Tax Laws Amendment (2007 Measures No.4) Act 2007* inserted an exception to the borrowing restrictions to allow investments of a limited recourse nature over any asset a fund would be permitted to invest in directly.
7 Dec 2014	**Financial System Inquiry 2014 Final Report released** In the final report, the FSI recommended removing '…*the exception to the general prohibition on direct borrowings for limited recourse borrowing arrangements by superannuation funds*' - Recommendation 8: Direct borrowing by superannuation funds
20 Oct 2015	**Government response to the Financial System Inquiry** In response to the FSI's recommendation, the Government stated that: • they do not agree with the recommendation to prohibit LRBAs; • there is insufficient data to justify this policy change • they will commission the Council of Financial Regulators and the ATO to monitor leverage and risk in the superannuation system and report back in 2018 (allowing time for the ATOs improved data collection on LRBAs).
9 May 2017	**2016-17 Budget announces two integrity measures for LRBAs and non-arm's length income.** • LRBAs entered into after 30 June 2017 will be treated differently. • Outstanding balance of a relevant LRBA will be included in a member's Total Superannuation Balance. • Repayments of a relevant LRBA from a member's accumulation account that result in an increase in the value of a retirement phase account will become credits for Transfer Balance Account purposes. • From 1 July 2018, non-arm's length income provisions that apply to superannuation fund earnings will be amended to consider expenses associated with a transaction.
February 2019	**The Council of Financial Regulators and the ATO provide first report to Government on leverage and risk in the superannuation** • Report finds that LRBAs do not pose a material systemic risk but could be to the detriment of some individuals' retirement savings where used in risky and inappropriate ways. • Recommends continued monitoring of LRBAs and another report to Government in three years.

Date	Details
February 2019	**Release of the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the Royal Commission)**
2021 - 2022	**Financial advice reforms implemented in response to the recommendations of the Financial Services Royal Commission** • From 1 January 2021, ending the payment of grandfathered conflicted remuneration. • From 1 July 2021, new requirements for the annual renewal of ongoing fee arrangements and a requirement for Australian Financial Services (AFS) licensees (including authorised representatives) to disclose a lack of independence. • From 1 October 2021, reference checking and information sharing requirements for financial advisers, and new requirements around how breaches are reported to ASIC and how misconduct is managed internally in firms. • From 1 January 2022, a new disciplinary system for financial advisers. In addition, the responsible Minister and ASIC have taken over the functions of the Financial Adviser Standards and Ethics Authority (FASEA). Financial advisers who provide tax (financial) advice services to retail clients are also no longer required to be registered with the Tax Practitioners Board.
December 2022	**Final report of the Quality of Advice review due to Government** • The Quality of Advice review was recommended by the Financial Services Royal Commission. • The final report of the review is due to Government by 16 December 2022.

APPENDIX B – GLOSSARY

Terminology	Definition
Fund size	Gross value of all assets held in the SMSF
Limited recourse borrowing arrangement (LRBA)	Limited recourse borrowing arrangements involve a superannuation fund taking out a loan from a third-party lender. The trustee then uses those funds to purchase a single asset to be held in a separate trust. If the loan defaults, the lender's rights are limited to the asset held in the separate trust. The lender has no recourse to other assets in the fund.
LRBA asset	Refers to the asset that is held in trust under the arrangement. When we refer to the value of LRBA assets it is the gross value of those assets.
LRBA borrowing	Refers to the amount borrowed under the arrangement. When we refer to the value of LRBA borrowings it is the value of the outstanding amount borrowed.
LRBA concentration	Proportion of assets held under LRBAs as compared to SMSF's total assets. The higher the proportion indicates a high LRBA asset concentration
Net fund size	The gross value of all assets held in the SMSF less any borrowings – this gives the net asset position of the SMSF at that time. For 2013 to 2016 net fund size has been calculated as total assets minus total borrowings, and for 2017 total assets minus borrowings from LRBAs
Phase	Refers to the payment phase of the SMSF. There are three payment phases: Accumulation – where no members are receiving pensions nor reporting exempt current pension income. Full pension – where all members are receiving a pension (including transition to retirement) and the SMSF reports exempt current pension income. Partial pension – where not all members are receiving a pension (including transition to retirement) and the SMSF reports some exempt current pension income.
SMSF LRBA population	Total number of SMSFs who are currently reporting a LRBA in the SAR
SMSF population	Total number of SMSF in an income year