CHAPTER 7

IN-HOUSE ASSET RULE

7.1 Under the in-house asset rule, superannuation funds are limited in their power to invest in, or lend to, their sponsor companies. The rule is designed to prevent employers from regarding superannuation schemes as sources of internal funding for their businesses or using superannuation funds to defend themselves from a takeover bid. The in-house asset rule, being phased in to ten per cent by 1995, was examined by the Government, in consultation with the superannuation industry, last year and was found to be appropriate.

7.2 However, the Committee notes that the Attorney-General's submission to the Committee and the ALRC have both recommended a lower figure of 5%, arguing that an in-house investment is not the same as any other investment of a superannuation scheme because if the employer goes out of business, not only will members lose their jobs but their superannuation scheme will suffer a loss which it may not have suffered if it had not invested in-house.[1] The recent House of Commons Social Security Committee report on *The Operation of Pension Funds* noted other reasons in the UK context (see Figure 7.1). ASFA notes in its submission that the in-house asset standard may require refinement.[2]

Figure 7.1

ARGUMENTS AGAINST IN-HOUSE INVESTMENT

- A pension trust is there to provide superannuation independent of the fate of the employing/sponsoring company.
- In-house investment creates potential conflict of interest between the pension fund and the sponsoring company.
- The insider trading rules make it increasingly difficult for trustees to authorise transactions by their pension fund in the stock of the sponsoring company of which they may be directors or employers.
- When a pension fund undertakes the acquisition or disposal of stock of the parent company it sends signals to the stock market.
- It is difficult for trustees to act dispassionately with respect to the company's share price.
- The relationship between the sponsoring company and the fund manager means that there is scope for conflict if the fund manager wishes to change the share of the pension fund's assets invested in the sponsoring company.

Source: Cited in *The Operation of Pension Funds* Second Report of the Social Security Committee, House of Commons, session 1991-92, pp xvii-xviii.

1 Sub No. 107, p 15, and ALRC, Discussion Paper 50, p 165.

2 Sub No. 89, p 28. ASFA notes 'The fact that the current in-house limits are based on the historical cost of assets can lead to some inappropriate results. However, it is recognised that a change to market value could create other problems. The ISC is currently addressing difficulties concerning the in-house asset standard.'

7.3 Mr Noel Davis in his evidence to the Committee [3] argued that when the financial circumstances of the employer become difficult, moneys in the superannuation fund are often regarded as being accessible and can be treated in one of three ways:-

- moneys can be lent to the employer;
- the funds can be wound up and the money in them distributed to the principals; or
- the moneys can be misappropriated through fraud.

7.4 Mr Davis noted that where a breach of the in-house asset rules is involved, the fund then attracts maximum marginal tax rates of 48.25 per cent,

> *but a desperate employer is not the least bit concerned that an adverse tax rate will be imposed on the superannuation money if it is a matter of survival.*[4]

7.5 Mr Davis went on to note that the loan can be made interest-free, in which case the superannuation fund does not pay the adverse tax rate, or alternatively, the employer can pay a low interest rate – in which case not much tax is paid by the superannuation fund. Moreover, even if the interest rate on the loan is at a commercial rate, the employer gets a deduction for 39 per cent and the fund is paying 48.25 per cent. If the two are regarded as being all part of the one, as some employers undoubtedly do, there is not much difference in terms of the tax deduction and the tax paid.[5]

7.6 Mr Lee in his submission argued that in-house investments should be prohibited.[6] Mr D Schwarz[7] said that all family funds, i.e. those with no arms' length members, should not have to comply with the in-house asset rule because of the cost of capital to small business. Mr Lucas made a similar point in his submission[8] and evidence to the Committee.

> *Recommendation 7.1:*
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> *The Committee recommends that funds which do not have arms' length members be subject to the same rules as other funds. The Committee considers that to do otherwise would provide scope for tax avoidance.*

7.7 Writing in the aftermath of the Maxwell fraud case, the recent House of Commons Social Security Committee report on *The Operation of Pension Funds* noted that:

> *Controls on self investment, ... are not a panacea. Indeed, it is the Committee's*

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3 Evidence, pp 622-24.

4 Evidence, p 622.

5 *ibid.*

6 Sub No. 78, p 7.

7 Sub No. 17, p 1.

8 Sub No. 22, p 3.

> *view that a complete ban on self-investment would be counterproductive. If self-investment were banned entirely, it would lead, in some cases, to the forced sale of pension fund assets, which could be directly contrary to the interests of employees and pensioners. There is also no evidence to suggest that even if there had been a total ban on self-investment this would have prevented Maxwell from carrying out his fraud since there would still have been the necessity for strong directors and trustees to oppose him. We do, however, believe that the government's introduction of a 5 per cent ceiling on self-investment with limited exclusions, is a prudent and sensible reform within the existing structure of the law.*[9]

7.8 The Committee notes that the proposed new information disclosure requirements to be introduced from 1 July 1992 (see Attachment A, Chapter 4) will require trustees to report percentages of asset classes and also to report to members any single asset that amounts to more than ten per cent of the assets of the fund at balance date by market value.[10] The Committee believes, however, that there remains scope for balance sheet restructuring and that it may be possible for funds to exceed the ten per cent rule during the year and not be detected unless the ISC is able to pursue an active audit program. As the Committee noted in Chapter 4 and in its earlier statement on the Byrnwood case[11], there is a need to improve ISC audit procedures at the earliest possible opportunity to detect breaches of the in-house assets rule and impose appropriate penalties on trustees.

7.9 The Committee recognises that any lowering of the in-house asset threshold is likely to cause some difficulties for the superannuation funds of those large employers which make up the top 20 stocks on the stock market. The Committee also believes small funds with arms' length members are at greater risk of insolvency. Figures by the ISC for 1986-87, show that small funds were more likely to have a level of in-house assets exceeding ten per cent(see Table 7.1) However, the Committee believes that the increased fiduciary duties of trustees, together with other changes to prudential arrangements recommended in this report, will not require a distinction to be made between small and large funds.

> ***Recommendation 7.2:***
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> *The Committee recommends that the in-house assets rule be reduced from ten per cent to five percent.*

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9 Social Security Committee, op cit, p xix.

10 Prudential Supervision of the Superannuation Industry, Statement by the Treasurer.

11 Report to the Senate, March 1992.

Table 7.1

NUMBER OF FUNDS* IN EACH CATEGORY – 1986-87
PERCENTAGE OF INVESTMENTS IN IN-HOUSE ASSETS

Total Investments $	Nil	1-4%	5-9%	10-19%	20-29%	30+%	Total
				Number of Funds			
0 to 100 000	55 095	1 182	1 795	2 864	3 276	9 117	73 329
100 001 to 200 000	7 476	451	614	597	676	1 560	11 374
200 001 to 500 000	4 214	280	358	366	341	798	6 357
500 001 to 1 000 000	1 314	50	72	55	58	171	1 720
1 000 001 to 10 000 000	1 687	47	64	28	24	58	1 908
10 000 001 and over	344	43	30	18	5	8	448
TOTALS	70 130	2 053	2 933	3 928	4 380	11 712	95 136+
No. of Funds in each category as a percentage of total funds	73.7%	2.6%	3.1%	4.1%	4.6%	12.3%	
				$ million			
Total Investments	25 215	4 401	4 423	1 490	795	1 469	37 793
Total In-House Investments	–	83	333	231	193	756	1 596
In-House Investments as a percentage of Total Investments (average)	–	1.9%	7.5%	15.5%	24.3%	51.5%	4.2%

* Employer Supported Funds with assets not all in individual insurance policies.

Source: ISC. Figures for later years are not available.