

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

**Response to the Final Report of the Financial System Inquiry  
31 March 2015**

## **SMSFOA Response to the Final Report of the Financial System Inquiry**

The SMSF Owners' Alliance made an initial submission to the Financial System Inquiry in March 2014 and provided a detailed response to the Interim Report in August 2014. A link to this submission is provided for easy reference.

We do not propose, in this response to the Final Report, to traverse all the ground covered in our earlier submissions.

Some of the issues raised in the Final Report's Recommendations, Significant Matters and Tax Summary sections will be examined in the forthcoming Taxation White Paper process, in response to which SMSFOA intends to make a substantial submission.

So in this submission we confine ourselves to some brief comments on two important issues raised in the Final Report:

- The objectives of superannuation
- Dividend imputation

And, in Table 1, give a general response to the Final Report recommendations relevant to superannuation generally and self-managed funds in particular.

### **1. The purpose of superannuation**

A significant recommendation in the Final Report is that broad political agreement should be sought on the objectives of the superannuation system and enshrined in legislation. We strongly agree. While it probably always will be necessary to review and improve the superannuation system as it evolves, a bipartisan approach will lessen the urge by Governments to tinker with superannuation and give Australians more confidence that their superannuation savings are secure without the rules being changed mid-stream to their detriment. Ideally, superannuation should be a 'no go zone' in the Federal Budget.

The primary objective suggested in the Final Report: *"To provide income in retirement to substitute or supplement the Age Pension"* and the subsidiary objectives listed in Table 3 is a minimalist definition.

We believe that an over-arching statement of objectives should also include a measure of what is considered to be an appropriate level of income in retirement relative to pre-retirement income. The concept of a Reasonable Replacement Rate, as accepted by the OECD and as discussed in the 2010 *Australia's Future Tax System Review* headed by Dr Ken Henry, is relevant and appropriate.

SMSFOA will canvas some policy options for a more effective, fair and efficient superannuation system that will deliver a reasonable replacement rate in the submission we are preparing for the White Paper process

A review of the fundamental purpose of superannuation inevitably will raise questions about how it is structured and the appropriate use of tax concessions to enable and encourage retirement savings. Changes to the system should not be to the detriment of people who have followed the rules to date and may have made important decisions about the timing of their retirement and standard of living they can expect in retirement based on the existing rules.

## **2. Dividend imputation**

SMSFs rely on franked dividends from corporations as a dependable source of income to grow their fund assets and underwrite the pensions they draw from their funds.

Dividend imputation was introduced, correctly in our view, to eliminate double taxation of corporate profits and remove the distortion 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 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 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 a reason why SMSF's largest investment category is Australian equities. Unwillingness to take on currency and sovereign risk may be another. 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 tax 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 corporate earnings (dividends) would be paid out of corporate after-tax earnings but interest and coupon 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 as suggested in the FSI report. Other factors, such as price, risk, accessibility and the appetite of wholesale investors, especially from offshore, are also at play.

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 and the bias in favour of debt funding.

### **3. General response to the Final Report's Recommendations**

In its Final Report, the Financial System Inquiry presents a generally thoughtful analysis of the strengths and weaknesses of the Australian financial system. It discusses the enabling role of the financial system in the Australian economy and points to some areas of concern, including that the superannuation system is not delivering retirement incomes efficiently.

SMSFOA agrees with these concerns. Apart from the cost of managing the system, which may be reduced with more competition among funds, the longer term outcomes of the superannuation system, as it is presently structured, are inadequate.

In its current settings, superannuation is not enabling most Australians to save enough during their working lives to be financially self-sufficient throughout their retirement. The 2015 Intergenerational Report noted that about 70% of people of pensionable age are now receiving the Age Pension. In 40 years, some 67% will still be drawing an Age Pension though more of them will be on a part pension. It is disturbing that 60 years on from the introduction of the superannuation system it is predicted that the majority of Australians will still be drawing a publicly-funded pension.

In contrast, self-managed superannuation funds are a shining example of success. They are already enabling many Australians to achieve the objective of financial independence in retirement. The success of self-managed funds is drawing unwarranted criticism.

This is generally based on claims that superannuation tax concessions are firstly, costing the Budget too much and secondly, skewed in favour of the better off.

Both of these claims are based on false premises. The supposed \$32 billion cost of superannuation tax concessions has achieved mythical status in some economic commentary and in some sections of the media, but has been exposed by SMSFOA and other commentators as misleading and wrong. Recently, a senior Treasury official has acknowledged that the Tax Expenditure Statement figures have no policy message and cannot be used to claim that Budget savings of that order can be made. Treasury should also confirm that the \$32 billion number is mathematically incorrect as it is derived from two components – concessions on contributions and on fund earnings – that Treasury says cannot be added together. However, in spite of that caution, Treasury did add these components in Table 1 of the 2012 Tax Expenditure Statement to create the \$32 billion figure in the first place. It has since become part of the folklore. Treasury has a responsibility to point out clearly when its numbers are misused in economic debate and media commentary, especially one so fundamental to the discussion about the cost and fairness of superannuation.

The FSI’s Final Report claimed that superannuation tax concessions are unfairly biased towards those on higher incomes and pointed out that the top 20% of income earners received about 55% of superannuation tax concessions. However, it did not acknowledge that the same 20% of taxpayers pay about 65% of income tax collected.

Superannuation tax concessions should not be viewed in isolation, but seen as a component of the overall taxation system. It is to be hoped that the Taxation White Paper will provide an objective analysis of where the weight of taxation falls and who does the heavy lifting on tax so a better informed discussion about the fairness of superannuation and other tax concessions can be held.

**Table 1 – SMSFOA response to relevant FSI recommendations**

<b>FSI Recommendation</b>	<b>SMSFOA Response</b>
<p>8. Direct borrowing by superannuation funds. Remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds.</p>	<p>Disagree. While borrowing is not undertaken by the majority of SMSFs, if undertaken sensibly it can be an appropriate strategy to grow fund assets, particularly for commercial and industrial property which can deliver higher and more predictable returns than residential property. Such property may support the SMSF owners’ business. Banning leveraged investment by SMSFs is an over-reaction to a relatively minor, albeit growing, asset allocation that can be monitored and if necessary better dealt with by lending controls (overseen by APRA in the case of financial institutions), targeted</p>

	<p>enforcement action by ASIC against unlicensed advisers; and reform of State legislation covering property developers and real estate agents. If the Government is genuinely concerned about borrowing by SMSFs causing a systemic risk, then such borrowing can be constrained by placing a cap on the gearing of fund assets. Policy decision making would be assisted if the ATO publishes statistics showing the proportion of borrowing by SMSFs for investment in residential property compared to borrowing for investment in commercial and industrial property and for other investments. It is not clear why FSI recommended a ban on direct borrowing, largely for property purchases, but not on borrowing for investment products such as warrants which carry market risk. More detailed comments on gearing were contained in SMSFOA's response to the FSI Interim Report – a link is provided below.</p>
<p>9. Objectives of the superannuation system: Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term.</p>	<p>Agree. Every working Australian and their family has a vital interest in the adequacy, sustainability and fairness of the superannuation system. It is a significant factor in their economic well-being throughout their working lives and retirement spanning over 60 years. Superannuation policy should be stable and predictable to encourage confidence in saving. A bipartisan approach to superannuation should foster stability and ensure that change is only made when it leads to positive outcomes. The purpose of superannuation and a broad performance benchmark – the concept of a Reasonable Replacement Rate – should be agreed and grounded in legislation. Once set, the superannuation system should not be subject to Budget pressures.</p>

<p>11. The retirement phase in superannuation. Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.</p>	<p>Agree. This is generally more relevant to members of APRA-regulated funds than to self-managed funds, but many SMSF members also have accounts with APRA funds. There is limited competition in the market for comprehensive retirement income products (CIPRs) and existing and new providers should be encouraged to develop a wider range of tailored products at reasonable cost. Use of these products should always be voluntary. The FSI Report rightly acknowledges that self-managed fund trustees should not be required to design or offer CIPRs because the trustees are the fund's members.</p>
<p>12. Choice of fund. Provide all employees with the ability to choose the fund into which their Superannuation Guarantee contributions are paid.</p>	<p>Agree.</p>
<p>13. Governance of superannuation funds. Mandate a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair; align the director penalty regime with managed investment schemes; and strengthen the conflict of interest requirements.</p>	<p>Agree. In SMSFOA's submission to the Treasury review of the governance and transparency of superannuation funds, we argued strongly for greater transparency of the trustee companies that administer APRA regulated superannuation funds. We said these funds should have a majority of independent directors and should meet the same standards of governance as public corporations, being subject to the Corporations Act and the ASX Governance Principles. Our submission said APRA funds should disclose the process of trustee appointments, fees taken from members' accounts and how members' money is spent. A link to our submission is below.</p>
<p>22. Introduce product intervention power.</p>	<p>Agree. If it is to be an effective and respected regulator, feared by unscrupulous product providers and sellers, ASIC needs the power to</p>

<p>Introduce a pro-active product intervention power that would enhance the regulatory toolkit available where there is a risk of significant consumer detriment.</p>	<p>intervene on a market-wide basis in a timely manner when significant consumer detriment is detected without having to first prove in court there has been a breach of the law. As the FSI Report says, this power will need to be exercised sparingly and kept under review.</p>
<p>23. Facilitate innovative disclosure. Remove regulatory impediments to innovative product disclosures and communications with customers, and improve the way risk and fees are communicated to consumers.</p>	<p>Agree.</p>
<p>24. Align the interests of financial firms and consumers. Better align the interests of financial firms with those of consumers by raising industry standards, enhancing the power to ban individuals from management and ensuring remuneration structures in life insurance and stockbroking do not affect the quality of financial advice.</p>	<p>Agree.</p>
<p>25. Raise the competency of advisers. Raise the competency of financial advice providers and introduce an enhanced register of advisers.</p>	<p>Agree. The Government should implement the recommendations of the report in December 2014 of the Parliamentary Joint Committee on Corporations and Financial Services dealing with proposals to lift professional, ethical and education standards in the financial services industry.</p>
<p>27. Regulator accountability. Create a new Financial Regulator Assessment Board to advise Government annually on how financial regulators have implemented their mandates. Provide clearer guidance to regulators in Statements of Expectation and increase the performance indicators for regulator performance.</p>	<p>Disagree. We agree that regulators need to be held accountable, but do not believe the creation of another layer of bureaucracy is necessary if it entails cost to taxpayers. The Government and Parliament are already able to monitor the activities and performance of regulators and to call them to account. Government agencies are also subject to the discipline of the Budget process. Clarifying Statements of Expectation and recalibrating performance indicators are sensible steps. Regulators should have internal review</p>

	processes to ensure they efficiently and effectively carry out their mandate.
<p>28. Execution of mandate. Provide regulators with more stable funding by adopting a three-year funding model based on periodic funding reviews, increase their capacity to pay competitive remuneration, boost flexibility in respect of staffing and funding, and require them to undertake periodic capability reviews.</p>	<p>Agree. These objectives should be achieved within Budget allocations and not result in any significant increase in funding for regulators.</p>
<p>29. Strengthening the Australian Securities and Investments Commission's funding and powers. Introduce an industry funding model for the Australian Securities and Investments Commission (ASIC) and provide ASIC with stronger regulatory tools.</p>	<p>Disagree. We are wary about giving regulators power to impose levies. Recent experience with changes to the ATO's SMSF supervisory levy did not fill us with confidence that proper processes were followed, including the carrying out of a regulatory cost impact analysis after the levy had been decided. We estimate that the increased ATO supervisory levy, over time, will have a larger impact on the asset worth of SMSFs than the GFC did. Public funding ensures the independence and accountability of regulators. ASIC's responsibility to ensure fair market conduct and product integrity is a benefit to everybody and should be funded via the Budget.</p>
<p>30. Strengthening the focus on competition in the financial system. Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investments Commission's mandate.</p>	<p>Agree.</p>

<p>32. Impact investment. Explore ways to facilitate development of the impact investment market and encourage innovation in funding social service delivery. Provide guidance to superannuation trustees on the appropriateness of impact investment. Support law reform to classify a private ancillary fund as a 'sophisticated' or 'professional' investor, where the founder of the fund meets those definitions.</p>	<p>Disagree. In principle, we strongly oppose directed investment and attempts to influence superannuation funds to invest their members' money in accordance with social objectives. Impact investment is a relatively new concept and may offer investment options that some superannuation fund trustees may wish to consider. However, trustees have a legal obligation to act in the best interests of their members and should not be pressured into making investment decisions influenced by social objectives.</p>
<p>33. Retail corporate bond market. Reduce disclosure requirements for large listed corporates issuing 'simple' bonds and encourage industry to develop standard terms for 'simple' bonds.</p>	<p>Agree. This will reduce compliance costs for corporates. More significant factors for SMSF investment in corporate, government and infrastructure bonds are:</p> <ul style="list-style-type: none"> <li>• Easy access to the bond market – the ASX has created opportunities for investors to purchase market-traded corporate and government bonds.</li> <li>• Marketing of bonds and other capital raising products in 'bite sized' packages attractive to self-managed funds in what is mainly a wholesale market often dominated by offshore investors.</li> <li>• Price and risk.</li> </ul> <p>Again, investment in public bonds, e.g. infrastructure bonds, must be left to the discretion of fund trustees and there should be no directed or policy induced investment.</p>
<p>37. Superannuation member engagement. Publish retirement income projections on member statements from defined contribution superannuation schemes using Australian Securities and Investments Commission (ASIC) regulatory guidance.</p>	<p>Agree.</p>

Facilitate access to consolidated superannuation information from the Australian Taxation Office to use with ASIC's and superannuation funds' retirement income projection calculators.	
40. Provision of financial advice and mortgage broking. Rename 'general advice' and require advisers and mortgage brokers to disclose ownership structures.	Agree. It is important for SMSF trustees and other investors to know whether the person they are dealing with is selling a product for his/her employer or acting solely in the interests of the investor as an independent adviser. General Advice might be more accurately defined as Product Advice.

**Links:**

**SMSFOA's Submission in response to the Interim Report of the Financial System Inquiry.**

[http://www.smsfoa.org.au/images/advocacy\\_2014/140826%20-%20SMSFOA%20Response%20to%20FSI%20Interim%20Report%20FINAL2.pdf](http://www.smsfoa.org.au/images/advocacy_2014/140826%20-%20SMSFOA%20Response%20to%20FSI%20Interim%20Report%20FINAL2.pdf)

**SMSFOA's submission to the Treasury review: Better Regulation and Governance, Enhanced Transparency and Improved Competition in Superannuation – February 2014**

[http://www.smsfoa.org.au/images/advocacy\\_2014/140212%20-%20SMSFOA%20submission%20on%20better%20regulation%20governance%20transparency%20of%20super%20funds.pdf](http://www.smsfoa.org.au/images/advocacy_2014/140212%20-%20SMSFOA%20submission%20on%20better%20regulation%20governance%20transparency%20of%20super%20funds.pdf)