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Borrowing to buy property in an SMSF can be risky

In its response last year to the Murray Financial System Inquiry, the federal government said it wouldn't proceed with the recommended ban on borrowing by self-managed superannuation funds to buy property investments. According to the response document, it didn't "consider the data sufficient to justify significant policy intervention".

SMSF borrowing may not be a problem for the government, but it's likely to cause financial distress for some investors in the coming years, especially as SMSF property investing has been such a fertile ground for financial mischief. Let's look at the issues you need to consider to ensure you're not one of those directly affected.

First, seek independent, genuine financial advice before proceeding with any investment or superannuation strategy, particularly when borrowing is involved. By genuine financial advice, I don't mean the real estate agent selling the property, a mortgage broker lining up your finance, or anyone – licensed financial adviser or otherwise – who has a financial interest in you proceeding with the purchase.

Unless you're wealthy, you'll probably spend a large proportion or many times your net wealth on a property purchase. That means the investment outcome will be life changing, so get expert advice from someone who genuinely places your financial interests ahead of their own.

Second, go in with your eyes wide open. Because of stamp duty, property trades are subject to high transaction costs.

The moment you buy a property, 5 per cent or more of the purchase price disappears in upfront costs. If you borrow 50 per cent, the leverage effect means you effectively vaporise 10 per cent or more of your equity (the funds you've contributed) on day one. Unless your timing is impeccable, there could be a significant waiting period before your superannuation balance gets back to its starting point.

The leverage effect also comes into play as property values fluctuate. A key reason many people have made their fortunes in property is because they've managed to borrow such a large proportion of the purchase price. This has allowed them to take on far more risk than their savings would have otherwise dictated, and it has paid off for them.

But this also works in reverse. If you buy a property and it falls 10 per cent in the first year, the combination of the price drop, transaction costs and the leverage effect means your super balance might be down by 30 per cent a year later. You'll need strong nerves to ride out a rough year or two of property prices, assuming you have the financial resources to do so.

One of the key points to remember with SMSF property loans is that they aren't a normal home mortgage. For instance, they contain review events that allow the lender to review and potentially terminate your loan.

If you keep up with your home mortgage repayments, the loan remains in place for its 25 or 30-year term. Whether you start a family, renovate or change your marital status, the bank isn't going to review your circumstances and decide it wants its money back. But with an SMSF loan, fairly normal events that the lender deems to be review events can allow it to do exactly that.

For example, let's take a look at the Commonwealth Bank SuperGear loan. According to the Product Information Booklet, the loan's review events include exceeding the product's loan-to-value ratio based on the latest valuation; any event that might affect the future value of the property, such as a bad neighbour moving in; a change in the investment strategy of the SMSF; the SMSF commencing pension phase (which every SMSF will do at some point); and a change in any of the SMSF members (even as a result of death).

This list is so broad that it's difficult to imagine an SMSF that won't have multiple review events, and every one of them may give the Commonwealth Bank sufficient cause to terminate the loan. To stay safe, think of SMSF loans more like a margin lending facility or a credit card than a long-term home loan, and ensure that you have a financial back-up plan that allows you to repay the loan if it gets called in.

If you're using your super to invest in property, do so with your eyes wide open to the risks. Many people are going to come unstuck in the coming years, and you don't want to be one of them.

Richard Livingston is a founder of Eviser (eviser.com.au). This article contains general investment advice only (under AFSL 469838).