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

16 September 2016

SMSF Owners' Alliance comments on the Productivity Commission's Draft Report:

How to Assess the Competitiveness and Efficiency of the Superannuation System

The SMSF Owners' Alliance appreciates the opportunity to comment on the Productivity Commission's Draft Report on 'Criteria to Assess the Efficiency and Competitiveness of the Superannuation System'.

The Draft Report is a comprehensive listing of the factors that should be taken into account in assessing the efficiency and competitiveness of the superannuation market. We agree the factors identified in the Draft Report are relevant and will facilitate a thorough assessment of efficiency and competition. As we broadly agree with the Draft Report, which covers many of the points made in our original submission, we will confine our comments and suggestions mostly to Appendix G which deals with self-managed superannuation funds.

However, first, we question the Draft Report's reference to the Government's proposal to legislate the objective of superannuation. The Draft Report says: *"The Government's objective is framed within the principles of fairness, adequacy and sustainability, and casts superannuation as only one part of the broader retirement income system."* Our view is that the proposed objective does not simply cast superannuation as only one part of the retirement income system. It positions the age pension as the central pillar and relegates the role of superannuation to substituting and supplementing the age pension. Instead, the age pension should be considered as a safety net to look after those who are not able to fund their own retirement while everyone else should be encouraged to achieve financial independence in retirement with the help of tax incentives to save. The intent of government policy should be to maximise superannuation and reduce pressure on the age pension. Realistically, this recalibration of the retirement incomes system will take a long time (the 2015 Intergenerational Report estimated that two thirds of Australians would still be fully or partially reliant on the age pension by 2055) but the objective of shifting the onus of retirement funding from taxes taken from future generations to savings made by current generations should be set now in legislation.

Measuring the Objective

Given the Objective chosen, it would seem a correct first step to quantify the task at hand so that an objective assessment can be made as to the efficiency and effectiveness of the 'system' to meet that quantified task. In this regard, and given the narrowness of the Objective, we suggest that it would be appropriate to first measure the future unfunded liability of meeting age pension payments from the budget. Similar assumptions as are used for the valuation of the Commonwealth's unfunded defined benefit pension liabilities could be used.

Appropriate level of retirement income

The Draft Report correctly notes that: *"This objective does not address the question of what level of retirement income superannuation should generate.*" This is a major shortcoming in the Government's proposed objective. It sets no broad performance benchmark for superannuation. We have suggested that the objective should be for superannuation to provide an income in retirement equivalent to about two-thirds of pre-retirement, after-tax income, a concept known as the Reasonable Replacement Rate.

We appreciate that the Commission does not set Government policy but do question whether it is possible to make a considered judgement about the efficiency of the superannuation system if the formal statement of its purpose does not set a performance benchmark nor, as noted above, if the unfunded task is not defined

Competition

The main competitive dynamic in the superannuation system is the existence of self-managed superannuation funds. SMSFs account for a third of Australia's superannuation savings, comprising the largest sector of the superannuation industry with more assets than any of the industry, retail, corporate or public sectors.

They are successful because they offer self-control of retirement savings for people who wish to take on this responsibility and flexibility of investment choice and risk appetite. They provide an option for people who want to take control of their own retirement savings and who may be disenchanted with the major pooled funds (APRA funds).

Transparency

Transparency is vital if people are to be able to make well-informed choices in a competitive market.

In our 2014 submission to the Treasury review of Better Governance, Transparency and Competition in Superannuation we made the point that APRA funds hold more savings in trust than the banks hold in deposits and therefore they should be subject to the same degree of prudential supervision as banks and the same governance and transparency standards as banks and other public companies.

In superannuation, transparency needs to be deeper than just informing fund members of their account balance and investment return, though many may be satisfied just with that level of information. For the more discerning investors, as well as for market analysts, regulators and government agencies, particularly high standards of disclosure and transparency should apply to the trustee companies managing the funds that hold people's retirement savings in trust.

Disclosure by trustee companies should include:

- How trustee companies and funds earn revenue, identifying all sources:
    - fees and charges to fund members (identifying administration charges and percentage fees on funds held in the account)
    - any fees taken by a fund from investment income before striking a unit price
    - income derived from the unit price spread (the difference between the buy and sell price of units)

    - any fees, commissions or other payments related to life and permanent disability arrangements with external insurance providers
    - any use of tax refunds by the fund without passing on the full benefit to members
- How trustee companies and funds spend their members' money, identifying significant cost items. These should include:
    - remuneration of trustees and senior executives
    - any commissions paid
    - marketing expenses, particularly for public offer funds seeking to acquire new members outside the default group to build market share
    - membership and other payments made to industry associations/advocacy groups (amount, recipient and purpose)
    - donations made to organisations, particularly if related to employer/employee sponsors (amount, recipient and purpose)
- The basis on which taxes, e.g. earnings tax and capital gains tax, are allocated to individual member accounts, including the allocation of unrealised capital gains on account closure.

Such transparency is necessary if people are to be able to make an informed choice on to whom they can entrust their retirement savings.

Aggregation of SMSF data

It should be borne in mind, when SMSF data is aggregated, that the average numbers produced may well conceal a wide range of performance. The performance of each fund will vary according to the investment strategy adopted by the trustees – which may change over time as the fund members grow older – and the degree of risk they are willing to take on their investments. There can be no 'one size fits all' approach to SMSFs.

The Draft Report correctly notes that the assessment of allocative efficiency needs to account for the institutional differences between the SMSF and APRA-regulated sectors, in particular that members and trustees are one and the same and that the members have actively chosen to manage their own retirement money, set their own investment strategy and their own risk parameters.

Performance

Assessing the performance of superannuation funds in terms of return on funds invested is clearly of paramount importance for members of pooled superannuation funds (APRA funds) as their fund balance and pension value will be directly affected by the investment returns achieved by the fund managers.

The performance of self-managed funds can be calculated in aggregate but it is not such a relevant benchmark as it is for the members of APRA funds. The true test of self-managed funds is whether their investments generate enough income to meet their members' expectation of an adequate income in retirement. These expectations will vary.

The trustees of SMSFs have an obligation to manage the fund in the best interests of the members of the SMSF. Conforming to this obligation is assured because the trustees and members are usually one and the same individuals. How they meet that obligation will depend on their own aspirations, what they believe to be an adequate retirement income and appetite for risk.

As the Draft Report notes, SMSFs tend to be more conservative and cautious investors than the managers of pooled APRA funds. Liquidity risk is an entirely different matter for an SMSF than it is for a major pooled fund which has significant cash flows in and out which can be managed as appropriate without upsetting the underlying assets. This probably is one explanation why prudent SMSF trustees will hold proportionately more cash. SMSFs hold a large proportion of their assets in cash and Australian equities with negligible investment in overseas shares; while APRA funds have lower holdings in cash and invest more in overseas equities. But as with a comparison of returns aggregation of asset classes of individual SMSFs has less meaning.

Perhaps the most significant difference giving rise to the difficulty in comparing pooled funds returns and asset mix with SMSF grouped statistics, is that SMSF trustees, in setting their asset allocation strategy, will take into consideration (apart from their specific risk, liquidity, life expectancy, state of health) their assets and liabilities that lie outside super. To them the SMSF is only part of their lifetime wealth strategy – this is a major benefit of having control but does cause significant differences when viewed against the 'average 'APRA pooled fund statistics.

We agree with the comment in the Draft Report (Appendix G – P15) that the rapid growth of SMSFs and relatively low set-up costs indicate that barriers to entry are relatively low and hence would not need to be a central focus of the Commission's assessment of competition. As noted in the Draft Report, the nature and extent of competition among service providers (such as financial advisers and accountants) to SMSFs is relevant, however the market for these services appears to be well supplied and innovative use of technology, such as the emergence of low-cost, online management tools is further driving competition.

We agree with the Draft Report that the popularity and rapid growth of SMSFs may indicate competition and efficiency issues problems and distortions elsewhere in the superannuation system.

The unique advantage of a guaranteed and ever growing flow of funds into superannuation via the SG places a greater responsibility on the APRA funds to ensure efficient management of their members' funds and keep the costs charged to members low.

Taxation

The Draft Report notes, quoting research, that minimising tax is one of the factors that influence people to set up self-managed superannuation funds.

It should be acknowledged that the taxation of self-managed funds is the same as taxation of APRA funds. The same tax laws apply to each.

SMSFs are seen to provide an advantage in that the investment mix and consequent taxation of the returns can be changed quickly. The taxation advantage is flexibility; (for example, some third party fund manager or the pooled super fund itself is not making decisions about whether or not to take capital gains, the SMSF Trustee does this in a way that best suits their fund). It is not that different taxation rules apply to self-managed funds or that they are liable to pay less tax.

The complication of unit pricing in most pooled funds does have an effect particularly when a member is changing from the accumulation to pension phase because of the effect of capital gain and loss accruals in the calculation of the unit price and their 'rough' allocation across all members of the fund. However this treatment is entirely chosen by the fund for administrative ease. There are pooled funds with more sophisticated systems which allocate tax per member per day.

SMSF trustees, representing their members, pay only the tax that is actually owed on their assets – the taxation cost is not spread across many members as it is with APRA funds.

SMSF data

The Draft Report observes (Appendix G – P17) that while data on the SMSF sector are not perfect, there appear to be no material data gaps.

The ATO Statistics on SMSFs (comprising an Annual Overview and Quarterly Reports) provide much useful data on self-managed funds, however there are still items that could usefully be included. The suggestions below would assist efficiency in the sense of providing the Commission, and the market generally, with more comprehensive information about the SMSF sector. It would also have the benefit of providing a more informed basis on which policy decisions about superannuation can be discussed in public and eventually made by government after proper consultation and due consideration.

1. *The value of non-concessional contributions.*

The ATO SMSF Statistics do not give a break-down of concessional v non-concessional contributions to SMSFs.

We assume this data would be available from the annual tax returns of funds. It appears to be available to Treasury as the Government made calculations on the revenue to be gained by the 2016 Budget measure to impose a $500,000 lifetime non-concessional contributions cap.

Public discussion about the taxation of superannuation would be better informed if the extent to which superannuation assets are sourced from non-concessional contributions, on which income tax has been paid, is known.

2. *Investment in non-residential property*

The ATO Statistics give numbers for SMSF assets in residential and non-residential property both in Australia and overseas. As with other asset classes, virtually all SMSF investment in property is made in Australia.

Investment in non-residential property may be in commercial/industrial property for the purpose of generating rental income and/or capital gains. In many cases, it may also be an investment related to the SMSF members' business. For example, the owners of a car repair business may use their superannuation fund to invest in the garage from which they conduct their business.

It would be useful to know to what extent investment in non-residential property is related to the business interests of SMSF members if this information can be extracted from tax returns.

3. *Multiple superannuation accounts*

It may be possible for the ATO to report on the number and value of accounts which SMSF members hold with APRA funds and, if possible, if they are also the beneficiaries of defined benefit superannuation schemes.

4. *Demographics*

The ATO Stats give some demographic data – the age and income profiles of SMSF members and the number of SMSFs and the value of their assets by State. This data could usefully be supplemented by additional information on the occupations of SMSF members by broad category, e.g. tradespeople, professionals, farmers, public servants, self-employed, retired and perhaps whether they live in metropolitan or regional areas. Analysis by post code would be useful if such an exercise can be done efficiently.

These suggestions are made on the basis that new information provided in the ATO Statistics on SMSFs should be drawn from tax returns without requiring significant extra compliance effort by SMSF trustees and their advisers and no significant additional cost to the ATO that would be passed on to SMSFs.

Regulatory risks

Government policy and legislation affecting SMSFs is subject to change from time to time. Governments should be required to demonstrate via regulatory impact statements that changes to superannuation will not inhibit competition or compromise efficiency.

Regulatory costs for SMSFs should be kept low and predictable. The sudden 50% hike in the ATO SMSF Supervisory Levy in 2013 imposed a cost burden on SMSFs amounting to $322 million over three years with a consequent reduction in the SMSF savings pool. Compounded over time, increases in regulatory costs can be very significant, even outweighing the effect of major market disruptions and volatility on superannuation fund assets.

Financial literacy

The Draft Report refers to research* that indicates that SMSF members have below average numeracy and financial literacy.

This seems counter-intuitive.

The survey results are somewhat contradictory. They conclude that SMSF Members are more likely to be:

"…better educated, better informed about SMSF rules, more risk tolerant, rate themselves as having a high understanding of finance, have an internal locus of control, trust financial professionals."

But, less likely to be:

"…highly numerate, highly financially literate, distrusting of financial professionals."

*Bird et al. 2016

The Draft Report cautions (Box B.7) that surveys on superannuation can be difficult to interpret and results may be affected by the methodology used and the questions asked.

Whatever their level of financial literacy and numeracy may be, SMSF trustees generally seem to get it right as the performance of SMSFs is comparable to that of the professionally managed APRA funds taking into account the typically conservative investment bias of SMSF trustees and that costs are much lower.

////