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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

SUPERANNUATION INDUSTRY (SUPERVISION) AMENDMENT BILL 2010

EXPLANATORY MEMORANDUM

(Circulated by the authority of the Minister for Financial Services, Superannuation and
Corporate Law, the Hon Chris Bowen MP)

Table of contents

| | |
|--|---|
| General outline and financial impact | 1 |
| Chapter 1 Limited recourse borrowing arrangements | 3 |

General outline and financial impact

Superannuation fund investment in certain limited recourse borrowing arrangements

Section 67 of the *Superannuation Industry (Supervision) Act 1993* (the Act) prohibits trustees of regulated superannuation funds from borrowing money or maintaining a borrowing of money subject to specific exceptions. One exception, introduced in 2007, permits superannuation fund trustees to borrow money on a limited recourse basis, provided certain conditions are met, to acquire any asset a fund is not prohibited from acquiring directly.

Since these amendments, market developments have led to practices that raise prudential concerns with the use of such limited recourse borrowing arrangements by superannuation funds.

Schedule 1 of this Bill amends the Act with the purpose of reducing the risks for superannuation funds investing in limited recourse borrowing arrangements. Schedule 1 also amends the Act to resolve uncertainty with the application of the borrowing exemption in light of concerns raised in consultations on the Bill.

Date of effect: The Bill will formally commence on the date of Royal Assent.

Proposal announced: The Bill will be announced in conjunction with its introduction to Parliament.

Financial impact: Nil

Compliance cost impact: These amendments are expected to result in a slight increase in compliance costs for the finance sector. The Office of Best Practice Regulation granted an exemption from having to provide a Regulation Impact Statement.

Chapter 1

Limited recourse borrowing arrangements

Outline of chapter

1.1 Schedule 1 of this Bill amends the Act with the purpose of reducing the risks for superannuation funds investing in limited recourse borrowing arrangements.

Context of amendments

1.2 The Act prohibits superannuation fund trustees from borrowing money, subject to limited exceptions, to minimise the risk of loss to fund assets as a result of a default on the loan. One of these exceptions permits superannuation funds to borrow on a limited recourse basis for investment purposes provided certain conditions are met. This is typically done through a limited recourse borrowing arrangement analogous to an instalment warrant.

1.3 An instalment warrant is a form of limited recourse borrowing that allows an investor to purchase an asset (typically shares) by means of one or more instalments. The asset is held on trust to provide limited security for the outstanding loan, but the benefits of ownership (such as dividends or rent) flow to the investor. If the investor defaults on the loan the rights of the lender are limited to the asset which is the subject of the warrant and the investor's loss is limited to the loss of the beneficial interest in the asset and the instalment payments made prior to the default.

1.4 Developments in the superannuation borrowing market have led to products and practices which raise prudential concerns for superannuation funds. These include:

- the use of personal guarantees to underwrite the lender's risk in the borrowing arrangement;
- borrowing arrangements over multiple assets which can potentially allow the lender to choose which assets are sold in the event of a default on the loan; and

- arrangements where the asset subject to the borrowing can be replaced at the discretion of the trustee or the lender.

Summary of new law

1.5 Schedule 1 of this Bill amends the Act to make sure that superannuation fund assets are protected in the event of a default on a limited recourse borrowing arrangement by ensuring that:

- the recourse of the lender and of any other person against the superannuation fund trustee for default on the borrowing is limited to rights relating to the acquirable asset;
- the asset within the arrangement can only be replaced in prescribed circumstances that arise from owning the original asset; and
- the borrowing is referable and identifiable only over a single asset (excluding money) or in prescribed circumstances, a collection of assets which are identical and are treated as a single asset.

Comparison of key features of new law and current law

| <i>New law</i> | <i>Current law</i> |
|--|---|
| Explicitly defines the interpretation of acquirable asset in the singular. | While the Act refers to 'asset' in the singular, it is possible to interpret asset in the plural. |
| Ensures that the recourse of the lender or of any other person against the superannuation fund trustee for default on the borrowing is limited to rights relating to the acquirable asset. | The Act limits the rights over the original asset in terms of the direct lender and associated borrowing only. |
| Limits borrowing arrangements to a single asset or a collection of identical assets together treated as a single asset. | Allows borrowing arrangements over multiple assets which may permit the lender to choose which assets are sold in the event of a default on the loan. |
| Clearly defines circumstances under which assets can be replaced. | Allows arrangements where the asset subject to the borrowing can be replaced at the discretion of the trustee or the lender. |

Detailed explanation of new law

The definition of ‘asset’

1.6 In allowing limited forms of borrowing, the Act refers to ‘asset’ in the singular. However, section 23 of the *Acts Interpretation Act 1901* provides that, subject to a contrary intention appearing, the singular includes the plural.

1.7 Some limited recourse borrowing arrangements targeted towards superannuation funds have been designed on the basis that ‘asset’ should be interpreted as including the plural.

1.8 Borrowing arrangements over multiple differentiated assets could expose superannuation funds to greater risk than if a trustee took out a number of discrete loans, each relating to, and only enforceable against, a single asset (or a group of identical assets treated collectively as a single asset).

1.9 Item 1 of the Bill inserts the definition of ‘acquirable asset’ into section 10(1) of the Act as the meaning given by section 67A, inserted by item 8.

1.10 The term ‘asset’ should now be read in the singular, so that it is not interpreted as permitting borrowing arrangements over multiple non-identical assets. However, the definition permits borrowing arrangements over a collection of assets that are identical and have the same market value.

1.11 Reflecting the policy intent to prohibit borrowing arrangements over multiple assets that can potentially allow the provider to choose which assets are sold in the event of a default on the loan, examples of a collection that can be treated as a single ‘acquirable asset’ include:

- a collection of shares of the same type in a single company;
for example, a collection of ordinary shares in X Ltd.
- a collection of units in a unit trust that have the same fixed rights attached to them;
- a collection of economically equal and identical commodities.

for example, a collection of gold bars, irrespective of whether they might, for example, have different serial numbers.

1.12 Examples of collections that would not be permissible include:

- a collection of shares in a single company that have different rights;

for example, ordinary and preference shares.
- a collection of units in a unit trust of different classes that have different rights attached to them or are potentially subject to differing trustee discretion;
- a collection of shares in different entities; and
- a collection of buildings each under separate strata title, irrespective of whether the buildings are substantially the same at the time of acquisition.

Note: A collection of such assets would rarely have the same market value over time.

1.13 To ensure that an acquirable asset for the purposes of this subsection is always interpreted in the singular, the words ‘collection’ and ‘identical’ should be interpreted as ensuring that an acquirable asset is one or more things that within the arrangement are seen and treated as a whole.

for example, a collection of shares must be acquired and disposed of as a collection and could not, for example, be sold down over time.

1.14 In the case of the purchase of real property for example, a single title for land and the accompanying house on it would be considered a single acquirable asset, but additional items such as furnishings would not be allowed to be purchased through the same limited recourse borrowing arrangement. Furnishings (or ‘non-fixtures’ of the property) can be acquired through separate limited recourse borrowing arrangements over a single acquirable asset or bought outright (but not held as security under the borrowing arrangement over the property).

1.15 As a further example to guide the interpretation of ‘acquirable asset’ in relation to real property, it is not the intention of this provision to prevent the acquisition of leased property. For the purposes of section 67A, the lease itself should not be considered as a separate asset as long as it is dealt with together with the property under the arrangement (and therefore does not need to satisfy the requirements of subsection 67A(3)).

1.16 The definition of acquirable asset excludes limited recourse borrowing arrangements that involve money as an asset (that is Australian

currency or currency from any other country). This addresses concerns with limited recourse borrowing arrangements over multiple assets that are traded for money and managed in a similar fashion to margin accounts.

Acquisition, refinancing and expenses related to the asset

1.17 For the purposes of paragraph 67A(1)(a) (inserted in item 8), an acquirable asset is ‘acquired’ at the time when the trustee of the holding trust (security trustee) gains a legal interest in the asset. At the same time, the regulated superannuation fund (RSF) trustee gains a beneficial interest in the asset as required by paragraph 67A(1)(b). The ‘beneficial interest’ arises on creation of the security trust over the acquirable asset. The RSF trustee has a right to acquire the legal interest upon repayment of the loan.

1.18 Item 8 inserts subparagraph 67A(1)(a)(ii) to clarify that the trustee can refinance an existing limited recourse borrowing. Refinancing may allow the RSF trustee to minimise the risk of default on a borrowing resulting from a temporary inability to make a repayment (for example, the fund is facing solvency issues due to benefit payment obligations).

1.19 Associated expenses in acquiring the underlying asset can be included as part of the borrowing. Item 8 inserts subparagraph 67A(1)(a)(i) to allow expenses that are considered to be intrinsically linked to the purchase of the acquirable asset. The examples provided in the subparagraph are specifically allowed as part of the borrowing arrangement.

1.20 The reference to ‘any other laws’ in subsection 67A(2) (inserted in item 8) captures all applicable laws, including the various Trustee Acts of the state and territory governments.

Replacement assets

1.21 In prescribing the terms to which a borrowing arrangement must adhere, paragraph 67(4A)(b) of the Act provides that the borrowing must be used or maintained to acquire ‘the original asset, or another asset (the replacement)’.

1.22 The broadness of the existing definition creates uncertainty over what constitutes the replacement asset and this uncertainty gives rise to arrangements that could place fund assets at risk.

1.23 For example, a lender may require a trustee to replace an asset within an arrangement if its value falls below a certain level, with an asset of greater value than the outstanding loan.

1.24 Consistent with the original policy intention and to provide greater clarity regarding eligible replacement assets, item 8 inserts section 67B into the Act to list specific circumstances permitting a replacement asset. Those listed are the only circumstances where replacement assets will be allowed.

1.25 To avoid any confusion with the circumstances listed, guidance regarding the use of ‘company’ and ‘instalment receipt’ for the purposes of this subsection follows.

1.26 ‘Company’ is to be interpreted as having its commonly understood and used definition. The use of ‘company’ in this subsection is for the sole purpose of allowing ‘shares’ as they are commonly understood, and is not intended to limit investment choice. To be clear, borrowing arrangements for, and subsequent replacement of, shares in foreign companies are permitted, so long as they meet the requirements of the amended legislation.

1.27 Item 3 amends subsection 10(1) of the Act to define ‘instalment receipt’. As is commonly understood, an instalment receipt is a product that does not ordinarily involve a borrowing; rather, it is the purchase of another asset by instalments. When ‘instalment receipt’ is specifically referred to in the context of replacement assets, it means a limited recourse borrowing arrangement over an ‘instalment receipt’ as the acquirable asset. This is not to be confused with a superannuation fund using an instalment receipt to purchase an asset in the absence of a borrowing, which is not relevant to the borrowing exemption.

1.28 The amended legislation provides for the regulations to prescribe additional circumstances permitting a replacement asset.

1.29 Examples of circumstances not permitting a replacement asset include:

- securities liquidated or traded or both for different assets only as a consequence of implementing an investment strategy;
- money or cash is not eligible as a replacement asset under any circumstances;
 - includes circumstances where the original asset would otherwise be replaced with an eligible replacement asset plus cash for example shares in X Ltd replaced by shares

in Y Ltd and a pool of cash as a result of a takeover of X Ltd by Y Ltd;

- replacement asset arising from an insurance claim covering the loss to the original asset;
- the replacement by way of improvement of real property;
- a series of titles over land replacing a single title over land that has been subdivided; and
- a replacement of a title over real property as a result of Government action such as the resumption of all or part of a property or re-zoning.

1.30 Item 8 inserts subsection 67B(2) to ensure that the requirements pertaining to the original asset also apply to eligible replacement assets.

1.31 Item 8 inserts subparagraph 67A(1)(a)(i) to clarify that money under a limited recourse borrowing arrangement applied for the acquisition of an asset can be used for expenses incurred in maintaining or repairing the asset, to ensure that its functional value is not diminished, but not to improve the asset, as this would fundamentally change the nature of the asset used as security by the lender, potentially increasing the risk to the fund.

1.32 The terms ‘maintain’, ‘repair’ and ‘improve’ have their ordinary meanings.

1.33 While subparagraph 67A(1)(a)(i) will have limited practical application to assets other than physical or real property in respect of maintenance and repairs, it applies to all eligible acquirable assets.

1.34 Item 8 inserts subsection 67A(4) to allow regulations to further specify circumstances in which an acquirable asset ceases to be one, to deal with specific situations where an alteration to an asset may result in it ceasing to be the original acquirable asset .

Protection of fund assets against guarantees and related borrowings

1.35 Several providers of limited recourse borrowing arrangements are requiring trustees, or third parties such as fund members, to provide guarantees of the borrowing to underwrite the provider’s risk from the limited recourse nature of an instalment warrant arrangement.

1.36 The Act does not prevent a lender exercising rights under a guarantee given by a third party since the lender’s rights under such

guarantees are not rights against the trustee of the fund. Accordingly, the lender has rights against the guarantor's assets if there is a default on the borrowing. The guarantor subsequently has a common law right to recover losses (which may exceed the value of the asset which was the subject of the borrowing) from the principal debtor — the trustee — and the trustee may then arguably seek indemnity out of the fund's assets.

1.37 It is also unclear, where a guarantee is given by a trustee in its personal capacity, whether a lender's entitlement to recourse against the trustee's personal assets may lead to the trustee claiming indemnity out of the fund's assets.

1.38 Item 8 inserts paragraph 67A(1)(b) to maintain the requirement that the acquirable asset must be held in trust. The trust structure is a feature of traditional instalment warrants and helps to quarantine the other assets of the superannuation fund from the investment risk that the limited recourse borrowing arrangement represents.

1.39 Item 8 also inserts paragraphs, 67A(1)(d), (e) and (f), which seek to protect fund assets from such claims by limiting the rights of the lender or any other person against the RSF trustee, for or in connection with or as a result (direct or indirect) of a default on a borrowing or charges related to the borrowing, to rights relating to the acquirable asset. In this way, a guarantor's rights against the RSF trustee are limited as the rights of the lender are limited, so that no claim against the RSF trustee should arise which could give rise to a claim for indemnity from fund assets. That is, a charge may be given over an asset that is acquired through a borrowing arrangement in order to secure that borrowing, but no other charge is permitted.

1.40 Paragraph 67A(1)(d) will ensure that the rights of the lender or any other person against the RSF trustee are limited to rights relating to the acquirable asset. No guarantee arrangement can be enforceable against the RSF trustee other than the rights relating to the acquirable asset.

1.41 Paragraph 67A(1)(f) will ensure that the acquirable asset cannot be subject to any other charge than that associated with the direct borrowing arrangement.

1.42 With the exception of the asset that is the subject of the borrowing arrangement, the assets of the superannuation fund cannot be given as security for a borrowing without breaching regulation 13.14 of the *Superannuation Industry (Supervision) Regulations 1994*.

1.43 This Bill does not explicitly refer to guarantees given the variety of ways that collateral agreements might be used to circumvent the limited recourse nature of the arrangement.

RSF trustee breach of duty

1.44 Item 8 inserts subsections 67A(5) and 67A(6) to ensure that the amendments of the Bill do not inadvertently prohibit members and co-trustees from being able to claim damages against a trustee that makes a decision to acquire an asset under a limited recourse borrowing arrangement in breach of its obligations as trustee, noting that the trustee in this situation is prevented from seeking any indemnity against fund assets by sections 56 and 57 of the Act.

Other amendments

1.45 Items 2, 4, 5, 6, 9, 10, 11, 12 and 13 make consequential amendments to related sections of the Act and item 7 formally repeals the existing borrowing exemption for instalment warrants.

Application provision

1.46 The amendments all commence on the day after the Bill receives the Royal Assent.

1.47 Item 14 inserts an application provision, which states that this Bill, and therefore the revised Act, will apply to all limited recourse borrowing arrangements entered into on or after the commencement date.

1.48 To avoid any reduction in the value of the 'property' owned under limited recourse borrowing arrangements entered into prior to the day after the Bill receives the Royal Assent, the Bill will not apply retrospectively to existing arrangements.

1.49 As noted in the application provision, an arrangement that is a refinancing of a borrowing of money under an arrangement entered into before, on or after that commencement, will be subject to the amended legislation.

1.50 A re-negotiation of a borrowing with the same lender that is simply a variation of a loan contract that continues to exist will not be subject to the Bill. However, where the re-negotiation amounts to a rescission or replacement of the original contract this is to be regarded as a refinancing and the application provision and therefore the amended legislation will apply to the arrangement.

1.51 Refinancing is not the only way that a new arrangement may arise to which the application provision applies. For example, a change to the terms and conditions of an arrangement that fundamentally alters the character of the arrangement may result in a new arrangement to which the application provision applies.