Super Fund Borrowing and Liquidity

Along with other panel members of the Australian Financial System Inquiry (AFSI) chaired by David Murray, I voted enthusiastically for a recommendation to prohibit leverage in (borrowings by) superannuation funds. Unfortunately, the government, after intense lobbying primarily from the self -managed super fund (SMSF) sector, rejected that recommendation.

While I have not changed my view on this as a general principle, I disagree with views such as those expressed by David Murray that the institutional funds should not have access to liquidity support via borrowings from the RBA. They should, particularly in current circumstances where a change in government policy allowing individuals to withdraw up to $20,000, potentially creates liquidity problems for the funds. And there are reasonable arguments for making that an ongoing feature of arrangements.

I am sure that each of the AFSI panel members put different weights on the arguments as to why "no leverage in super" would be good policy. I focused on two. First, leverage can lead to SMSFs taking excessive risk, and it also enables some to 'rort' the system by getting more assets into the tax-preferred status of superannuation at the expense of the taxpayer.

The second argument is the one about financial sector stability. Leveraged financial institutions can be at risk of insolvency and exposed to runs by creditors (depositors in the case of banks). A highly levered financial system with lots of interconnectedness can face problems of fragility. Keeping super "un-levered", as is generally the case for institutional super funds, would be good for financial stability.

In this regard, it is good that the government accepted our recommendations about capital requirements to make banks "unquestionably strong". That is particularly comforting at the current time when banks are being called upon to support the economy in various ways.

But the issue with super funds at the moment is not one of insolvency. In principle at least, unlevered accumulation funds cannot go insolvent. If the value of assets falls, liabilities (amounts due to members) fall correspondingly.

Instead super funds face an issue of liquidity, where an unanticipated change in government policy means that existing liquidity management plans are blown out of the water. If forced to sell assets at poor prices to meet a resulting spike in cash withdrawals, members will suffer.

Banks generally face liquidity management problems, since they "borrow short and lend long" which could be referred to as "liquidity leverage". That transformation of short term savings into long term investments has social benefits (and private benefits for bank shareholders due to an increased interest margin), if not overdone - as it was prior to the GFC.

Liquidity regulation attempts to prevent too much "liquidity leverage", and banks have access to RBA liquidity support if liquidity problems do arise. Generally these borrowings, secured by assets handed over to the RBA, (via a repurchase agreement) are at a penalty interest rate to reduce the moral hazard of banks taking excessive liquidity risk knowing that RBA support is available.

"Liquidity leverage" is not a feature of super funds. They can invest in long term illiquid assets (such as infrastructure) because their liabilities are long-term. Yes, members can shift to other funds, change portfolio choice (eg cash rather than growth), and withdraw cash when in retirement or in some other circumstances. But these, generally, dictate that a relatively small holding of cash and liquid assets is needed.

And allocating long-term savings to long-term investments makes a lot of economic sense and can assist economic growth.

But when an unexpected policy change creates a liquidity problem for super funds, it behoves policy makers to find a solution which avoids the need for funds to generate cash by selling assets at depressed prices. Allowing super funds to borrow from the RBA using repurchase agreements would be such a solution. And since the liquidity need is a consequence of the policy change, such borrowings, at the current time, probably should not be at a penalty interest rate.

It is important to note that these borrowings are different to the type we argued against in the FSI. There, we were concerned about funds increasing the size of their portfolios by borrowing and taking on additional risks due to resulting leverage. Here, the borrowings would act to enable funds to avoid shrinking their portfolios and reducing the risks and costs which they (more precisely their members) would face.

So, I would argue that while borrowings by super funds should generally be prohibited, accessing temporary liquidity support from the RBA should not be included in that prohibition. It may be that if access to such a facility is ongoing, that access would be at penalty interest rates, and that there may be some case for liquidity regulation of super funds – but that is an issue best left for reasoned discussion in more settled times.

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