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Leading Commercial Finance

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LRBAs remain an important debt instrument, especially for SMEs.

Limited recourse borrowing arrangements (LRBAs) are never far from the news. Fuelled by the media's seemingly insatiable appetite for stories about this borrowing instrument, regulators, politicians, government inquiries and industry funds have variously offered critiques on why they should be restricted or even banned.

ASIC was the latest to join the chorus. In a response to a recent question on notice from the Parliamentary Joint Committee on Corporations and Financial Services, ASIC flagged a need for tighter LRBA rules (such as funds requiring a minimum balance before they can borrow), and even went so far as to suggest banning them.

Before the last federal election, Labor policy was to prohibit LRBAs – a position it still holds. And the final report of the Financial Services Inquiry chaired by David Murray recommended their abolition – the one recommendation then Treasurer Scott Morrison did not embrace. And industry funds have consistently been prophets of doom on the issue of LRBAs – despite being conflicted on the issue.

But are LRBAs a time bomb waiting to go off inside SMSFs, a superannuation sector now presiding over more than $750 billion in FUM? The evidence would suggest not – and that's despite their robust growth, with ATO figures showing LRBAs made up 4% of all SMSF assets at $25.4 billion at 30 June 2016, and in the two years to 30 June 2016, jumping 68% compared with 18% for all SMSF assets.

To the contrary. There has not been any evidence that there is widespread abuse of, or deficiencies in, LRBAs. Instead, it seems the critics' focus has been on their growth (it's fast so, ergo, it must present an unreasonable risk) and, rightly, the property spruikers who prey on the vulnerable by encouraging an unsupportable SMSF and corresponding LRBA.

Any responsible lender cannot afford to be associated with spruikers. The regulators have the powers to shut them down and that is what is happening now.

Yet the critics take these isolated incidents – almost always involving residential property, so it will be most interesting to see how demand for LRBAs holds up in falling Sydney and Melbourne markets – to argue LRBAs represent a systemic threat.

Certainly, it hasn't been the Thinktank Property Finance experience. While our LRBAs are in the non-residential sector, they offer a contrary story to what the critics are saying. Since December 2013, Thinktank has financed 265 loans in this sector of the market with the loan balance currently standing at $134.9 million, an average loan size is $548,000, and the repayment type split between interest only at 21.5% and principal and Interest at 78.5%. The average loan-to-value ratio (LVR) is 63.9%.

Self-employed borrowers represent nearly 90% of the loan book, while owner-occupiers make up nearly 60%. But most importantly, none of the current loans are in arrears, and only one loan has ever defaulted which was in the wake of a cyclone (and that loan did not incur a loss).

Importantly, these numbers should not surprise. In our experience, borrowers get good advice before using an LRBA to ensure it meets both immediate commercial needs and a properly considered long-term wealth management and retirement income strategy, the loan-to-value ratios (LVRs) are conservative, and all LRBAs are in accumulation funds, not those either transitioning to retirement or in pension phase.

Quite simply, to ban LRBAs would deny many SMEs and self-employed owners the opportunity to efficiently align their commercial and superannuation ambitions. For many of them, it makes good financial sense to place their business premises in an SMSF – a tax effective solution that provides increased business certainty as well as meeting their long-term retirement income goals.

The Council of Financial Regulators is currently reviewing LRBAs, so it's to be hoped it applies itself to objectively balancing up the benefit these debt instruments offer, especially to SMEs, against the activities of a small rogue element that is already being cast out by the corporate regulator and shrill voices with less than a thorough appreciation of the topic.

Lauren Ryan- Investment Business Development Manager Thinktank