Super Fund Borrowing

A significant number of wealthy individuals have utilised the ability of Self Managed Super Funds (SMSFs) to borrow for property and other investments and supercharge the size of their funds. According to Michael Roddan (writing in the Financial Review on 22 April) the largest 100 funds had borrowings averaging around $10 million each. Given the tax benefits granted to superannuation, this exploitation of the system by the wealthy is scandalous – albeit legal.

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 (ie borrowings by) superannuation funds. Unfortunately, the coalition government, after intense lobbying primarily from the self -managed super fund (SMSF) sector, rejected that recommendation in 2015.

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.

But even unlevered super funds, such as is the case with the institutional super funds, can face problems if there is a "run" of members wishing to withdraw money. That arises because super funds, believing that there are legislated limits on when members can access funds, have invested significant amounts in longer term, illiquid assets which should provide better returns for their members.

Changing those legislated limits, such as with the current change to allow withdrawals of up to $20,000, means that the funds need to sell off assets to generate enough cash to meet withdrawals. And this is not a good time to be selling assets. Depressed sale prices mean that the value of all members' accounts will be further reduced.

Alternatively, super funds could borrow to obtain the cash needed to meet withdrawal demands. But that would expose their members to increased risk if the crisis saw asset prices fall further in the future. If they borrowed and hence were leveraged they would have to eventually have to pay back the contractual loan amount from a smaller value of assets.

But if this is purely a temporary liquidity problem, brought on by a temporary change in legislation, borrowing might not be such a bad option compared to a "forced sale" of assets.

While I have not changed my view on prohibiting borrowing as a general principle, I think current circumstances warrant a limited exception. That exception is that in situation where there is a temporary liquidity problem, brought on by government changing the rules, the institutional funds should have access to liquidity support via borrowings from the RBA. Banks have such access, why not super funds?

In this regard, I am at variance with commentators like David Murray and indeed the Reserve Bank itself. Moreover, I think there are reasonable arguments for making that an ongoing feature of arrangements.

Such liquidity access, often referred to as the RBA being a "Lender of Last Resort" is not about bailing out insolvent financial institutions. It is about providing temporary liquidity, at a price, to solvent, but illiquid institutions. And the current issue is one of illiquidity, not insolvency. In principle at least, unlevered accumulation funds cannot go insolvent. If the value of assets falls, liabilities (amounts due to members) fall correspondingly.

Banks generally face liquidity management problems, since they "borrow short and lend long". Liquidity regulation attempts to prevent too much of this "liquidity leverage", and banks have access to RBA liquidity support if liquidity problems do arise. Generally these borrowings, secured by assets temporarily handed over to the RBA, (via what is known as 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.

Oh, and there should be a severe crackdown on the ability of wealthy individuals to rort the tax benefits of super through borrowing via their SMSFs. For the government to allow such borrowings but not support institutional fund access by borrowing from the RBA to help smooth current problems seems, at best, anomalous.

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