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Manager
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The Treasury
Langton Crescent
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7 March 2010

Dear Sir/Madam**,**

Submission (in confidence) on Exposure Draft – Corporations Amendment Regulations 2012 – Limited Recourse Borrowings by Superannuation Funds (Instalment Warrants)

Prelude

As a Chartered Accountant with over 15 years of commercial lending experience, my practice specialises in corporate finance advisory services. I have a sound understanding of the key drivers of business credit and have witnessed significant changes in regulation of the financial market, which has left many borrowers confused when trying to seek advice.

I agree that the distribution of Limited Recourse Borrowings by Superannuation Funds does require more stringent controls than currently exists in the market, having witnessed poor distribution that has resulted in unnecessary costs to consumers, inappropriate structures and a lack of knowledge about SMSF requirements in terms of the SIS Act and the future cash flows of the fund by distributors of these products.

I also believe that this area is one of the most difficult and challenging areas to regulate due to the transaction complexities and breadth of experience required to ensure protection of consumers. As a company who has helped many disaffected clients, I personally welcome regulatory input. Having said that, I strongly believe that there is a better way to ensure the required outcomes are achieved. In my view, the proposed method of improving distribution as set out in the Exposure Draft will not achieve the desired outcome of regulators and will not adequately support access to product knowledge for SMSF trustees.

My suggestion for regulators that should achieve the desired outcome

Drawing on my experiences since the introduction of these products, the only way to effectively manage the distribution of these complex products is:

1. Distribution should be via authorised credit licences and representatives who hold either:
    a. Both a Australian Credit Licence **and** a either a full or limited representative status of AFSL (subject to completion of PS 146 and suitable SMSF training offered by RTO or industry body such as SPAA, Financial Planning Association of Australia or ICAA SMSF Specialisation) OR
    b. An Australian Credit Licence **and** newly created "SMSF Gearing accreditation" provided by RTO or appropriate industry body (i.e.; SPAA, FPA, ICAA). Training for the accreditation should adequately cover:
        i. The roles and responsibilities of SMSF Trustees
        ii. A thorough understanding of the requirements of S67 of the SIS Act.
        iii. The various SIS Act limitations and how they apply to SMSF Limited Borrowing Recourse Arrangements.
        iv. Understanding the process and timeframe required for a SMSF Limited Recourse Borrowing Transaction and the specific lending parameters.
        v. Understanding property market risk and cyclicality.
        vi. Understanding the responsibilities and accountabilities of the various advisors working on the transaction.
        vii. Understanding the future cash flow needs of the SMSF including future pensions and limitations around contributions.
        viii. Understanding the importance of the future objectives of clients in relation to the underlying property.
        ix. Credit risk assessment and understanding debt servicing requirements and various lending parameters and policies especially in relation to the commercial property market.
        x. Ensuring the accreditation is only provided to applicants who have sufficient lender accreditations to major lender products across the commercial and residential lending market.
2. Credit Licence holders require separate ASIC Licence scope/category to extend scope to distribution of SMSF Gearing product and distribution of SMSF Gearing advice services (encompassing any form of lending where funds borrowed will be used for SMSF purposes) and this licence condition be subject to meeting the above skills/training requirements.
3. Credit Licencees/Representatives holding the SMSF Gearing credit advice licence extension should hold accreditations with a broad cross-section of lenders given the differences in the products and policies. Examples of differences include – inability to take a fixed rate without a premium being applied compared to other lenders, structure differences in terms of requirements for trustees, pricing differences, debt structure differences (especially maximum interest only and loan term) – consumers need to understand their options in this regard.
4. In my view, the following should be mandatory for all product distribution in Australia:
    a. Make it mandatory for lenders to receive and review a Statement of Advice prepared by an AFSL holder or representative prior to formal approval. Some lenders require this, others just make clients sign documents that exempt the lender from the responsibility of ensuring the fund retains complies with the SIS Act.

b. Make it mandatory for lenders and distributors of their product to provide borrowers, at first meeting, a Product Information Disclosure Document outlining:
   i. The things to consider before entering a contract to purchase a property in a SMSF
   ii. The role of the various advisers/licence holders during the transaction and the need for them to work together.
   iii. The process and timeframes expected for the transaction.
   iv. How the product differs from a normal loan and important parameters around the lender's products and policies including factors impacting the minimum and maximum loan term, length and availability of interest only periods, acceptable income for debt servicing assessment, ongoing lending covenants, events of default, conditions precedent and other loan pre-requisites such as minimum SMSF net assets, etc.
   v. The prerequisite need for a Statement of Advice from an AFSL licencee or representative confirming the transaction is in line with the fund's investment strategy and commentary around future cash flow considerations of the fund.

c. How the product differs from a normal loan and the need for independent financial and legal advice.

5. Suggest a transition period to enable sufficient time for market participants to achieve the educational requirements.
6. ATO to consider a further Publication for SMSF Trustees to understand these products.

One of the key problems that I have witnessed in the marketplace is the fact that the various advisers to the transaction do not work closely together to ensure a smooth and seamless process for the client and clients don't know what the process involves and cannot effectively manage it. Clients often misinterpret advice from one adviser when informing another advisor. I believe the reason advisors rarely work closely on the transaction is fear of osmosis (re poor advice) and/or fear of loss of client or loss of face if skill set of adviser is deficient.

The ATO Publications for self managed superannuation funds are very useful. Perhaps there should be one specifically for these leveraged transactions, which helps clients understand the typical transaction process to help educate SMSF Trustees understand how to avoid the pitfalls and unnecessary costs.

From experience, the attached suggested process we employ has worked very well for clients, and we encourage our clients to organise meetings of all advisers together in the one room so that there is no miscommunication and each adviser can ask questions of the other (e.g.: Financial planner may wish to understand current loan interest rates and gain an understanding of likely loan term in order to complete the Statement of Advice): The attached process details how the current existing regulatory framework (i.e.; defining the roles of AFS Licencees and Australian Credit Licencees and the associated laws) fit together.

In my view, regulators should be focused on ensuring all stakeholders understand the appropriate process and ensuring there is a minimum standard for distribution of the product as outlined above.

Why the Proposed Exposure Draft will not achieve the intended outcomes

Having been involved with many clients seeking SMSF Limited Recourse Borrowings, and having dealt with many allied advisors to SMSF's, my concern is that the proposed regulation:

1. Was proposed before Australian Credit Licencing come into being (June 2010). It does not take into account the need to consider the provisions of the NCCP Act and the application of this change to the requirements of the NCCP Act.
2. It does not take into account that the policies and products on offer for SMSF Limited Recourse Borrowings differ substantially from lender to lender and a separate proper assessment of credit risk by Credit Licencees is a required part of the process.
3. Most AFSL holders do not hold an Australian Credit Licence. Providing a credit service is broadly defined in the NCCP. Additionally Australian Credit Licencees who deal with any party who should be licensed but are not will be in breach themselves. How can an AFSL holder who does not hold an Australian Credit Licence provide advice to a borrower on which product, given the differences in these products, without breaching the NCCP Act?
4. Credit Licencees are not to accept transactions from unlicenced parties unless they have met the strict Referrer guidelines within the NCCP framework – doing so contravenes NCCP and represents a breach by the Licencee.
5. The proposed framework will further confuse the public who are trying to work out which advisers are licenced for what and who they need to approach to seek advice in a particular area
6. Promotes the potential for creating conflict of interest situations (one person will have the opportunity to financially benefit from both sides of the transaction (providing both debt and investment advice).
7. Does not adequately look into the skill sets of financial planners to undertake complex commercial debt transactions in a market that has become more fickle and challenging.
8. The proposed regulatory response does not take into account that these transactions cover two different sectors of credit market distribution (consumer banking and commercial/business banking) and each have differing skill set requirements. It does not adequately assess the required skills, networks and systems to successfully negotiate and complete complex debt transactions that have complex transaction management processes and require a deep understanding of debt markets to ensure timely settlement within contract terms.
9. It does not take into account that credit transactions in the SMSF environment continue to be done outside of the Limited Recourse Borrowing arrangements – either with individuals borrowing in their own names with cash contributions or member loans to the super fund then funding the underlying property, or under grandfathered unit trust arrangements.
10. SMSF Trustees have a poor understanding of the product and the impact of the SIS Act. Better education is required.

The access to credit has significantly tightened post GFC, especially in the commercial property sector. Lending for commercial properties has become a complex advice area as lenders reshuffle their exposures and seek to mitigate credit risk that has resulted from the GFC that is outside the lenders new policies or preferred lending parameters.

It is widely recognised by the lending community in Australia that distribution of lending products for commercial property, whether inside or outside of superannuation is a more complex and risky debt transaction. The lending parameters for commercial property loans differ significantly to residential loans and anyone providing advice in this area needs a thorough understanding of the commercial property lending parameters, commercial property risk fundamentals and what constitutes “specialised commercial property”.

Additionally, most commercial property SMSF transactions involve self employed members who quite often have complex structures that need to be fully assessed across all entities to fully understand serviceability of the SMSF Loan (the super fund contributions and rent that usually fund the SMSF loan require year on year servicing analysis across all business entities to ensure the continued ability to contribute and pay rent to the super fund). In my view, Financial Planners (who hold the required AFSL should these products be deemed a ‘financial product’ do not have the required training to understand this. Nor do they have exposure and knowledge of lender appetites following the GFC and the mergers that took place since that continue to impact appetite for commercial property transactions.

For this reason, regulators need to take into consideration the intended further regulation of business credit proposed under NCCP and the recent Green Paper and industry feedback that have been gathered. Debt pricing models and products for commercial property lending differs substantially to consumer lending products, which are more commoditised. In the marketplace, many lenders restrict access to commercial property and business loans to those with the necessary experience in business lending.

In my response to the Green Paper on regulation of business credit, I outlined key differences between consumer credit and business/commercial property credit, which it is pertinent to reiterate here, especially given that SMSF Limited Recourse Borrowing for commercial property is likely to involve a ‘whole of business’ risk and servicing analysis. I have reattached relevant parts of my Green Paper Response submission below:

Relevant responses to specific questions posed within the Green Paper

Question 1: Are there any differences in how small business borrowers use credit compared to individuals? If so, what are they? Please provide reasons for these differences.

Key Difference	***Consumer/Individuals***	***Business***
Character	For consumer debt, assessment is usually assessed on: • Credit reference report • Conduct evidenced by past bank statements • Credit card behaviours	Analysis of character for business debt extends beyond consumer analysis to include but not limited to: • ATO running balance reports • Business entity searches and credit checks • Business transaction account analysis • Business loan repayment conduct • Wealth relative to years in business – signs of success • Position in market/market share • Assessment of management capability and experience • Assessment of borrower understanding of their industry and view of industry outlook

		consistent with bank • Assessment of level of organisation and efficiency
Capacity/ Income	For most consumers, income is pretty consistent and reliable from year to year – majority being PAYG income. Where this is not the case, then lender will generally average the income over the past 2 – 3 years. Any major discrepancies from year to year will increase the risk to the lender, making access to finance difficult for consumers with inconsistent income histories (especially where there are not favourable explanations). There are far less risks potentially impacting the sustainability of consumer income. The size of the consumer market and the structure of it being majority "pay in" " loan payment straight out" means that lenders are able to take a more commoditised approach to their assessment of consumer capacity, putting very little focus on risks of loss of income. Also the market critical mass means that insurance for loss of income is available and affordable.	For business lending, income varies significantly from year to year and timely and reliable financial information is rarely available. Additional complexities for the assessment of business credit include: • Complex business models and structures usually mean the lender may need to work their way through a web of financial statements to determine the true net income available to service the debt. This is common across all sizes and maturities of businesses – and emanates from businesses mitigating indirect taxes, allowing for differing ownership or asset protection, etc. • A profitable business may still struggle to meet debt repayments where working capital needs impact cash flow or new competitors move in or large clients are lost or products are damaged or key staff leave, etc. Ability to repay debt from business income can be very easily impacted overnight by so many different factors. Lenders do not go to this level of detail in consumer transactions. • Availability of insurance to mitigate risks against loss of business income are far less affordable and in many cases are either not available or uncommercial.
Collateral/Security	Key security is real property or vehicle for consumer lease.	Security structures vary significantly depending on the business, the industry, the borrower's history and success, etc. Complex business structures further complicate security arrangements. All lenders generally require guarantors to seek

		independent legal and financial advice. Most lenders prefer to decline business where there is significant reliance on any guarantor who is unlikely to benefit from the transaction (i.e.: where they are not a shareholder or beneficiary of the business).
Cash flow	Most consumer lending is based on PAYG income where actual cash inflow follows a set formula.	Business profits may not be available to service debt. Further significant analysis may be required of flow of funds through entities and requirements of past and future working capital impact.
Capital	All lenders are comfortable lending up to 80% of residential property values, providing the borrowers debt servicing and credit scoring meets the lenders guidelines. A lender can actually extend up to 95% of residential property values using Lenders Mortgage Insurance to “outsource’ the additional risk. Rarely do lenders extend beyond 95% of the residential property value.	Many small businesses are funded with most capital coming from equity accumulated in borrower’s property assets. Cash flow lending against business assets has significantly reduced post GFC, with one major bank even quitting the market. Many lenders extend up to and beyond 100% of the property value (with the property security providing comfort to the lender that the borrower is fully committed to their business and its ability to succeed. This applies regardless of the size or age of the business. Sometimes there can be a mix of commercial and residential properties.
Debt pricing	Commoditised. Interest Rates are generally published and differences between lenders rarely exceed 0.5%pa. Upfront costs rarely exceed $600.inclusive of property valuation cost.	For business borrowers, pricing is a function of the underlying transaction and business risk. Where the business loans are considered to be fully secured by lenders (up to 80% LVR against ‘standard’ residential properties and 65-70% LVR against non-specialised commercial properties), lenders do not generally charge a risk margin and pricing is rarely more than 1% above consumer interest rates. For business lending that is partially or fully unsecured, the interest rate consists of a base rate plus a margin for underlying business risk. Lender pricing models often require manual input of financial statements, and feedback on up to 20 different risks

		before integrating with borrower conduct history and external credit checks to provide a pricing risk rating that determines the margin to be applied. Upfront costs are far greater for business lending due to the amount of analysis that needs to be done for credit decisioning. Lenders usually charge between 0.5-1% of loan amounts as an application fee. Commercial property valuation fees, Search fees across all entities, legal fees to review important documents that the lender is relying on such as trust deeds, customer contracts, lease agreements, franchise agreements etc are further costs for borrowers that may not be known until late in the process.
Underlying lender risk	Known and predictable. Lenders second exit (security for loan) is more readily saleable.	Complex and potentially unpredictable. Lenders second exit may be complex and elongated process.
Lenders Mortgage Insurance	Available to protect lenders whenever they extend credit beyond 80% of residential property market values. Post GFC, insurers have become much tougher in their approval processes. This cost varies based on the underlying loan value ratio, location of the property, size of loan and borrowers history.	No lenders mortgage insurance available for business and commercial property credit.
Borrower Legal structure	Borrowers and guarantors are usually individuals or family trusts. Usually relatively simple structures.	The mix of borrowing entities and guarantors can vary significantly – properties are usually held by individuals or family discretionary trusts for CGT and asset protection reasons. Trading entities are usually companies so that owners can benefit from limited liability to unsecured creditors. Often more complex structures regardless of borrower size.
Products	All relatively similar products, process efficiencies and service levels vary	Diverse range of products Complexity of products Assumptions regarding business owners knowledge across range of products and how they work (eg:

		invoice finance, commercial bills, trade finance, etc)
Loan preconditions	Usually just related to contracts for the purchase/sale of property or build of property. Timing and Certainty is more reliable	Vast and varying Can require significant industry knowledge (industry specializations across business banking) Can be significant, complex, uncertain and longwinded.
Loan covenants and conditions	N/A	It is usual for banks to seek: • Updated financial information in set timeframes • Updated commercial property valuations (some now 12 mths) • Financial covenants – typically debt and/or interest cover (affordability), NTA backing and or Debt/equity (leverage), GPM/NPM (profitability), current ratios (liquidity).Breaches are usually events of default. These are communication tools for banks to communicate key reliance they place on business risk areas they see as critical to their comfort with the underlying credit given the changing nature of businesses and their performance.
Lender systems and processes	Processes are standardised and commoditised. Most credit decisioning is done using automated systems, which will either approve, decline or refer consumer loan applications after doing a credit enquiry on the proposed borrowers and guarantors. The process usually takes around 2-10 working days depending on lender volumes, and sometimes distribution channel used by the borrower. Capacity to repay calculators provide certainty of process.	No capacity to repay calculators exist. Bank guidelines are not reliable and are not universally applied. Processes are more manual and (skilled) labour intensive involving significant analysis. Lenders can take several months to assess a transaction and information required can vary significantly. Over this period of time, the transaction and borrower needs can often change (moving of goalposts) and information sought by lenders to finalise approvals may take several months to obtain (eg: selection of site, signing of leases, etc). Often assumptions about sites, property values, transaction costs, etc are made to avoid costs until lenders provide indicative approvals. The steps in the lending process between the lender and the borrower can have many hurdles to pass to finalise the credit

		decision. Business credit submissions prepared by lenders 'behind the scenes' usually take 10-50 pages to explain the business proposition and key risk analysis for the lenders credit decisioning areas. Historical trend analysis is done, sensitivities are prepared, lender databases are checked to benchmark business performance and provide industry outlook assumptions. Borrowers are interviewed to cover risk areas including industry outlook, management performance, concentration risks, political and regulatory risk, seasonality, cyclicality, security of tenure, supplier power and dependence, competition, etc. Very little automation. Time consuming and intensive process extends to the vast majority of businesses – small or large, start up or mature. When a lender suffers a loss, they have a tendency to change their policies for the whole industry overnight. Many business owners like to split their banking to reduce their reliance on one key lender. While there has been some scope to do this in the past, recent events have seen many lenders more forcefully demand full share of wallet (business lending, transactional business and consumer products) as part of their lending approvals.
Credit decisioning	Majority would be system approved. Referred decisions usually only take one level of decisioning.	Very little system generated approvals. Credit decisioning may be done at up to 4 levels, each can take a week to look at it. For example, a large borrowing exposure (lenders now have to separately report exposures above $10m) in a higher risk industry with a specialist product type (depending on the size of the lender) may require decisioning by: • (Recommendation by) line banker • Local product specialist • Local industry specialist

		• Local credit manager • Head office credit manager The size of the lenders balance sheet can be relevant too – a $10m client exposure for a Big 4 bank may have local sign-off, whereas for a smaller bank, it is likely to need board sign off. As such, I have seen even small companies with less than 20 staff outgrow their lenders, especially if they are in a capital intensive industry.
Credit complexity	Stable/predicable income available to cover debt. Usually just deals with 2 individuals. Risks well understood and limited. Limited third party interaction in transaction. Streamlined simple and low cost valuation processes. Public data available to assess valuation impact.	Non-stable/predicable funds available to cover debt. Business structures can be complex regardless of business size/maturity. Risks vary substantially and change over time. Significant third party interaction in transaction. Valuation processes costly, hence often left until late in process unless significant time pressures – and then trying to ensure one is engaged that is acceptable to lenders approached can be challenging. Very little public data to assess commercial property impact.
Competing goals of borrowers/their advisors and lenders	Structured products and security	Many borrowers and their advisers seek to mitigate risk by separating business lending exposures among different entities/lenders etc and also many seek to achieve "asset protection" and "tax minimization" strategies. Additionally, there can be transactions involving non-related parties, who wish to borrow some funds against their personal wealth to tip into business joint ventures – but due to differing personal circumstances they do not want a joint and several security structure. Proposals to legislate could have significant adverse ramifications to consumers in this area.

Question 4: What are the main differences and similarities between lending and providing credit service assistance to small business borrowers?.

Refer response to Question 1 above.

Question 7: What are the main differences and similarities between lending and providing credit service assistance to small business borrowers?.

Refer commentary to Question 1.

Question 10: Do small business borrowers use other sources of advice and/or assistance not identified in relation to credit contracts?
Question 11: What is the nature of this advice?

By their very nature, most business owners are entrepreneurs and tend to take others advice at face value, but trust and act on their own judgement. This is significantly different to a consumer seeking credit, with the average consumer relying on the bank to determine whether they can afford their repayments.

Business borrowers generally only seek assistance or advice in the following circumstances:

- When they are in financial difficulty and the bank is making demands
- When they seek support with their negotiations with their lenders
- When they have complex situations and feel they need to learn more prior to acting.
- When they have experienced difficulty getting their finance needs approved or achieving the terms and conditions that they believe they should have access to.
- When they believe they can achieve a better solution than they have been offered.
- When they have been asked to provide the bank with business plans and/or rolling 3 way forecasts.

The impact of changing banks is far greater for business borrowers, given the complexity of their transactional needs and online banking systems. Bank account numbers and direct payments are usually set up to go to their account, meaning a massive amount of administration to inform customers and suppliers is involved in changing banks. For this reason, there is much less churning or changes compared to the consumer market.

The business banking market and appetites of the lenders is changing constantly. People outside the industry struggle to fully comprehend the complexity of it.

Many business owners do not know where to go to get good strategic advice on their capital structure and improving their business performance. Government grant programs that have helped advisers establish business health checklists are helping to change this. Accountants are realising they need to break away from being compliance driven. There are very few advisors that understand accounting, management consulting (both in terms of technical knowledge and execution of strategy) together with understanding cash flow drivers and banking industry drivers.

When business owners are requested to provide forecasts to the bank, most are of poor quality, lack assumptions and sensitivities (even when sourced from qualified accountants), are rarely updated to become “rolling forecasts” and are of limited use to the business owner. Unfortunately, the majority of business owners do not see effective forecasting models as a valuable management tool, and this is an area that needs further education of both business borrowers and advisers in general.

I am happy to share examples of recent complex transactions in the SMSF space (privacy protected) and the role the various experienced team of advisers played at each stage of the transaction to help regulators better understand the complexities at ground level.

Please do not hesitate to contact the writer for further clarification.

Yours faithfully

Jenny Wilks

Jenny Wilks CA
Director

Abbreviations used throughout:
AFSL – Australian Financial Services Licence
ACL – Australian Credit Licence
APRA – Australian Prudential Regulatory Authority
CGT – Capital Gains Tax
GFC – Global Financial Crisis
NCCP – National Consumer Credit Protection Act
RTO – Registered Training Organisation