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Media Release
1 October 2013

The Real Picture on SMSFs

There's been much commentary in the media in the past week on the role of SMSFs in relation to the property market and the regulation of SMSFs.

Last week the Reserve Bank of Australia referred to SMSFs in its Financial Stability Review, noting a speculative demand for property that did not exist in the past, and decided at its September meeting to monitor SMSF borrowing.

Also last week, the new Assistant Treasurer, Senator Sinodinos, was quoted as saying the Government would look to provide a level playing field in the superannuation sector.

Government and regulators are right to keep an eye on how the superannuation system is evolving and be alert to any developing risks to superannuation savers and the general economy. But any moves to further regulate SMSFs must only be on a considered assessment of the facts with solutions proportionate to the scale of proven rather than perceived problems.

Senator Sinodinos should be wary of the motives behind calls from the industry and retail fund sector for a level regulatory playing field, implying that SMSFs are not properly regulated. The self-interest of the major pooled funds is clearly evident. They have seen billions of superannuation savings flow into SMSFs which is lost fee income for them. It is in their interests to make it more difficult for individuals to set up and manage an SMSF by hedging them in with more rules and restrictions. Instead, they might be better advised to recognise why people are finding SMSFs an attractive alternative.

As surveys have shown, the key attractions are control, choice and cost.

For instance, SMSF owners can choose to pay an adviser to manage their funds and select investment options or do it themselves. They can choose to can pay for a range of services, such as administration platforms, or not. The fact that SMSF owners have a choice as to whether to use an adviser who can be fired if they are unhappy with the adviser's performance, is one of the attractions of the SMSF sector compared to major pooled funds.

Cost is also an important factor. Research recently conducted for ASIC by Rice Warner Actuaries shows that SMSFs with $100,000 to $500,000 in assets can be competitive with pooled funds if the owners undertake some administration and above $500,000 running an SMSF is a cheaper option.

The key features of SMSFs;

- individual choice;
- competition; and
- encouraging self-reliance;

are entirely consistent with Liberal philosophy and should guide the policy making of the new Coalition Government.

So we should be confident that the current government will appreciate the motivation that may lie behind recent commentary. However, the retail and industry superannuation sector is very strong with a powerful lobbying capability and the owners of SMSFs need to be on their guard and make sure their voice is heard in Canberra.

SMSFs and Property

The ATO statistics on SMSF asset allocation do not suggest a wholesale rush by SMSFs into property.

In June 2008, investment by SMSFs in non-residential or commercial property amounted to $30.3 billion or 9.6% of total SMSF assets. By June 2013, investment in non-residential property amounted to $58.6 billion or 11.8% of total assets. Much of this would be in related property where the SMSF owns the property from which the fund members run their business.

Looking now at residential, in 2008 SMSFs held $10.6 billion in residential property or 3.37% of their total assets. By June 2013, that had barely moved in proportional terms with residential property investment amounting to $17.5 billion or 3.53% of total assets.

Current concerns over a housing ‘bubble’, on which there are differing views, may have much more to do with historically low interest rates and rising confidence in the economy than with SMSFs pushing up property prices.

ASIC has expressed concern about people being enticed by property spruikers to set up SMSFs and then to borrow via the SMSF to buy property. ASIC is concerned about the quality of advice being provided to these investors and has proposed that advisers be required to warn potential SMSF owners that they will not be covered by compensation for fraud or theft as they are with managed funds.

SMSFOA shares ASIC’s concerns in this regard. It is generally considered unwise for a newly set up SMSF to hold only one, highly leveraged asset. SMSFs would normally spread their assets across regular asset classes like shares, cash, property and, perhaps, bonds. However, some trustees may prefer to hold a majority of their assets in a single class, most likely cash, and this is quite valid if it is part of a considered investment strategy.

The solution to the property gearing problem – to the extent it is real – lies in the quality of advice, the licensing of advisers including property promoters, and the education of SMSF trustees. It does not lie in limiting investment choice for SMSFs.

One issue is that property promoters, as opposed to financial advisers, are beyond the reach of ASIC as they are regulated at the State level. This should be addressed by Federal and State governments.

There may be merit in declaring property investment packages marketed to SMSFs as financial services with the same disclosure requirements as other investments.

Borrowing

Again, the ATO statistics do not suggest that SMSFs are overdosing on borrowed funds.

In June 2010, when borrowing figures were included in the statistics, SMSF borrowings amounted to $2.9 billion or 0.8% of total assets. By June 2013, borrowings had risen to $6.8 billion, a significant increase but still a relatively low 1.37% of total assets.

The Cooper review of the superannuation system in 2010 recommended that the issue of borrowing by SMSFs should be looked at again in two years time. That review is now overdue.

However, a further review is not starting with a blank page. If the question of whether SMSFs should be allowed to borrow was being raised for the first time, there might be an argument not to allow it on the grounds of gearing risk but that threshold was crossed six years ago when SMSFs were allowed to borrow to buy property as well as invest in shares and other financial products. The clock can't be wound back.

Now, the sensible response to concerns about over-gearing by SMSFs, to the extent that it may exist, lies in better quality financial advice, effective licensing of advisers and education of investors.

Credit control by lenders, backed up by RBA capital requirements as necessary, can apply an effective brake to borrowing by SMSFs and other property investors.

The limiting of SMSF borrowing to limited recourse loans ensures that only the asset for which the money was borrowed is at risk.

A factor that may be influencing people to borrow via their SMSF to own property and build their asset base is that the opportunity to build super savings by making voluntary contributions was severely curtailed by the previous Government which halved contribution caps, then halved again the cap for over 50s before belatedly repairing some of the damage by allowing over 60s to put in more this year and over 50s from next year.

SMSFOA would like to see voluntary contribution caps for all super savers returned to their former levels of $50,000 per year for under 50s and $100,000 for over 50s. However these should also be indexed from when they were first introduced and provided as an annual allowance, with unused allowance carrying forward to subsequent years.

This greater flexibility would help women, the self-employed with variable incomes and indeed most taxpayers who realistically find it difficult to contribute until the last decade or so of their working lives. And it would remove some of the incentive for investors to borrow via an SMSF to build their retirement savings.

Taxation

It is sometimes claimed that SMSFs have a tax advantage over pooled funds; however members of SMSFs, supervised by the ATO, are subject to the same tax requirements and pay the same taxes as members of managed funds regulated by APRA. The ATO ensures that SMSF tax returns, verified by the fund's auditor, are correct and the proper amount of tax is paid.

In practice, SMSFs generally have more flexibility in relation to treatment of capital gains in the retirement phase, however this is not due to differing taxation but because of the way in which APRA-managed funds choose to pool members' superannuation.

Regulation

Calls for a level playing field tend to overlook a fundamental difference. Pooled funds require close prudential regulation because they hold in trust the retirement savings of millions of Australians and invest the funds on behalf of their members. The Henry Review stated that *"the government's role should be restricted to providing for minimum and essential needs and facilitating self-provision".*

The growth of SMSF sector is evidence that some fundamental parts of the system are working. However, history has shown that funds held on trust by third parties (i.e. retail, industry and corporate funds) require much tougher regulation.

By contrast, the trustees and beneficiaries of SMSFs are the same people and they make investment decisions with their own interests in mind. There is no third party element of trust that requires prudential regulation.

As the Cooper review pointed out, SMSFs are generally well run and perform at least as well as professionally managed funds. There is less need for active regulation of them than there is for managed funds which, Cooper noted in passing, do not always act in the best interests of their members.

ASIC recently released an analysis of SMSF performance conducted by Rice Warner Actuaries which showed that, averaged over seven years from 2005 to 2011, SMSFs outperformed APRA regulated funds in terms of investment returns by 8.8% to 5.4%. SMSFs outperformed managed funds in six of the seven years. Rice Warner noted that while these results might not prove that SMSFs were better investment managers than APRA funds, they did show that members of SMSFs are not disadvantaged when compared to members of APRA funds.

The claim sometimes made by representatives of the pooled funds sector that SMSFs are unregulated and pose a prudential risk to the superannuation system is not borne out by the facts. If it is argued that APRA-style regulation should be imposed on SMSFs, why then not also on an individual's private investments outside super? The only role of the government in relation to SMSFs should be to ensure taxation compliance and set basic governance and investment rules, which are checked by independent auditors.

The question of what is the most appropriate and cost effective regulatory structure for superannuation generally and SMSFs in particular was considered in depth by the Cooper Review. If the Government wishes to again review regulation of this sector, it can do so as part of the proposed review of the financial system.

In this context, a major concern for SMSFs is the cost of regulation. They already pay annual supervisory fees to the ATO and to ASIC if they have a corporate trustee. The revenue raised by the ATO levy will increase by 61% over the next four years and SMSFOA has strongly questioned the justification for this rise.

Any change to the regulatory arrangements for SMSFs flowing from the financial system review should not result in any higher regulatory charges for a fund type that is proving the most successful in achieving the objectives of Australia's retirement savings strategy.

In any reshaping of superannuation policy, Senator Sinodinos needs to be mindful of the success of SMSFs, understand why they are the savings vehicle of choice for a million Australians and be aware of the self interest of the powerful industry and retail super fund lobby groups.

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