

**AUSTRALIAN PRUDENTIAL
REGULATION AUTHORITY**

**SUPERANNUATION CIRCULAR
NO. II.D.4**

**BORROWING BY
SUPERANNUATION ENTITIES**

SEPTEMBER 1998

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IMPENDING CHANGES

The 1998 Budget and the Assistant Treasurer's press release of 28 May 1998 foreshadowed changes covering the transfer of the responsibility for the regulation for certain small funds (currently known as excluded superannuation funds) to the Australian Taxation Office and the tightening of existing investment rules covering all superannuation funds.

These impending changes may impact on the information contained in this Circular and trustees should seek current information on the arrangements and how they apply to each entity's circumstances.

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Objective

1. The aim of this Circular is to explain the rules under the *Superannuation Industry (Supervision) Act 1993* (“SIS”) relating to borrowing by regulated superannuation funds, approved deposit funds and pooled superannuation trusts. The primary provisions outlining these rules are sections 67, 95 and 97 of SIS.
2. This Circular replaces and updates Superannuation Circular “Borrowing by Superannuation Entities” which was released by the Insurance and Superannuation Commission in October 1994.

Introduction

3. An underlying policy of SIS is generally to enable trustees to make investment decisions as they see fit. However, in addition to facilitating sound and productive management of fund assets, various SIS provisions also prohibit or limit investment practices which are inconsistent with retirement income policy objectives. Trustees who breach these provisions are exposed to significant penalties.
4. The investment restrictions help protect and enhance the retirement benefits of members by limiting the exposure of such benefits to unnecessary risk. The borrowing restrictions ensure that accumulated benefits are not directly exposed to risks associated with geared investments and, in particular, stop lenders from acquiring a claim over fund assets ahead of members. Similarly, SIS regulation 13.14 prohibits a trustee from giving a charge over or in relation to any asset of the fund (subject to limited exceptions in SIS regulations 13.15 and 13.15A).

Borrowing by regulated superannuation funds

Section 67

5. Under section 67, regulated superannuation funds are generally prohibited from borrowing or maintaining an existing borrowing of money.
6. A contravention of section 67 will continue for however long a prohibited borrowing is maintained.
7. There are certain exceptions to the general rule which are described in the following paragraphs 8 to 13.

Temporary borrowing to pay beneficiary

Section 67(2)

8. Regulated superannuation funds may borrow to make a payment to a beneficiary if:

- the payment is required to be made by law or by the governing rules of the fund; and
- apart from the borrowing, the trustee would not be able to make the payment; and
- the period of the borrowing does not exceed 90 days; and
- the total amount borrowed does not exceed 10% of the value of the assets of the fund.

9. It should be noted that APRA expects that this type of borrowing would only be required in exceptional circumstances. Another trustee duty is to prepare an investment strategy under paragraph 52(2)(f) of SIS which has regard to (inter alia) liquidity requirements. A need to borrow to fund payments to beneficiaries would appear to demonstrate a lack of trustee diligence in meeting the investment strategy requirements.

Temporary borrowing to pay superannuation surcharge

Section 67(2A)

10. Regulated superannuation funds may borrow to make a payment of the superannuation surcharge or an advance instalment which is required under the *Superannuation Contributions Tax (Assessment and Collection) Act 1997* if:

- apart from the borrowing, the trustee would not be able to make the payment; and
- the period of the borrowing does not exceed 90 days; and
- the total amount borrowed does not exceed 10% of the value of the assets of the fund.

Temporary borrowing to cover settlement of securities transactions

Section 67(3)

11. Regulated superannuation funds may borrow to cover settlement transactions for the acquisition of a wide range of securities and other financial instruments which are listed in section 67(3)(a) if:

- at the time the investment decision was made, it was likely that the borrowing would not be needed; and
- the period of borrowing does not exceed 7 days; and
- the total amount borrowed does not exceed 10% of the value of the assets of the fund.

12. The effect of this is that trustees cannot, as a matter of course, borrow to settle security transactions, unless at the time the transaction was entered into it was likely that the borrowing would not be needed. This means that trustees should not enter into transactions with the intention of borrowing to cover settlement. However, APRA has the power to make a written determination to exempt a particular transaction from this requirement. Any such determination would be considered on the merits of the particular case, although it is worth noting that this discretion has not been exercised to date.

Borrowing by public sector funds

Section 67(6)

13. Section 67(6) allows public sector funds which borrowed on or before 1 July 1990 to maintain those borrowings until 30 June 2000, subject to certain conditions.

Borrowing by approved deposit funds

Section 95

14. Approved deposit funds (“ADFs”) are generally prohibited from borrowing under section 95 except in the following two circumstances:

- with the approval of APRA in the situation where the trustee has satisfied APRA that special circumstances exist to justify the borrowing; or

- temporary borrowing to cover settlement transactions under identical terms as those applying to regulated superannuation funds. (Refer to paragraphs 11 and 12 for the requirements relating to settlement transactions.)

Borrowing by pooled superannuation trusts

Section 97

15. Pooled superannuation trusts (“PSTs”) are generally prohibited from borrowing under section 97 except in the following two circumstances:

- when the trustee borrows to pay beneficiaries under identical terms as those applying to regulated superannuation funds (Refer to paragraphs 8 and 9 for the requirements relating to payments of beneficiaries.); or
- temporary borrowing to cover settlement transactions under identical terms as those applying to regulated superannuation funds and ADFs. (Refer to paragraphs 11 and 12 for the requirements relating to settlement transactions.)

Borrowing contrasted with other debts

16. Not all liabilities of a superannuation entity will be borrowings within the meaning of sections 67, 95 and 97. Whether a particular transaction constitutes a borrowing will depend on the facts and applicable legal principles in any given case. In general, however, a borrowing usually involves receiving a payment from someone in the context of a lender/borrower relationship on the basis that it will be repaid. A transaction which gives rise to a debtor/creditor relationship does not necessarily give rise to a lender/borrower relationship, and hence may not necessarily represent a borrowing for the purposes of this restriction.

17. Examples of amounts paid on behalf of, or owed by, superannuation entities which would constitute borrowing include:

- a loan, whether secured or unsecured;
- in normal circumstances, a bank overdraft; or
- a transaction where the borrower and lender are the same legal entity.

18. A borrower and a lender cannot normally be the same legal entity. However, the situation may arise where a common trustee of two

superannuation entities borrows money held in one entity for the purposes of the other entity. Thus a borrowing may occur where:

- the borrower/lender is a trustee; and
- the trustee has provided personal money, or money held on behalf of another person (i.e. another trust fund), to the entity; and
- the trustee in its personal capacity (or the capacity of the other persons on whose behalf it holds money) does not claim or record any personal interest in the asset purchased with the borrowed money; and
- the fund accounts record the transaction as a borrowing or a loan (and repayments are purported to be made).

19. Examples (and this list is by no means exhaustive) of amounts paid on behalf of, or owed by, regulated superannuation funds, ADFs or PSTs which generally would not constitute borrowings are:

- amounts payable by a superannuation entity arising out of expenses paid on behalf of a superannuation entity by an agent of the trustee or other person entitled to reimbursement;
- normal commercial delays in the payment of expenses incurred by a superannuation entity;
- financial leasing arrangements and hire purchase transactions in general;
- the liability of a fund to pay benefits to members as they fall due;
- pre-paid contributions, provided they were properly characterised at the time of payment as being contributions;
- the purchase by a trustee of property where ownership of the property passes to the trustee before the instalments are finalised. Under this example, an investment in endowment warrants or instalment receipts may not be considered borrowing. It is necessary to check the obligations that lie with the purchaser to meet the instalment(s), as these determine whether the investment is a borrowing. Where the remaining instalment(s) is not “compulsory” and the warrant/receipt holder receives the value of the warrant/receipt (less handling or sales costs) on “default”, APRA considers the warrant/receipt does not constitute a borrowing.

20. These examples are not intended to be conclusive and it is important to consider the particular facts of each case. For regulated superannuation funds and ADFs there may also be a separate question whether a charge has been given over the entity's property which, subject to certain exceptions, is prohibited under SIS regulation 13.14.

Investments in geared unit trusts

21. Any investment in a geared unit trust may result in a reduction in the security of members' entitlements. Consequently, the existence of a unit trust borrowing is a relevant consideration to be taken into account by the trustee in the formulation and implementation of the investment strategy of a fund under section 52(2)(f) of SIS.

22. The Government announced, in the 1998 Budget, an intention to restrict investments in associated parties. This would effectively prevent the circumvention of the borrowing rules by funds investing in associated entities such as unit trusts.

23. Under the foreshadowed amendments, transitional provisions would apply to investments by superannuation entities as follows:

- investments made prior to 7.30 pm on 12 May 1998 (Budget night) would remain subject to the existing rules;
- investments made after 7.30 pm on 12 May 1998 and before the introduction of the legislation to the Parliament would be subject to the new rules from 1 July 2001; and
- new investments made after the introduction of the legislation would be subject to the new rules.

Penalties

Sections 42, 43, 44, 193, 202

24. Significant civil and criminal penalties may apply to trustees breaching borrowing restrictions.

25. In addition, where a trustee contravenes any of the borrowing rules, the regulated superannuation fund, ADF or PST may as a result be refused complying status for the relevant year of income, with adverse taxation consequences.