SMSF
Owners'
Alliance
Limited ABN 96 161 052 464
Not-for-profit public company

RESPONSE TO THE INTERIM REPORT OF THE FINANCIAL SYSTEM INQUIRY

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Consultation

The SMSF Owners' Alliance Limited is a not-for-profit organisation set up with one purpose in mind – to speak for the interests of over one million Australians who have chosen to strive for financial independence in retirement through a self-managed superannuation fund. Our original submission to the Financial System Inquiry (FSI) and our web-site www.smsfoa.org.au has further background on the SMSF Owners' Alliance Limited (SMSFOA).

When we made our first-round submission to the FSI, we had hoped and expected that we would have an opportunity for direct consultation with members of the FSI Panel and/or staff prior to the drafting of the Interim Report and we were disappointed this did not occur.

We appreciate that the FSI received over 280 submissions and it may not have been practicable to consult with all of the stakeholders, however we point out that SMSFOA is one of the very few organisations specifically dedicated to the interests of the trustees and beneficiaries (the owners) of SMSFs and independent of any product manufacturers, advisers, retail or industry funds. That we cannot match the firepower of the large APRA-regulated funds should not diminish the value of our ideas and input – perhaps the contrary! We note the volume of superannuation savings held in SMSFs outweighs that held in either industry or retail managed funds.

So we confirm that would be happy to meet with members of the Financial System Inquiry to discuss this submission, its implications and any other areas of interest. Furthermore, we would be willing to share the detailed results of our modelling used to develop some of the views in this submission.

Overview

The focus of this submission is on superannuation and particularly SMSFs though there are also other issues of interest to our members on which we have offered a comment.

In determining the sections into which we group our comments, we have been guided by your listing of superannuation issues on page 2-95 but expanded your comment on costs to include other factors that impact the efficiency of the superannuation system and added a specific section on the retirement phase. Page references are to the pages in the FSI Interim Report.

Our report is therefore divided into the following sections:

- Stability and fairness in superannuation
- Costs and efficiency
- Leverage
- Issues re pension phase

We note that on page 1-5 the FSI "takes the view that the status quo is the appropriate starting point for policy discussion" and agree with this approach.

Over the past two decades Australia's superannuation system has developed well, particularly the self-managed sector which now holds the largest share of superannuation assets. The success of SMSFs has shown that people are capable of managing their own retirement savings and performing, on average, at least as well as professionally managed funds.

There are structural and operational improvements that can be made to the system but any proposed changes must respect the need for continuity, consistency, certainty and confidence for people who have made superannuation savings under the current rules. The Interim Report acknowledges the importance of policy stability to maintain long term confidence in the system.

The history of changes to the taxation and regulation of superannuation has added to complexity and confusion. Superannuation is for the long-term and confidence in consistency of policy is very important.

People make fundamental and long-term decisions – such as how to set their retirement savings against other spending priorities like housing and education, choosing the best time to retire and the income they will need in retirement – based on the current superannuation rules. Any change to contribution and withdrawal rules, particularly the taxation of savings and pensions, should not disadvantage people who have grown their super under the existing rules. Changes should either be grandfathered or implemented in a way that does not adversely impact the financial situation of superannuation savers.

We accept that a system as large and complex as superannuation needs to be kept under review and modified from time to time as the system itself and the broader economy in which it performs evolve. Structural change, for example moving from a TTE system to an EET system (See section 2.5 below), must be undertaken carefully and implemented over a long period without substantially disadvantaging anyone. Likewise, operational changes, including taxation, should not leave existing savers worse off.

Government support of a superannuation system though tax incentives should be sustainable and justifiable in the long-term but superannuation savings must not be viewed by governments as a short-term ready source of revenue to rescue the budget when they run into fiscal trouble.

FSI suggested a set of principles to guide the actions of Government and regulators which look very sound and we emphasise from our viewpoint the importance of the following extracts from the Interim Report:

- "Regulation should be as simple as possible to achieve the policy outcome desired".
- "Actions of Government or regulators should also be consistent and predictable"
- "Regulators should have clear mandates determining their objectives"; and
- "Regulators must be held to a high level of accountability for their performance relative to their mandate".

Unfortunately governments have not always kept to these simple principles and, as a result, have contributed to instability, uncertainty and unfairness in the superannuation system.

1 Stability and fairness in superannuation

We have included 'fairness' in the heading because FSI has suggested (and we agree) that this is an important objective. FSI has also suggested that unfairness can lead to Government intervention and therefore instability in the system.

1.1 Too much/frequent Government intervention

> *FSI Observation page 2-118*
>
> *Superannuation policy settings lack stability, which adds to costs and reduces long-term confidence and trust in the system*

We agree with this observation and would suggest it is the greatest impediment to the system achieving its original objectives which, in themselves need to be clarified. It is strange that such a large and complex system, with a profound influence on the welfare of most Australians and the national economy has developed without an over-arching statement of purpose and objectives.

We note that FSI has repeated the objectives proposed in *Australia's Future Tax System Review* (2-97) as follows:

> **Broad and adequate** – to protect those unable to save against poverty in their old age and provide the means by which individuals must or can save for their retirement.
>
> **Acceptable** – to consider the income needs of individuals, both before and after retirement, to be equitable and not to bias savings decisions inappropriately.
>
> **Robust** – to deal appropriately with investment, inflation and longevity risk.
>
> **Simple and approachable** – to allow individuals to make decisions that are in their best interests.
>
> **Sustainable** – to be financially sound into the future and detract as little as possible from economic growth.

We agree that it would assist stability and confidence if the Government committed to a set of objectives and guiding principles with respect to our retirement system.

> **The above objectives appear to be generally acceptable although we would caution FSI against unreasonably guiding Government towards an overly prescriptive or simplistic approach to superannuation in the interests of protecting those who have no knowledge of or interest in establishing self-reliance through superannuation if such an approach disadvantages those in Australia who do have the capability and commitment to secure their financial independence in retirement and reduce their dependence on and cost to the Budget.**

We note that the FSI supports the "3-pillar" structure of our superannuation system. Both the Henry and Cooper reviews suggested that such system should meet the following retirement objectives as proposed by the World Bank:

- Through a combination of compulsion and incentives allow most taxpayers to retire on a privately-funded pension at a reasonable Replacement Rate; and
- Provide a Government-funded pension only as a 'back-stop' for a minority of taxpayers who for whatever reason have been unable to achieve this objective.

The rationale for encouraging retirement savings with tax incentives was well expressed in Henry's 'Australia's Future Tax System' review:

"The essential reason for treating lifetime, long term savings more favourably is that income taxation creates a bias against savings, particularly long-term savings. Taxes on savings income, including the taxation of inflationary gains, can discriminate against taxpayers who choose to defer consumption and save. The longer the person saves and reinvests, the greater the implicit tax on future consumption….These individuals pay a higher lifetime tax bill than people with similar earnings who choose to save less."

The Replacement Rate is a widely accepted term meaning the pension as a proportion of a person's pre-retirement income or, as Henry put it, the Replacement Rate "compares a person's spending power before and after retirement." It is generally accepted internationally that in an equitable and advanced society taxpayers should expect to retire on a pension that bears a reasonable relationship to their income before retirement.

In our modelling we use a Replacement Rate of 60-70% of real after-tax pre-retirement income and understand that this is generally considered a reasonable assumption.

The notion that the superannuation system of tax incentives and compulsion is merely a means to ensure taxpayers are not on the Age Pension and a burden on taxpayers is not correct. This is one outcome but the system is mainly about providing opportunities for people to attain financial independence in retirement and should treat all taxpayers equitably in providing incentives for each to achieve their reasonable Replacement Rate.

1.2 Is superannuation being used for purposes other than retirement?

> *FSI Observation; page 2-120*
>
> *The large number of individuals with very large superannuation balances suggests the superannuation system is being used for purposes other than providing retirement income.*

It is unclear what FSI means by "large number" and "very large balances" and why it believes that the existence of large balances suggests the system is being used for purposes other than providing retirement income.

ATO statistics show that SMSF members who had more than $10 million in super in 2013 accounted for only 0.1% of the 963,852 members of SMSFs and this proportion had been consistent over five years. Fewer than one thousand Australians had more than $10 million in their SMSF accounts. The proportion of SMSF members with $5-10 million in their accounts was 0.3% - fewer than three thousand. Source: ATO – self-managed superannuation funds – a statistical overview 2011-12(Table 14).

We do not believe it is reasonable to conclude that the relatively small number of individuals who have relatively large superannuation balances are using the system for purposes other than retirement income. For comparison, these figures are similar to the balances required to fund a pension equivalent to the defined benefit schemes of Government Ministers and senior public servants.

ATO reports a very low level of tax return errors (only 2% of returns are qualified by auditors) so balances higher than the norm can only be due to maximising savings under the rules and successful investing.

Figure 4.3 on page 2-121 of the Interim Report, showing a small number of accounts hold a high proportion of assets, should not be a surprise. A comparison of salaries and income tax payments would be similar. If superannuation balances are to fund pensions that bear a relationship to pre-retirement income then one would expect a range of sizes reflecting the range in incomes.

The size of fund balances required to provide reasonable fully-funded pensions is substantial. A 30 year old on average weekly earnings will require a superannuation balance of $2.79m to provide a fully-funded superannuation pension. (Source: SMSFOA 2014 Pre-Budget Submission Table 1). The fact is that contributions to superannuation are and have been constrained.

Limits have been set on voluntary contributions that are taxed concessionally and also on voluntary contributions that are taxed at the individual's marginal income tax rate. It is relevant in this context to know the proportion of superannuation funds that have been contributed from post-tax income. However, the ATO does not publish the value of non-deductible contributions in its SMSF Statistics. Anecdotal evidence is that the proportion of post-tax contributions to SMSFs is relatively high and may account for a significant proportion of the assets held in high-value SMSFs.

Likewise, Judgements on whether it is fair for a small number of SMSFs to have assets valued at more than $10 million, or even $5 million, can only be made with full knowledge of the way in which these assets have been accumulated. Factors that need to be known are the net value of assets after borrowings have been taken into account, the amount of non-deductible contributions (on which income tax has already been paid), related party property transfers, the financial performance of funds, the number of members of the fund and for how long they have been established.

The FSI might usefully recommend that the ATO publishes a more detailed analysis of SMSF assets in its regular SMSF statistics, or at least a representative sample, so policy decisions are based on more complete knowledge of the circumstances of apparently high value SMSFs.

Policy decisions that affect the taxation and regulation of SMSFs should not be made when there are significant knowledge gaps in the way SMSF assets have been built and borrowings against the assets.

Limits have been set on the transfer of related party assets to superannuation funds. These limits have been varied from time to time by governments but all governments have agreed it is legitimate for people who have the capacity to do so to boost the value of their superannuation assets as much as they are allowed under the rules to underwrite a dependable retirement income stream at reasonable Replacement Rates. If parties have complied with the contribution limits and transferred assets into super at valuation then it appears to us that the only reason that some individual accounts could be very large is that they have performed above the market.

It is more appropriate to control superannuation by limiting contributions than to penalise those who have complied with the contribution constraints and whose balance and income is higher due to successful investing.

To suggest that something should be done to perhaps penalise success is not in the interests of a properly functioning financial sector. It suggests a 'tall poppy' syndrome which is not consistent with a democratic, free-enterprise based system.

As noted above, there are constraints on contributions to superannuation, although we do not necessarily agree that a fixed $ contribution limit is equitable when dealing with people on different incomes trying to achieve funding for a pension at a reasonable Replacement Rate.

The other equity issue with the current concessional cap regime is that it is an annual limit.

This discriminates against women, self-employed and others who may have broken or volatile work patterns during their working life.

We have already proposed that the Government allows a system of "rolling" contributions caps, similar to the contribution limits that apply to non-concessional contributions. This would be fairer and assist women, self-employed and others with broken or volatile work patterns.

An alternative worthy of serious consideration is a lifetime AWE indexed contributions cap which would be more equitable. Although it would not appear to be a role for FSI to comment on the detailed taxation arrangements for superannuation, it has already become involved because of suggestions that anomalies in the system may result in further Government intervention resulting in uncertainty and instability in an important segment of the financial system.

1.3 Are tax concessions fairly distributed?

FSI Observation; page 2-121

The majority of superannuation tax concessions accrue to the top 20 per cent of income earners. These individuals are likely to have saved sufficiently for their retirement, even in the absence of compulsory superannuation or tax concessions.

There is no evidence presented to support the FSI's observation that "these individuals are likely to have saved sufficiently for their retirement, even in the absence of compulsory superannuation or tax concessions."

The fundamental purpose of the superannuation system is, or should be, to enable as many Australians as possible to be financially independent in retirement and enjoy a standard of living based on the widely accepted concept of a Replacement Rate (see 1.1). Those who achieve this goal will not be a burden on the Age Pension budget, unlike in other countries, such as the UK, where everyone is entitled to a universal pension whatever their financial status because of the taxes/levies they have paid out of earned income during their working life.

Our modelling has shown that "spending" a dollar on superannuation tax concessions is a more effective use of Government funds that paying out an Age Pension. The former encourages taxpayers to forego consumption during their working life in order to provide for their retirement. Most of the funds in super are an individual's contributions. The tax concession is only approximately 10% whereas the Government pays 100% of an Age Pension. An efficient super system makes economic sense.

Even if there was a flat income tax rate, Australians on higher incomes would contribute more in income taxes to support those on lower incomes. The combination of our progressive rate income tax system and welfare structure exaggerates this to a dramatic extent.

However, the retirement system should not be another mechanism for redistribution of wealth in addition to existing transfer mechanisms, notably income tax and social welfare payments.

The reality is that those on higher incomes pay substantially more tax even after superannuation tax concessions. Taxation statistics show that the 16.7% of taxpayers who earn more than $80,000 pay 63.6% of the income tax paid by Australians. The 83.2% who earn less than $80,000 pay 36.5% of income tax. The top 2.3% of taxpayers who earn more than $180,000 pay 26.2% of income tax.
Source*: ATO Taxation Statistics 2011-12*

One of the issues with our tax and welfare system is that most Australians do not pay any tax net of welfare. They are net recipients of welfare funded by the higher earning taxpayers.

On Chart 4.3 on page 2-122, the Interim Report shows that the top two deciles of income earners receive about 57% of total superannuation tax concessions. To present a more balanced picture, the Interim Report should also have acknowledged that the top two deciles of income earners pay 64% of income tax revenue. That is, they more than pay their way as their level of super tax concession is actually lower than the proportion of the total income tax which they pay, as we have pointed out in previous reports.

(Table 15/Figure 4 – ATO Taxation Statistics 2011-12 https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-statistics/Taxation-statistics-2011-12/?anchor=Individualstables#Individualstables).

The ATO statistics clearly show that top 20% of income earners get a share of superannuation tax concessions that is proportionally less than the share of income tax they pay.

It seems entirely logical and fair that the people who pay the largest share of income tax also, as a consequence, get the largest $ share of superannuation tax concessions even if a lower percentage.

We can illustrate our point that the 'rich' are not benefiting unfairly from superannuation tax concessions by looking at two typical scenarios we published in a recent Research Paper.

(Refer SMSFOA Research Paper: *After the Budget Hysteria – July 2014* at:
http://www.smsfoa.org.au/images/advocacy_2014/140703_SMSFOA_After_the_Budget_Hysteria.pdf

> Bob is 30 years old and on average earnings. When he retires at 70 he will have paid a total of $1.8m in taxes over his working lifetime after taking into account the $276,000 in superannuation tax concessions he has received whilst contributing into super at the SG level. Although he will have nearly $2m in superannuation on retirement, he will immediately become eligible for part-Age Pension and receive $2.1m in pension welfare during his retirement. Note that not only is his welfare greater than his tax concession, it is also greater than his lifetime tax payments.
>
> This modelling assumes that the planned 2014 Federal Budget changes, and particularly the increase in the pension age to 70, are all implemented. Under the Pre-Budget assumptions Bob would have cost the Federal Government even more in Age Pension.
>
> The partial Age Pension would not only have been significantly higher but he would have run out of his superannuation towards the end of retirement and be forced onto a full Age Pension.
>
> Bob can be compared to Tom, a 30 year-old who is earning three times average earnings. When he retires at 70 he will have paid a total of $8.2million in taxes over his working life after taking into account tax concessions of over $1million. He will be able to fully support himself in his retirement and takes no Government support.
>
> His tax concession is substantially less than the welfare payments and tax concessions paid to Bob who makes no net payment for Government services.

So yes…Tom's tax concession is larger (nearly four times Bob's) but it is less than Bob receives in part-pension payments. Significantly, Tom makes a total contribution to the Federal Government budget of $8.2m which not only pays for Government services but helps pay the shortfall in Bob's Age Pension not covered by his own tax payments.

Without that tax revenue from the higher paid, the Federal Government would not be able to function and maintain welfare payments to those who genuinely need support.

So what is "fair and equitable"? Whatever it is, it has to be viewed from a "whole of life/whole of cost/benefit" basis per person, not just one measure of "superannuation tax concession."

1.4 Does dividend imputation create a bias?

> *FSI Observation; page 1-15*
>
> *There is a question of whether the corporate tax regime, particularly the dividend imputation system, is effective in reducing the cost of capital in Australia. The dividend imputation system creates a bias for individuals and institutional investors (including superannuation funds) to invest in domestic equities, and it may be a contributing factor to the lack of a deep domestic corporate bond market in Australia.*
>
> *Also FSI Observation; page 2-122*
>
> *The Inquiry notes that, due to refundable imputation credits and tax-free superannuation in retirement, a growing proportion of company tax collected could be refunded to superannuation funds and retirees over time. Although this is of enormous benefit to retirees, it may erode one of the largest sources of revenue for the Australian Government at the same time expenditure pressures are increasing.*

Dividend imputation was introduced, correctly in our view, to eliminate double taxation of corporate profits and remove the distortion that this would otherwise cause in the markets.

> **It is incorrect to suggest the bond market is disadvantaged because interest payments (coupons) on bonds do not carry tax credits. It ignores the fact that interest payments on bonds are deductible to the issuing corporations, whereas dividends are not, so that the tax impact on cost of capital is neutral with imputation and would be distorted without it.**

It is true that imputation encourages investment by Australian taxpayers in domestic equities rather than investment in corporations based in other tax regimes that do not provide a full credit available to Australian taxpayers. However, this is a distortion caused by imperfections in our various tax-treaty arrangements and because we are not allowing a tax credit for tax paid in such countries rather than due to our imputation system.

It is also incorrect to suggest that the availability of imputation credits to superannuation funds may erode a valuable source of Government revenue over time. If the source of revenue referred to is corporation tax receipts then this suggests a misunderstanding of how the imputation system works in aggregate.

With respect to Australian taxpayers, if it is assumed that all taxed income is distributed over time to shareholders or unit holders, then the only relevant income tax rate is the individual one. From this viewpoint, raising or lowering the corporate tax rate does not change the tax raised by the Government because of imputation. Lowering the corporate tax rate benefits foreign shareholders of Australian companies and thus may attract more investment into this country. The Federal Government's tax receipts from corporations tax is irrelevant.

We would agree that the existence of imputation may bias rational investment towards domestic equities and that may be why SMSF's largest investment category is Australian equities. We would also argue that a high holding of domestic equities – earning over the long term a positive real rate of return and essentially an investment in the Australian economy – provides SMSF beneficiaries with a natural hedge against their retirement expenditure which in most cases would be substantially in Australia and subject to Australian inflation and cost pressures.

We do not agree that the refunding of imputation credits to superannuation funds is a benefit. It is merely refunding tax that has been paid by corporations so that the only relevant tax rate is

that of the investor in a corporation's shares. Removing this credit would distort and damage the equity market in that corporation's earnings (dividends) would be paid out of corporate after-tax earnings but interest and coupons payments would be deductible to a corporation with no consequential taxation in a pension superannuation fund. However, we would not agree that a bias towards equities is the sole or even the most important impediment to the development of a retail bond market in Australia.

The fact is that there are a number of other factors that impinge on the growth and maturity of a bond market in Australia for retail investors as we discuss in section 4.1 below.

SMSF trustees tend to be risk averse and so less likely to invest offshore with exposure to currency and sovereign risk. In keeping with a more cautious approach to risk, particularly in the retirement phase, SMSFs keep a larger proportion of their assets in Australian shares (Chart 3.9 on page 2-83).

It has been claimed (Credit Suisse – Australian Investment Strategy – 'Rise of the Selfies' 16 Jan 2014) that SMSF investment in blue chip stocks in order to benefit from imputation credits is distorting corporate capital allocation by influencing company directors to pay high dividends to satisfy SMSF investors rather than preserve capital for future development.

The pursuit of yield and secure returns in the context of low interest rates is a key driver for all investors, not just SMSFs.

SMSF owners are looking for healthy and reliable returns so naturally they focus on the top tier of listed companies. This is not surprising as the whole point of self-managed super is to generate a dependable income during retirement. Trustees are required to manage their funds prudently. Their investment strategy tends to be more conservative with an emphasis on top tier stocks and cash.

It is, of course, the responsibility of company directors to make a careful judgement on the appropriate balance of after-tax profits between dividends paid to shareholders and earnings retained to fund future growth.

On balance, imputation can be considered to be contributing to the development of a strong domestic funding base for our industry and its removal would cause considerably more distortion by re-introducing double taxation.

1.5 SMSF owners are actively engaged with their retirement savings

> *FSI Observation; page 2-123*
>
> *The growing number of SMSFs may be a positive sign that more Australians are actively engaging with their retirement savings.*

We agree with this observation which has been borne out by research.

A survey by RiceWarner Actuaries probed the motivations for people setting up SMSFs. It showed the main factors were a desire for control over investing the fund's money (95%), flexible investment choices (75%), lower costs (62%), better tax management (58%), easy transition from accumulation to pension (48%), estate planning (43%) and ability to borrow (18%). In this survey, 87% of respondents indicated the performance of their SMSFs met their expectations.

(Source*: Survey of Financial Needs and Concerns – RiceWarner Actuaries – October 2012)*

1.6 Should there be limitations on establishment of SMSFs?

> *FSI Observation; page 2-126*
>
> *The Inquiry seeks further information on the following areas:*
>
> *a) To what extent should the Inquiry be concerned about the high operating expenses of many SMSFs?*
> *b) Should there be any limitations on the establishment of SMSFs?*

We do not believe the FSI should be overly concerned about the cost of operating an SMSF.

As Chart 4.4 on page 2-124 shows, the operating expense ratio for SMSFs compared to APRA-regulated funds is high for low balance funds with less than $200,000 in assets, is roughly the same between $200-500,000 in assets and from then on SMSFs are significantly cheaper to run. ATO data on SMSFs shows that about 23% of SMSFs have less than $200,000 in assets, 26% have between $200-500,000 and 51% have more than $500,000. The average balance is $928,724. (Source: ATO – self-managed superannuation funds – a statistical overview 2011-12(Table 14).

So, 77% of SMSFs are cheaper to run than APRA-regulated funds and by a significant margin for higher balance funds. The main reason for the more economical operation of SMSFs is because the services they require, such as accountancy, auditing and advice, are generally provided on a fee for service basis rather than on a combination of service fees and an investment management fee set as a percentage of fund assets as charged by APRA-regulated funds. One of the main motivations for setting up an SMSF is to escape the high, percentage based fees of APRA-regulated funds.

Some SMSF owners may be prepared to pay a cost premium to achieve the independence and flexibility of investment that an SMSF provides.

It can be assumed that the majority of low-balance SMSFs have been established for a relatively short time and are owned by younger people. The ATO statistics show 31% of SMSFs have been established for less than eight years and 32% of SMSF members are under the age of 45.

Over time, it can be expected that account balances will grow and more funds will have larger assets than can be managed more efficiently at a lower cost. The ATO statistics also note that management costs for SMSFs have been trending down in recent years.

Other relevant factors are the economies that can be achieved when two or more people share an SMSF structure and the advantages of someone with a lower balance deciding to establish an SMSF in anticipation of their balance growing and wanting to develop appropriate expertise and engagement with their savings whilst the balance and capital risk is small.

We do not believe that there should be any limitations on the establishment of SMSFs on the grounds of operating costs. Nor should the cost of running a low balance SMSF be a distraction from the much more important issue of the cost of APRA-regulated funds where most Australians are compelled to place their superannuation savings. Those who set up an SMSF do so by choice and may be prepared to accept a higher cost in the initial years of their fund while they build their balance to the point where their fund will be more economical to run.

If there is to be any particular focus on the subject of costs it should be to ensure all potential SMSF owners can access adequate and competitively-priced advice on the establishment of SMSFs. This is covered more in 1.10 below. There may be instances in which people have been advised inappropriately to establish an SMSF but this is a quality of advice issue not an SMSF cost issue.

1.7 Role of ATO

FSI Observation; page 3-117 & 3-120

During the GFC and beyond, Australia's regulatory coordination mechanisms have been strong although there may be room to enhance transparency.

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

Increase the Council of Financial Regulation (CFR) to include ACCC, AUSTRAC and the ATO

The role of ATO in supervising SMSFs is not a prudential one. It is essentially to ensure compliance with the tax and SIS law relating to SMSFs.

In contrast to APRA regulated funds, there is no corresponding issue of trust for SMSFs as the trustees and beneficiaries of these funds are the same people. This distinction was well made in the final report of the Cooper Review in 2010 which noted the emphasis on prudential regulation of pooled superannuation funds while for self-managed funds the regulatory focus is on tax compliance. With respect to the SMSF sector, the Cooper Review was very clear that this sector required less regulation than those funds regulated by APRA because *"members' interests in the APRA Funds are not always paramount."*

Treasury's FSI submission said *"SMSFs should not be prudentially regulated".* Treasury noted that as SMSF risks were carried entirely by the beneficiaries, there should be no regulatory assurance for them and compliance oversight of self-managed funds should continue to reside with the ATO.

We believe that the primary supervision and regulatory thrust with regard to SMSFs is on the providers of product or advice to SMSFs. ASIC is currently charged with this responsibility and that appears to be the appropriate place for it. We support the current plan to strengthen the regulation of financial advisers.

We support the continued role of ATO with respect to SMSFs.

We do not have a firm view on whether the ATO should join the Council of Financial Regulators.

The value of ATO's participation in CFR is essentially for the ATO and the other regulators to judge. The CFR has an information sharing and policy co-ordination role, facilitated by the Reserve Bank, which should not involve any material cost to the regulators involved. However, if there were to be any significant cost for the ATO's involvement and if this was passed on to the regulated community (SMSFs) then we would be concerned. Indeed we are already concerned that ATO appears to be charging a Supervisory Levy to SMSFs for roles which are substantially provided to other taxpayers free of charge and our concern would increase if the ATO's involvement in the CFR gave another excuse for them to justify further increases in this fee with no added benefit to SMSFs.

2 Costs and efficiency

2.1 Fees in superannuation sector too high

FSI Observation; page 2-99

There is little evidence of strong fee-based competition in the superannuation sector, and operating costs and fees appear high by international standards. This indicates there is scope for greater efficiencies in the superannuation system

The Interim Report highlights the relatively high cost of managing Australians' superannuation savings compared to other countries. The Grattan Institute's finding that a quarter of fund earnings since 2004 have been consumed by management fees is clearly of concern.

The high level of fees imposed by APRA-regulated funds is likely to have contributed, in part, to the relatively high growth of SMSFs. Research conducted by RiceWarner Actuaries indicates that lower costs are a major driver behind the proliferation of SMSFs. Their study suggests that 61% of SMSF members see lower costs as a key benefit, though other factors – control over investing their own money (95%) and investment flexibility (74%) rank higher. Source: "Survey of the Financial Needs and Concerns of SMSF Members" by RiceWarner Actuaries for SPAA & Vanguard – October 2012"

While concern over the cost of managed funds is significant, we believe other factors may also be relevant including:

- The expertise of trustees of some APRA-regulated funds;
- Perceived conflicts of interest for trustees of APRA-regulated funds who have other responsibilities;
- Lack of transparency regarding fee and return calculations;
- The 'pooling' of investment decisions which therefore do not take into account a taxpayer's specific situation;
- Apparent focus on short-term performance through overly active management of funds (churn) to boost short-term results, and performance incentives to managers, perhaps to the detriment of long-term returns; and
- Levels of liquidity necessary in pooled funds are higher than necessary in an SMSF, dampening returns.

These concerns and a philosophical approach to taking personal and direct control and responsibility for such an important investment lead many taxpayers to establish SMSFs even if the cost of so doing does not, at first, appear to be justified.

We contend that the direct personal responsibility SMSF trustees then take for their retirement funding leads to better long-term investment decision making and returns. SMSFs therefore tend to be inherently more efficient in outcomes.

This is not to say that costs are unimportant. In this regard the following costs are important to the trustees of SMSF:

- Cost of regulation; audit and compliance;
- Cost of financial products in which SMSFs may invest; and
- The cost of advice.

In relation to the cost of regulation, we have still not seen any adequate justification as to why the ATO charges such a high supervision fee to SMSFs when most other categories of taxpayer pay no fee to the tax office for the collection, supervision and reporting of tax and tax statistics.

Some earlier modelling by us demonstrated that over the life of an SMSF, the ATO fee could have a greater impact on an individual's retirement pension than the impact of a GFC.

2.2 Governance and disclosure issues

> *FSI Observation; page 3-44*
>
> *To contribute to the effectiveness of the financial system, sound corporate governance requires clarity of the responsibilities and authority of boards and management. There are differences in the duties and requirements of governing bodies for different types of financial institutions and, within institutions, substantial regulator focus on boards has confused the delineation between the role of the board and that of management.*

> FSI Observation; page 3-56
>
> *The current disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs on industry participants.*

It is in the interests of SMSFs to have access to comprehensive information on the governance and performance of APRA-regulated funds. In particular, financial planners and other advisers to SMSFs need access to such information so they can confidently advise their SMSF clients on managed investments as one of the options open to them.

There are good arguments to support a raising of the standards of governance and transparency for APRA-regulated funds. Given the size of the funds they hold in trust, we believe that prudential supervision of them should be just as stringent as APRA's supervision of banks. The governance standards of managed superannuation funds should be extended to their trustee companies and also be comparable to the governance standards required of banks and other large corporations.

We acknowledge that some leading APRA-regulated funds already provide a high level of disclosure of fund performance to investors via their annual reports and websites.

However, information on the governance of the trustee companies that manage the funds and the financial arrangements between the trustee companies and the funds is not made so readily and publicly available.

In our view, such trustee companies should be required to meet equivalent standards of governance and disclosure as are required of public companies under the Corporations Act and the ASX Corporate Governance Principles and Recommendations. The principles embodied in corporate law and the ASX guidelines are relevant to APRA-regulated funds though their application may require adjustment in some cases, given their different legal structure.

For example, perhaps APRA-regulated funds and their related trustee companies should be required to hold annual public meetings of investors with financial accounts being presented for discussion, as public companies must do. They should allow access for analysts and be encouraged to provide an opportunity for investors and analysts to question trustee company directors about investment strategy, the performance of the fund, cost allocation, the governance structure (including independence), the appointment of trustees and any other issues pertaining to the fund.

2.3 Shortcomings in the advice industry

FSI Observation; page 3-63

Affordable, quality financial advice can bring significant benefits for consumers. Improving standards of adviser competence and removing the impact of conflicted remuneration can improve the quality of advice. Comprehensive financial advice can be costly, and there is consumer demand for lower-cost scaled advice.

From the perspective of an SMSF trustee there are two areas where it is important that regulation is effective. They are:

- regulation of Product and
- regulation of Advice.

The current system of regulation serves only to confuse trustees (and consumers) in these areas. The issue is a structural one; 'product sales' needs to be distinguished from 'advice' (whether general or personal advice). Product sales should be relatively simple and with less regulation for those licensed to produce product. On the other hand, 'advice' (general or personal) should only be given by those appropriately licensed and accredited by a professional association which maintains high educational qualifications, an enforceable disciplinary process and an approved code of ethics and standards which, among other things, bans conflicted remuneration and requires the clients' interests to be paramount.

To put it simply, when SMSF trustees sit across the table from an adviser, they need to know whether the adviser is an independent professional working solely in the best interests of the fund beneficiaries and taking a fee for service or whether the adviser is, in reality, a sales person acting in the interests of the product manufacturer and who may be incentivised to sell that product.

Under current financial adviser training, (apart from that delivered by some universities), critical thinking is marginalized. This form of training is little more than training to sell products and services which suit existing business models. For example, current financial adviser training assumes that actively managed funds which are benchmark aware are a suitable form of investment, despite the clear and consistent evidence that the majority of these funds under-perform their investment benchmarks.

In this regard we submit that an urgent overhaul of the role and involvement of Registered Training Organisations (RTOs) needs to be made. Under current rules for RTOs (which can deliver vocational training to financial advisers, as well as to a wide range of other occupations), far more emphasis is placed on educational mapping than on the calibre of the teachers or course content. Registration of financial adviser education should be singled out for far better quality control than the current system allows.

We submit that any training courses which qualify financial advisers for their professional roles, including Continuing Professional Education, should be undertaken independently of product manufacturers or Institutions/AFSLs unless it is vocational training specially approved or regulated by a recognised professional body.

In the current system the product manufacturer (bank, insurance company, fund manager or APRA regulated superannuation fund - "Institution") becomes an Australian Financial Services Licensee “AFSL" and then in turn licenses the ‘Adviser’. This system may have been appropriate back in the early 90's when a limited number of institutions produced product and when the sales of that product were largely via their 'tied' network of salespeople. However, the market changed very soon after when many new product manufacturers entered with a vast array of products and the superannuation and other laws became ever more complicated.

In this environment trustees and consumers generally sought independent advice but were more than often disappointed because the "advisers" were still part of and licensed to the Institutions/AFSLs. To add to the problem they were employed using 20th century remuneration models, including commissions and trail fees, as was their insurance heritage. Obtaining true independent advice has been a battle ever since.

The problems have been exacerbated by the vertical integration which has since occurred, resulting in the major banks and life insurers, as major product producers, adopting deliberate strategies to control and dominate “adviser” channels.

Where an Institution/AFSL such as a bank is heavily regulated by APRA and ASIC (and in many cases also by the ASX) and where they have a major reputation risk if their product is not true to label or is in any way deceptive, then we recognise that their identified representatives/salespeople should be able to sell a product with less red tape, rather than more.

This would be on the proviso that those representatives/salespeople are clearly identified as such and do not offer advice (either general or personal) other than factually about a product and what it is designed to achieve in a general sense. This may include comparisons with other similar products on the market. It also assumes the institution has appropriate governance in place to deal with breaches of its own and ASIC’s rules.

However, a problem arises when those salespeople are held out to be more than product sellers and are presented as financial planners/advisers. This can and has resulted in SMSF trustees and other investors receiving less than objective advice and being under a misapprehension as to the qualifications and independence of the adviser. This is particularly topical at the moment when realtors and mortgage brokers are reported to be ‘advising’ new real estate investors to buy properties in an SMSF structure.

The structural problem is one of ‘product sales’ versus ‘advice’ (whether or not it is general or personal advice).

The regulation of product sales by Institutions/AFSLs of their own product by their own sales people (identified as such) and for which they take responsibility should be relatively straight forward.

As long as the representative/salesperson is licensed to and clearly identified as such and they do not stray into either general or personal advice then the process and even remuneration could be simplified -- saving red tape. But these people should not be described as or hold themselves out to be a financial planner/adviser.

On the other hand if an SMSF trustee goes to someone called a financial planner or adviser including those who are employed by or licensed to an Institution/AFSL, then a much higher degree of responsibility should be on the planner/adviser. Their designation as a financial planner/financial adviser should be recognised in the corporations law.

They should not only be compliant with their AFSL's own procedures and rules but also they should be subject to and monitored by a professional body whose rules as to education, conflicted remuneration, best interest and fiduciary relationship to their client must be considered superior to their relationship to and rules of their AFSL and whether they give general or personal advice they should not be remunerated in a conflicted manner.

In older professions (doctors, lawyers, accountants etc.) where the trust relationship is such that the adviser is in a position of power over their client (either because of skill or knowledge or both) professions have grown up around the education, conduct of members use of titles etc. and in many instances the profession holds accreditation rights to the members authorisation to practice. In some cases legislative authority also exists to reinforce or even just to recognise the authority of those professions to discipline members.

SMSFOA believes that this link has been missing in the structure of this very important retail sector of the financial services industry, largely because it has grown so quickly and come from a base controlled by Institutions.

SMSFOA accepts that the Government's recent FoFA changes deliver a workable solution but would encourage the FSI to recommend to the Government that the recent Senate Economics Committee recommendations be adopted in so far as they align with the 10 Point Plan submitted by the financial planning profession.

2.4 More to efficiency than external costs

Whilst we acknowledge that management of costs and the encouragement of a competitive market in supply of financial products are significant factors in the development of an efficient superannuation market, the overall structure of the superannuation system also contributes to inefficiencies.

The FSI interim report has commented on a number of taxation matters in relation to superannuation and investment but has not made any comment on the structural efficiency of the current "TTE" superannuation system. That is, T (taxation of contributions); T (taxation of earnings) and E (pension exempt from tax).

We have made a number of submissions to Government regarding the long-term possibility of moving, with appropriate grandfathering, to an EET system – that is E (no tax on contributions); E (no tax on earnings) and T (pension included in an individual's income tax return).

Australia's superannuation system as originally introduced relied on a better taxation structure and if allowed to continue could have led to the Government now being in a better fiscal position.

Originally, neither contributions into superannuation nor earnings on superannuation were taxed but the resultant pension was taxed at on individual's marginal tax rate.

Shortly after the compulsory SG levy was introduced for all workers, the Government introduced taxation of contributions and fund earnings so that for a time there was three-way taxation of super; on contributions, fund earnings and on pension payments. Subsequently, under the

Howard Government, fund earnings and pensions paid in the retirement phase were exempted from tax which remained on contributions and fund earnings before retirement.

The original system was more effective in encouraging savings, resulted in lower long-term cost to Government, substantially simpler to administer and more equitable. Such a system would impose no tax on contributions or superannuation earnings but any pension or lump sum withdrawn from super would be included in that individual's tax return and assessed at his or her marginal income tax rate. The effects would include:

- no requirement for a separate system of taxation of the superannuation funds, considerably simplifying administration;
- no requirement for an actuary for funds with both retired and working members and therefore better able to handle intergenerational administration of the fund;
- retirees income would be subject to the progressive income-tax scales which would discourage lump-sum withdrawals; and
- therefore any changes to income tax rates would impact all Australians – working and retired.

We recognise that moving back to such a system would not be easy. In particular changing to such a system without prejudice to those who have accumulated retirement savings under the present system and without damage to the Government Budget will present challenges.

Changes to the structure and taxation of superannuation must only be made in the context of a holistic review of the system and consistent with a clear plan to move to a better system over time.

We do not believe that any plans to move to a better retirement system should be dismissed just because it appears to be difficult to achieve. Rather, we propose that there should be a healthy debate about how we can move to a better system without substantially disadvantaging any group.

In taking a long-term view of structural improvements to our financial system, the FSI needs to consider the overall structure of superannuation from an efficiency and fairness viewpoint, though we accept this is a very significant policy question which may be addressed in the forthcoming Tax White Paper and any further review of the retirement incomes system.

3 Leverage

> *FSI Observation; page 2-116*
>
> *If allowed to continue, growth in direct leverage by superannuation funds, although embryonic, may create vulnerabilities for the superannuation and financial system.*

We agree there is a risk that high levels of gearing could create vulnerabilities for the superannuation and financial system. The Cooper Report recommended that gearing in superannuation be reviewed after two years and we have repeatedly supported such a review.

Given that under the current system the Government underwrites the risk that someone's superannuation will not last until death – by providing the Age Pension if it doesn't – then we acknowledge Government has an interest in ensuring the risk taken on by superannuation funds is within reasonable bounds.

The Interim Report appears to sometimes mix up the concept of default risk with volatility risk. For the Government there are conflicting risks that:

- Superannuation returns will be too low (depressed by Government restrictions on investments) to accumulate and fund a pension that will keep the taxpayer off the Age Pension; and
- A fund will be too highly geared and will default in a market downturn leading to loss of assets and the taxpayer to become dependent upon the Age Pension.

There is no evidence of widespread abuse of gearing although there has been some concerns that some parties have been ill-advisedly establishing SMSF with high levels of gearing without the proper understanding of the beneficiaries. In particular, there is concern about property promoters encouraging people to set up SMSFs to borrow to invest in residential property.

As the Interim Report notes, the number of SMSFs taking on gearing is relatively small but growing.

We agree that superannuation is fundamentally a savings system and establishing an SMSF to hold one highly geared asset is unwise and contrary to the generally accepted approach of balancing portfolio risk.

We do not believe it is appropriate for SMSFs to have high levels of gearing but we are also wary of Government mandating what SMSFs must and must not invest in. Government prescription as to what and how people can invest has not had a good history of success.

Sensible analysis of SMSF gearing must delineate between the benefits of "protected" SMSF loan products, compared to newer, riskier SMSF lending technology which certainly should be under the microscope.

Investment control is the main reason people set up SMSFs. Many buy and hold assets for the long term – the opposite of the high turnover trading of actively managed "benchmark aware" managed funds. The buy and hold approach accesses a growing income stream from rent or dividends, insulating the capital value of the portfolio from the risk of loss that comes with high frequency trading and investment products like traditional managed funds.

SMSF gearing is required by law to be "limited recourse" - it must not allow the lender to recover any losses from the general assets of the borrower. Apart from selling the secured asset to cover

any loan default, the lender can't chase the borrower to top up any remaining losses. That can lead to systematic risks to the banking sector and that is why – at least in the case of SMSF lending against shares – loan providers typically embed additional protection mechanisms when they lend to SMSFs.

Properly used these protection mechanisms can actually reduce risk to investors.

In the case of protected equity loans and instalment warrants, because the loan subsides the cost of investment, the investor actually enjoys lower risk than if they purchased the share outright. (Assuming that the investor does not multiply their exposure to the underlying shares using multiple instalment warrants, in which case the investor's risk of loss may equal or exceed the full face value of each share).

Further, as long as annual interest payments are made on the instalment warrant loan, the investor retains total control over the loan and hence controls when and if the underlying share is sold. SMSF property loans work similarly – as long as the loan interest is paid, the lender can never force the sale of the property against the wishes of the SMSF.

Typical instalment warrants capitalize the interest cost such that a "default" in payment of interest is in practice impossible to occur.

The concern expressed about SMSF borrowing by the Reserve Bank and others appears to be centred on geared residential property. A distinction should be made between SMSF investment in residential property and commercial/industrial property. We note that the proportion of residential property assets held by SMSFs is relatively lower (3.62%) than the proportion held in non-residential property assets (12.12%) which would include commercial/industrial property. Source: ATO – Self-managed superannuation funds: A statistical analysis 2011-12 – Table 15: SMSF Assets Allocation https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Annual-reports/Self-managed-superannuation-funds--A-statistical-overview-2011-2012/?page=41#Table_15__SMSF_asset_allocations__2012_

The ATO statistics do not give a breakdown of SMSF borrowing to fund property assets. It is likely that some proportion would be undertaken to purchase commercial and industrial property which would be a sounder investment than residential property and which may in many cases be connected with the SMSF owners' business. We suggest that more research is done on the purpose of SMSF borrowing before a blanket restriction is placed on borrowing. Otherwise, a restriction imposed to deal with a perceived problem with residential property may restrict lower risk and more productive leveraged investment in commercial and industrial property for more reliable returns.

Apart from considering some limitation on the extent to which SMSFs can borrow, the issue of property spruiking is being addressed by ASIC's current focus on advisers. We support firm action by ASIC to crack down on dubious property sales promotion and to ensure that advisers who give advice to potential or current SMSF members are properly licensed and fulfil their licence obligations to give sound advice in the interests of their clients. We note that concern about inappropriate investment advice is not limited to SMSFs but more generally to consumers who may be vulnerable to a slick sales pitch, for example encouraging pensioners to use the equity in their house to borrow to invest in property or in poorly managed investment funds.

Another step regulators could take is to examine the sources of finance for property loans to SMSFs and, where they originate from regulated institutions, to ensure that lending criteria are appropriate.

Education of consumers, including potential and existing SMSF members, will help them to better appreciate the risks inherent in investing their superannuation savings. Within our limited resources, SMSFOA would be pleased to work with ASIC and other parties engaged in improving financial literacy. One initiative that might be considered is to develop investment strategy and asset allocation models taking into account the profile of members at various stages of the accumulation/drawdown cycle.

Given the default risk referred to above, one restraint that could be considered is to limit the proportion of a super account's assets that can be secured by any limited recourse borrowing. If this limit was, say, 50%, then, in the event that the value of the geared asset fell below the level of borrowing, the lender would not have recourse to the other 50% of an account's assets and savers would be left with some superannuation to support their pensions.

The gearing level applied to that asset could also be restricted although arguably the market would limit gearing in a limited-recourse situation.

Finally, perhaps any gearing restrictions should only apply when the account is in pension phase.

These measures, and steps to ensure adequate quality of advice to SMSFs and to promote education of trustees on the risks of gearing will help to address the perceived problem.

4 Issues in pension phase

4.1 Development of bond market

> FSI Observation; page 2-86
>
> Australia has an established domestic bond market, although a range of regulatory and tax factors have limited its development.

There are a number of factors that have inhibited the development of the domestic bond market, including:

- Putting aside the most recent developments in the listing and trading of Commonwealth bonds via the ASX, the retail investor has been largely ignored when both governments and corporates have issued bonds. The ease (including price, terms and structure) with which the wholesale markets (both domestically and internationally) have provided debt has not encouraged quality issuers to tap the retail market.
- Added to this has been an ever increasing, complicated and expensive regulatory regime which discourages retail issues even by the major borrowers and has forced the more traditional smaller corporate issuers towards bank facilities. The cost of prospectuses, reporting, registry and other compliance is a major contributing factor.
- Liquidity in the corporate and even the Commonwealth and State markets has always been an issue particularly for an SMSF trustee in the pension phase.
- The fact that interest rates are at an all-time low at present of course has a self-evident effect.
- It is also a fact, that for a number of decades Australians were not net savers at a retail level. While SMSFs now provide a source of savings the market was not anticipating such a strong development and it has come at a time of low rates. Issuers need to make a long term commitment to retail raisings if they want to continuously tap these funds.
- Even where issuers have started to tap retail funds many have sought to complicate the issues with various hybrid structures to suit capital adequacy requirements rather than focus on vanilla bonds and without a depth and variety of choice of pure bond issues the retail investor is not well serviced for choice.

Many SMSF trustees (particularly those in the pension phase) would find access to a variety of quality bond issues, with reasonable liquidity, simplicity in structure and that were traded on a recognisable market, quite attractive when they feel that the cash flow certainty factor is at an appropriate trade off point with return.

Compared to the share market, the corporate and government bond markets in Australia have not recently been strongly supported by retail investors. However, this may change with easier access to debt markets, via such exchange traded products as ASX Government Bonds, and simpler prospectus requirements.

Another factor may be that it is easier and probably cheaper for corporate issuers to raise the large amounts of capital they need on the wholesale debt capital markets in Australia and overseas.

Governments can also find ready buyers for their bonds, particularly from overseas investors who seek the security of AAA rated paper. However, both Commonwealth and State Governments may see value in tapping into the superannuation savings pool to fund infrastructure. Accessing the valuable but very diverse SMSF sector will entail a targeted marketing effort with products tailored to suit SMSF investors in terms of project appeal, parcel size, price of bonds and coupon rates.

It may be that SMSF investors are more familiar with equity markets than they are with debt markets – contrast the heavy media coverage of the share market with comparatively little mention of bond markets – and that their appetite for bonds will grow over time as they become more familiar and comfortable with this form of investment.

We are strongly of the view that bonds – whether issued by corporates or governments – must be able to compete on their merits alongside shares and other forms of investment in terms of price, accessibility, risk and yield.

If the reference to “tax factors” implies that imputation credits disadvantage bond issuers, this is incorrect - see our comment in section 1.4 above.

There should be no element of compulsion to SMSF investment in debt capital instruments. This would run contrary to the obligation of SMSF trustees to exercise their best judgement in the interests of fund members.

4.2 Retirement phase underdeveloped

FSI Observation; page 4-8

The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees.

We agree that it would be preferable if there were more products available that are tailored to meets the needs of retirees attempting to amortise their super over an unknown retirement period.

However, we do not understand or agree with the observation that retirees have to make a once off major decision at retirement. In our experience with SMSFs, whilst the portfolio management may change to allow the account to pay pension at the required or mandated level without having to realise assets in a distressed market, the issue of managing longevity risk need not be addressed until well into the retirement period.

The development of a deep and competitive market in lifetime annuities that an individual could acquire towards to end of his/her retirement period to cover some, if not all, of his/her planned pension until death would be valuable for most SMSF owners. We believe that a stronger and deeper Government bond market is necessary for the lifetime annuity market to develop.

Whilst we can see the advantage of some annuity products, most SMSF owners appear to prefer less-structured products. It is a truism that every layer of ‘structure’ involves a cost which reduces the underlying investment value of the product. Development of minimally structured products may be preferable to many investors. For example, just as there are life insurance products that

pay out when an individual dies – taking the risk on that – a product that pays out when an individual lives beyond life-expectancy might find a ready market amongst SMSF owners who could then manage their fund longevity risk.

A greater range of products that can be used to assist in the management of longevity risk is desirable, and we expect the market will deliver such products as demand grows with an ageing population, but in our view it would be contrary to the ethos of self-responsibility and a retrograde step for government to mandate the acquisition of annuities or other longevity products which would create a captive market for providers. Raising the availability and quality of advice to SMSFs, and the education of SMSF trustees, are preferable to any government mandated investments.

As an example of the perils of government intervention in markets, the US Government's forcing of banks to provide low-cost housing finance without recourse in in the event of default and the investment packaging of these poor quality loans, was a significant factor in destabilising US financial markets and institutions and undoubtedly contributed to the GFC.

SMSF trustees have demonstrated a sound ability to manage their affairs and the Government should ensure that any changes it considers to the superannuation system should have as an objective the further development of this sector and encouragement of SMSF trustees to become further engaged with their retirement savings.

4.3 Impediments to development of 'income' products

FSI Observation; page 4-25

There are regulatory and other policy impediments to developing income products with risk management features that could benefit retirees.

If there are impediments to the development of 'income' products then we would support their removal. We would not agree that the Government should provide any targeted support for such products, although some encouragement of inflation-adjusted bonds might be beneficial.

We understand that many providers of financial products would be arguing to improve their ability to develop and sell such products. However, all such products involve costs that reduce the underlying investment return and SMSF owners tend to be wary of any instrument that they don't understand.

The recent development of the EFT market is an example of the market meeting investor's requirements.

Development of 'income' products that seek to smooth out income are frequently not efficient when compared to an individual following a simple diversification strategy. Volatility not does necessarily damage returns if sensibly managed when one recognises that superannuation should be considered a long-term investment – even in retirement. By comparison, commercial funds, may be driven by frequent performance reporting in the 'competitive' market, may not take an adequately long-term view when structuring products to the detriment of long-term investment returns.

SMSFOA Response to the Interim Report of the Financial System Inquiry – August 2014