Financial System Inquiry

Submission by Switzer Financial Group Pty Ltd

1. Introduction

1.1 Switzer Financial Group is the holder of an Australian Financial Services Licence (AFSL No, 286531). It specialises in providing financial services to the members and trustees of Self Managed Superannuation Funds (SMSFs).

1.2 Through its financial planning practice, Switzer provides personal financial advice to retail clients. Many of these retail clients use an SMSF as the entity to manage and grow their super monies.

1.3 Switzer is also the publisher of the *Switzer Super Report*, Australia's leading investment newsletter for the trustees and members of SMSFs. Published three times a week, the *Switzer Super Report* is distributed to more than 5,000 subscribers. (see www.switzersuperreport.com.au)

1.4 While the focus of the *Switzer Super Report* is on the provision of general advice relating to investing the funds of an SMSF, the report also covers regulatory and compliance issues relating to managing and administering an SMSF, changes to any super laws and superannuation strategies.

1.5 Our expert contributors include Peter Switzer, Paul Rickard, Charlie Aitken, Roger Montgomery, Barrie Dunstan, Tony Negline, Penny Pryor, James Dunn and Professor Ron Bewley.

1.6 Most of our subscribers do not have a financial adviser, preferring to take control of the asset allocation and investment processes. This is in keeping with what we understand to be the situation across the industry, where surveys consistently show that, of the circa 500,000 SMSFs, more than half do not have a financial adviser.

1.7 Switzer Financial Group welcomes the opportunity to provide a submission to the Financial System Inquiry, and in keeping with the outlined consultation process, has chosen to provide comments on areas where we consider we can offer a unique insight.

1.8 Our submission focuses on the role Self Managed Superannuation Funds (SMSFs) play in producing a dynamic, competitive, innovative and vibrant superannuation market place. Further, we consider the issues of the ageing population and linkages with pension and preservation ages, and offer a perspective on whether there is actually retail investor interest in the development of the much hyped corporate bond market.

2. The growth of SMSFs

2.1 The number of Self Managed Superannuation Funds (SMSFs) has almost doubled over the last nine years – from 271,515 in June 2004 to 509,362 in June 2013[1]. Over the same period, the number of members has increased from 524,000 to 964,000[2]. Total assets have grown from $127.5bn to $506bn, and the market share of the superannuation pool held by SMSFs has increased from 20.0% to 31.3%[3].

2.2 Clearly, many Australians love the idea of managing their own superannuation monies and they are voting with their feet.

2.3 Our work with clients and subscribers suggests that the popularity of SMSFs is due in the main to four key reasons – control, potentially improved taxation outcomes, flexibility and cost savings. Some of these reasons may be perceived rather than real, and in some cases, the driver can be dissatisfaction with their current industry or retail fund provider.

'Control' means the ability to determine the fund's investment strategy and which investments the fund makes. For business owners, the ability for the SMSF to purchase the business's property and then lease it back to the business is a key driver. For others, the ability to invest in alternative asset classes such as collectables, or for example to have a much higher weighting to shares paying fully franked dividends, are important benefits. In certain circumstances, improved control may also extend to how superannuation death benefits are distributed.

While all superannuation funds are subject to the same taxation arrangements, trustees of SMSFs can potentially exercise more control over the taxation outcomes of the fund through their investment selection and timing thereof. While a retail or industry fund seeks to optimise the taxation outcomes for the members in aggregate, an SMSF can optimise the taxation outcomes for the individual member. Further, many retail or industry funds are not able to support the ready transfer of a member's funds from accumulation phase to pension phase, and charge the member an "assessed" capital gains tax impost.

SMSFs can also potentially be more flexible than other superannuation funds. This flexibility can extend to the implementation of more complex strategies (for example, maintaining both accumulation and pension accounts for the same member, or running multiple pension accounts for the same member). Further, if there is a legislative or taxation change (up until 2013, all too frequent), an SMSF can potentially adapt to these changes earlier and more specifically than a large retail or industry fund.

Finally, many trustees maintain that they can run their SMSF more cost effectively than the alternative of an industry or retail fund. The Rice Warner study commissioned by ASIC[4] concluded that compared to APRA Regulated Funds, "at sizes above $500,000, SMSFs can be the cheapest alternative"[5]. "SMSFs with $200,000 or more are competitive with both industry and retail funds

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[1] APRA Annual Superannuation Bulletin 2013, revised 5 February 2014
[2] ibid
[3] ibid
[4] ASIC Consultation Paper 216 September 2013, Rice Warner 'Cost of Operating SMSFs – May 2013'
[5] Rice Warner 'Cost of Operating SMSFs – May 2013' – pg 10

provided the trustees undertake some of the administration"[6]. While we believe that Rice Warner was conservative in this second statement and misinterpreted some of the "nice to haves" such as online reporting and analysis as administrative services, their underlying findings support the belief many trustees hold that there are cost savings in running their own SMSF. The average SMSF balance is very close to $1,000,000[7].

2.4 The popularity and growth of SMSFs is a major source of competitive pressure to the industry and retail funds. This pressure is driving APRA regulated funds to be more innovative in their product offerings (for example, Australian Super's Member Direct Investment Option, which now has more than $1.0bn in funds [8], or ING Direct's Living Super[9]). Downward pressure is being exerted on the investment management and administration fees charged by the retail and industry funds.

2.5 Any lessening of the competitive pressure that SMSFs apply puts at risk these positive developments, which ultimately may lead to the Australian consumer paying more for the management of their superannuation monies and having less money to enjoy in retirement.

3. Performance of SMSFs vs APRA Regulated Super Funds

3.1 Studies by the Super System Review, the Australian Taxation Office and more recently by Rice Warner, have confirmed that the trustees of SMSFs deliver satisfactory outcomes in managing the investments of their fund.

3.2 Rice Warner was commissioned by ASIC to review the cost effectiveness of operating an SMSF, and as part of this study, compared the aggregate investment performance of the SMSF sector to APRA regulated funds. According to Rice Warner[10] , the aggregate investment returns (gross of fees) for the APRA and SMSF segments were as follows:

Table 1- Investment Performance of APRA & SMSF Funds

Year Ending 30 June	APRA Funds	SMSFs
2005	13.25%	17.4%
2006	14.0%	16.0%
2007	15.6%	20.1%
2008	-7.6%	-4.0%
2009	-11.9%	-4.5%
2010	9.8%	8.3%
2011	8.7%	11.25
7 Year Average	**5.4% pa**	**8.8% pa**

[6] ibid – pg 9
[7] APRA Annual Superannuation Bulletin 2013, revised 5 February 2014
[8] see http://www.australiansuper.com/investments-and-performance/super-investment-choices/member-direct.aspx
[9] see http://www.ingdirect.com.au/superannuation/living-super.html
[10] Rice Warner 'Cost of Operating SMSFs', May 2013 – pp 16-17

3.3 This is a massive difference in performance – 3.4% pa over seven years. Moreover, the SMSF sector delivered higher returns than the APRA sector in six of the seven years, and in good as well as bad years.

3.4 The conclusion from Rice Warner, though somewhat understated, is telling. "These results may not support the proposition that SMSFs are better investment managers than APRA funds, but they do indicate that members of SMSFs, in aggregate, are not disadvantaged when compared to APRA funds".[11]

3.5 An alternative conclusion could potentially be: "The members of APRA regulated funds, in aggregate, are disadvantaged when compared to SMSF members".

3.6 While these findings consider the aggregate performance of the industry segments, and individual funds will have quite different investment performance and quite different asset allocations, the magnitude of the difference suggests that in the main, SMSFs, after costs, are doing pretty well.

4. SMSFs myths exposed

4.1 Some of the more common myths about SMSFs and their members/trustees are as follows:

- there is a looming crisis developing with SMSFs borrowing to invest in property;
- there has been a massive shift into cash/term deposits post the GFC;
- SMSFs are just waiting to invest in infrastructure assets or corporate bonds;
- there are compliance issues with SMSFs; and
- SMSF members want a compensation scheme.

In this section, we explore these myths.

4.2 Borrowing by SMSFs to invest in property is not out of control. According to the most recent data from the ATO, total investment by SMSFs in residential property is $19.42bn[12]. This represents only 3.57% of total SMSF assets. Investment in business property, which has always been higher and an important driver in the growth of SMSFs (see 2.3 above) is $64.86bn, or 11.9% of total assets. In aggregate, an allocation of 15.5% is well within the expected range to property as an asset class.

While there have been some issues with Limited Recourse Borrowing Arrangements (LRBAs), which received a boost when the ATO revised a taxation ruling that effectively allows Trustees to access other capital inside the fund to "improve" the property[13], these issues will diminish as lenders start to better manage their risks. A number of lenders were determining servicing eligibility essentially around the continuity of contributions and rental income, and placing no emphasis on the other investment income of the fund. This approach ignored the risk that contributions might stop if the member loses his or her employ, and the obvious risks from exposure to a single asset or a very material asset.

[11] ibid
[12] ATO Self Managed Super Fund Statistical Report – December 2013
[13] ATO SMSFR 2012/1- 'SMSF: Limited Recourse Borrowing Arrangements – application of key concepts'

Most lenders have now tightened their lending standards and are considering the fund's underlying investment income, asset concentration risk, LVRs and the type of property (and how it is purchased).

We do not see any compelling case why s67A and s67B of the *SIS Act* should be changed to prevent SMSFs accessing limited recourse borrowing arrangements. In a total home loan market of approx $1.27 trillion outstanding (and $420bn in investment loans)[14], the SMSF component of this through LRBAs represents only a tiny component. While there will be a couple of blow-ups from loans written earlier in the piece before lenders really understood their risks, the vast majority of loans are helping trustees to grow their retirement wealth. Borrowing by SMSFs to invest in residential property is not fuelling the current property boom.

4.2 Asset allocation by SMSFs has been relatively stable. As the following table shows, cash and term deposits have always represented a major proportion of aggregate SMSF assets. At the height of the last equities boom (2007), 24.8% of assets were in cash or term deposits. Post the GFC, the amount of SMSF funds invested in cash and term deposits reached a peak in percentage terms at 32.1% in June 2012, yet in nominal terms, it continued to grow. According to the latest ATO figures, cash and term deposit investments totalled $154.6bn at 31 December 2013[15]. Despite a 15% rally in the Australian equities market in 2013, the amount invested in cash and term deposits rose from $143.6bn to $154.6bn.

We contend that SMSF trustees are relatively conservative when it comes to asset allocation. The high degree of cash and term deposits (even in a very strong equities market in 2007 and 2013) is typical of this conservatism, and also due to 35% of members drawing a pension.

Table 2 – Aggregate Assets of SMSFs ($ billions)[16]

	Jun 07	Jun 08	Jun 09	Jun 10	Jun 11	Jun 12	Jun 13
Cash & Term Deposits	$77.3 24.8%	$81.8 25.5%	$94.0 29.2%	$96.5 27.1%	$115.3 28.3%	$138.6 32.1%	$150.3 29.8%
Aust Shares	$108.1 34.6%	$103.3 32.1%	$92.8 28.9%	$111.5 31.2%	$126.7 31.1%	$121.2 28.0%	$153.4 30.4%
Business Property	$33.0 10.6%	$30.4 9.5%	$36.0 11.2%	$41.2 11.6%	$47.8 11.8%	$53.9 12.5%	$61.7 12.2%
Residential Property	n/a	$10.7 3.3%	$11.5 3.6%	$13.2 3.7%	$14.7 3.6%	$16.1 3.7%	$18.5 3.7%
All Other	$93.8 30.0%	$95.2 29.6%	$87.2 27.1%	$94.2 26.4%	$102.3 25.1%	$102.4 23.7%	$120.0 23.8%
Total Assets	$312.2	$321.4	$321.5	$356.6	$406.8	$432.2	$503.9

4.3 **I**nvestment in offshore assets remains dismally low at $5.3bn as at 31 December 2013 – less than 1% of total assets. This proportion hasn't changed materially in the last decade. We consider that

[14] ABS Housing Finance Jan 2014
[15] ATO Self Managed Super Fund Statistical Report – December 2013
[16] Compiled from ATO Statistical Reports

this demonstrates the innate conservatism of SMSF trustees, and that the suggestion that trustees are ready to embrace a new asset class, such as infrastructure assets or corporate bonds, is incredibly naive. More so, if these newer assets are not tax advantaged.

4.4 The ATO reports that compliance breaches by Trustees are relatively low in frequency. "In the year ended 30 June 2013, 7,700 SMSFs had ACRs (Auditor Contravention Reports) lodged containing 18,000 contraventions. From the previous year, this is a decrease of 10% in the number of SMSFs with an ACR and of 11% in the number of contraventions. To 30 June 2013, just under half of all contraventions were reported as rectified."[17] The number of funds involved in a compliance breach has remained stable at approximately 2% of the SMSF population.

The Super System Review also gave the SMSF sector a relatively clean bill of health. We contend that there are no material compliance issues within the sector.

4.5 Suggestions that there should be a compensation scheme for SMSF members gain currency whenever there is a default by a product provider or financial adviser. Proponents seem to include some APRA regulated funds, the media, and some members of government. There is no evidence to suggest that SMSF members want a compensation scheme or more importantly, are prepared to pay for it.

All surveys of SMSF members point strongly to the opposite – particularly if it is suggested that they pay for it. We accept that responses to a question of this nature tend to be unreliable, because like insurance, no one really wants to pay for it until they need it. That said, we contend that there is no need for a compensation scheme because electing to become a member of an SMSF is, and should remain, a voluntary action.

We also note the requirements ASIC is proposing about financial advisers providing warnings to their SMSF clients[18], and suggest that the ATO be even more proactive in advising Trustees that there is no compensation scheme.

5. Superannuation and Ageing – some key issues

5.1 There has been considerable community discussion about increasing the pension age for social security benefits. The pension age is currently 65 years for men and 64.5 years for women, and is being increased to age 67 for both by 2023. While the size of any further increase is rarely discussed, we imagine that the proposal may mean to age 69 or 70 on a transitionary basis, commencing sometime after 1 July 2023.

5.2 The preservation age is also important when discussing superannuation and ageing. The superannuation preservation age is currently 55 and is being increased to 60, which will finally apply to all Australians by 1 July 2024.

[17] ATO 'Self Managed Superannuation Funds: A Statistical Overview 2011-12', revised 16 December 2013
[18] ASIC Consultation Paper 216

5.3 While we are not advocating an increase in the preservation age per se, we think it would be an anomaly to make one change without the other. In making any such changes, it will need to be recognised that older Australians do face employment challenges, and that there will be an ongoing need for many individuals to access their superannuation monies before reaching pension age and, potentially, obtaining financial support from the Government.

5.4 We further suggest that the current 'employment tests' around withdrawal of benefits or contributions to superannuation be simplified or abolished, and replaced by simple tests. The tests are complex, ineffective and easy to get around. For example, the definition of "retired" depends on your age as follows:

> *If a member is aged at least 55 and stops gainful employment before age 60, then a superannuation fund trustee must be "reasonably satisfied" that the member never intends to be gainfully employed for more than 10 hours per week again.*
>
> *If a member is aged at least 60 and a gainful employment arrangement has come to an end.*

The definition of "employed", which is used to assess whether a person is eligible to make a contribution after age 65, is similarly convoluted:

> *"worked more than 40 hours in a period of not more than 30 consecutive days in that financial year"*

Any of these tests can be easily passed – for example, the 40 hours by working one full week of the year, or by working one day of the week for five weeks. To retire at age 55, you just advise your Trustee that it is not your intention to work more than 10 hours a week again. Within a couple of months, you change your mind and go back to work.

With the introduction of contribution caps, an ageing population, and the removal of other discriminatory measures, we can't see any substantive reasons why contributions to superannuation should be subject to other aged-based restrictions.

We recommend that:

a) the conditions of release relating to superannuation be simplified by removing all retirement and work-based tests, and replacing them with age-based tests; and
b) that all Australians, irrespective of age and subject to any contribution caps, be eligible to make contributions to superannuation.

5.5 A key issue for the superannuation industry and Government is the lack of relevance, or the irrelevance, of superannuation to many participants. The fact that approximately 80% of members of APRA regulated funds[19] have their compulsory superannuation contributions paid into the default fund suggests that millions of Australians don't care about their superannuation.

[19] Australian Government 'Stronger Super' – see http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/government_response/key_points.htm

Many younger Australians, particularly those who work part time and who end up with multiple super accounts, see their contributions squandered on weekly or monthly fees. Others see their contributions go into “compulsory” life insurance premiums – an arguably absurd proposition for a person who doesn’t have any dependants.

Disinterest or complacency by consumers cannot be a healthy state. It means that funds are not held fully accountable for their performance, for the fees they charge, and potentially, some consumers are invested in a less than optimal investment options.

We suggest that one way to increase interest in superannuation, particularly amongst younger Australians, is to allow some portion of superannuation savings to be used as a deposit for a primary residence. We doubt that this would really fuel an uptick in housing prices, and don’t believe it is as hard to administer or control as some have suggested. A possible model may be ‘the lesser of 33.3% of a person’s superannuation account, or 10% of the average home price’, and the withdrawal to be paid directly by the superannuation fund to the vendor of the home. By registering a caveat on the title, the fund could protect the member’s super interest by requiring repayment if the property was sold.

6. The development of a corporate bond market may be stymied by limited retail investor interest

6.1 There has been considerable discussion about the development of a corporate bond market. As recently as Tuesday 26 March, the Inquiry Chairman, Mr David Murray, was reported to have said that there should be “$400 billion of corporate debt on issue rather than the paltry $50 billion outstanding”.[20]

6.2 Comments by Dr Ken Henry in 2012 at a speech to the Association of Superannuation Funds Conference that “super funds were overloaded with shares” and that “the reluctance of fund managers to invest in corporate bonds and the lack of a local bond market had left retirement incomes exposed to volatile shares and increased the economy’s reliance on offshore funding” [21] ignited a debate about whether super funds should invest more in fixed interest securities. The debate was quickly linked to the need to expand the corporate bond market.

6.3 As SMSFs have the largest share of the superannuation pool (approx 31.3%), it has been taken by some commentators as a “given” that SMSFS should, and will invest, in corporate bonds. They are overloaded with shares, so it is just a matter of getting the market right. If supply is created, demand will follow.

6.4 We support many of the initiatives that have been canvassed in the media/industry forums about creating the right environment for a corporate bond market to prosper. These largely “supply side” initiatives include simplification of the prospectus requirements and improved clearing, settlement and registration facilities. While these initiatives cannot but help, we don’t believe that the

[20] Australian Banking & Finance, 27 March 2014 http://www.australianbankingfinance.com/banking/asic--murray-clash-with-rba-on-corporate-bonds /

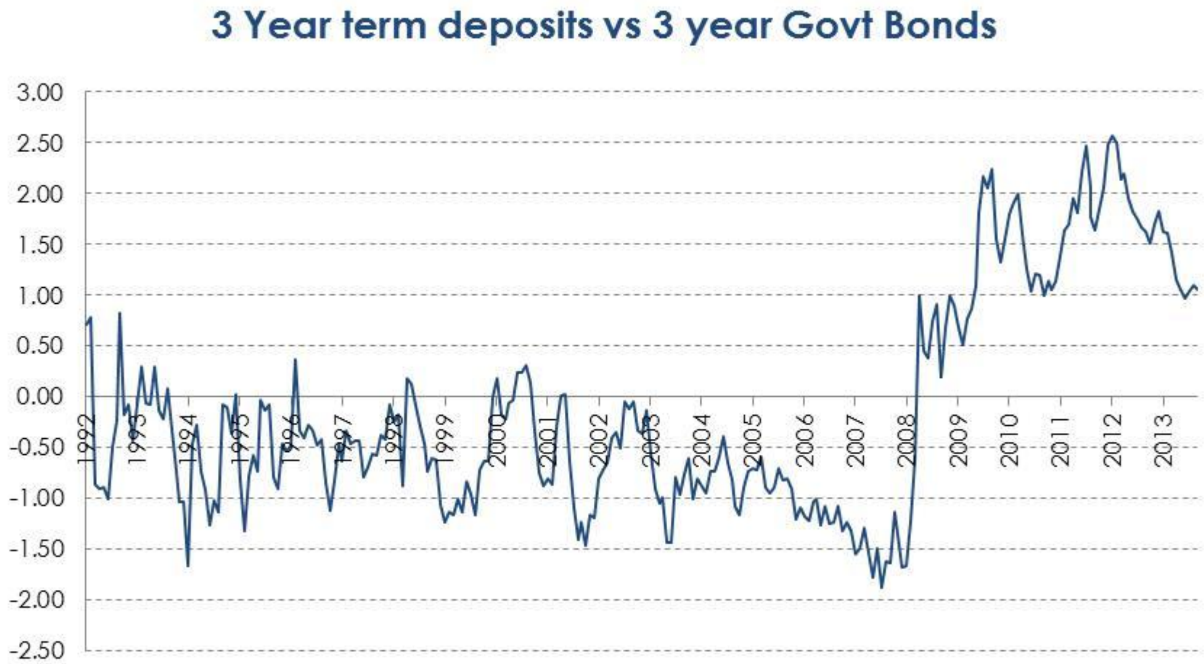
[21] Australian Financial Review, 17 March 2012

“demand” part of the equation (at least in respect of that portion represented by SMSFs) is ready to buy in any material way.

6.5 The first major obstacle to purchase is the spread between term deposits and government bonds/bank bills. As a consequence of the GFC and the premium placed by ADIs on “retail deposits”, retail investors are now paid a higher rate of interest than wholesale investors. This phenomenon defies general market principles, where size is usually rewarded with a higher return.

Under the Government’s Financial Claims Scheme (administered by APRA), deposits with ADIs are guaranteed up to $250,000 on a per name/per institution basis. An SMSF can, therefore, invest in a 3-year or 5-year term deposit with a government guarantee, and potentially earn interest at a rate of at least 1% over the government bond rate (see chart below). Even higher margins are available, if the SMSF investor chooses to invest in a term deposit from a second or third tier ADI, and by spreading the investment across multiple ADIs, the SMSF can potentially invest a considerable amount.

We note that although the margin has contracted over the last two years as GFC funding pressures have abated, the distortion caused by the government guarantee and premium for retail deposits largely remains. While there will certainly be some interest in “junkier” corporate bonds, we cannot see any material interest by SMSF investors in medium term “investment grade” corporate bonds while term deposits are available at such attractive margins.



Source: Tim Farrelly and Portfolio Construction Forum

6.6 The second obstacle is the relative unattractiveness of corporate bonds as an income investment compared to the fully franked dividends paid by the leading companies, including the major Banks. As the following table demonstrates, the equivalent interest rate to a 5% fully franked dividend yield is 7.14%, and for a fully franked dividend yield of 7%, the equivalent rate is 10% pa.

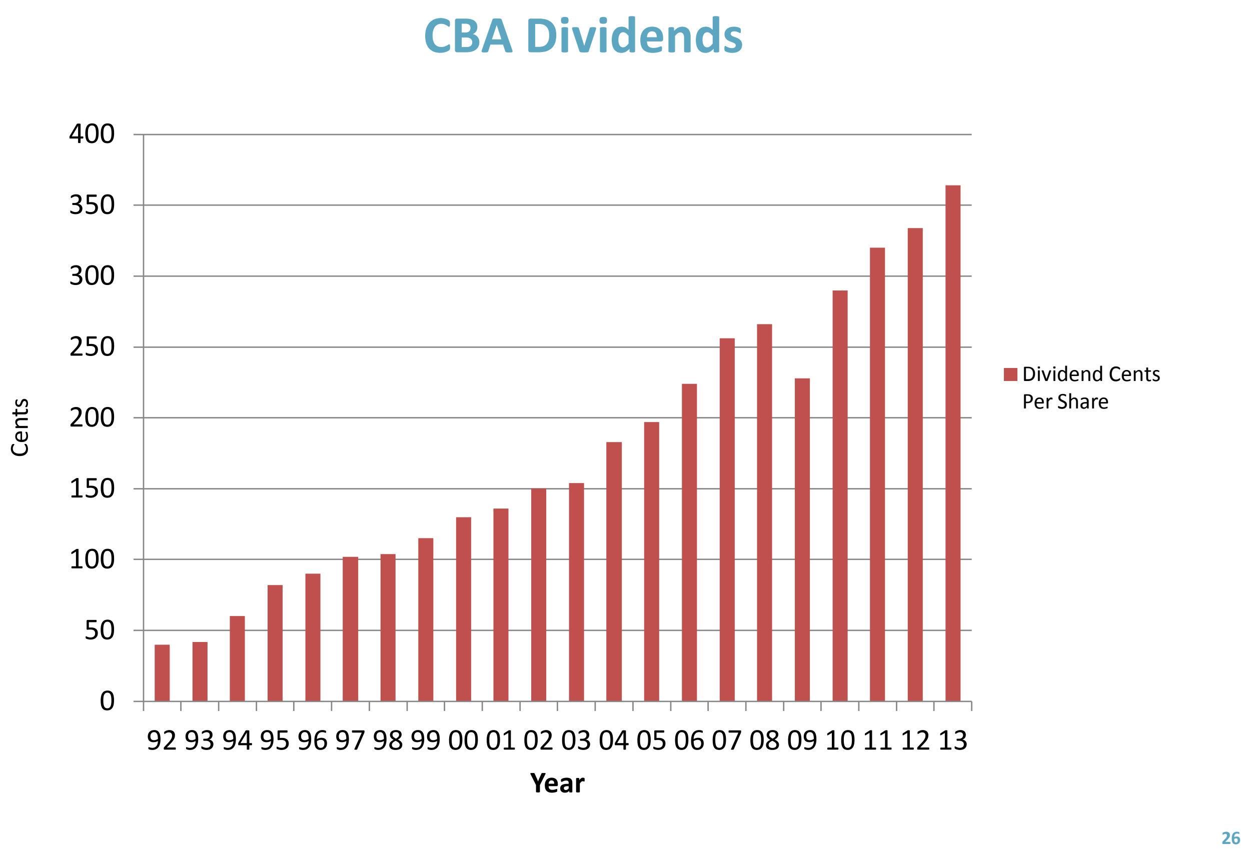
Table 3 – Franked Dividend Yields and Grossed Up Rates

Franked Dividend Yield	4%	5%	6%	7%
Grossed Up Rate	5.7%	7.14%	8.57%	10.0%

Admittedly, these are different asset classes and the risks are quite different. The corporate bond is most likely to return the principal, while with the share, it could lose capital value or appreciate in value.

However, many SMSF trustees recall that Commonwealth Bank shares were listed at $5.40 in 1991 and are now trading around $77, and also the major increases in share prices that the other major banks have enjoyed.

Moreover, some investors look at the major bank shares and see investments that pay increasing income returns. As the following chart shows, the Commonwealth Bank (CBA) has paid a higher dividend each year, with the exception of the year immediately after the GFC. The same CBA share that paid a dividend of 40c for FY92 paid a dividend of 360c for FY13 – a ninefold increase. There aren't too many corporate bonds that offer an increasing income stream.



Source: CBA Annual Reports, Switzer Super Report

6.7 The point of the discussion above is to suggest a note of caution to any thinking that only supply side issues need to be addressed in order for this market to develop. The buy side (at least from a retail investor/SMSF perspective) is not there.

If development of a corporate bond market is considered by the Inquiry to be a priority issue, we recommend that:

a) Government consider attaching some form of taxation advantage to an investment in corporate bonds (potentially, the interest income could come with imputation credits);
b) Government commit to funding an extensive and ongoing investor education programme.

6.8 Our comments in 6.7 above would also apply to infrastructure assets.

7. Summary and Recommendations

7.1 Our submission has focused on the important role Self Managed Superannuation Funds play in producing a dynamic, competitive, innovative and vibrant superannuation market place. The data suggests that SMSFs have, on the whole, outperformed APRA regulated funds, and for many members, are a more cost effective option. There are no material compliance issues.

We have also canvassed some of the "myths" about SMSFS, including that there is a looming crisis developing with SMSFs borrowing to invest in property, that SMSFs have made a massive allocation of funds into cash/term deposits post the GFC, that SMSFs are just waiting to invest in infrastructure assets or corporate bonds and that SMSF members want a compensation scheme. We conclude in each case that these remain "myths".

In relation to the superannuation and ageing debate, we suggest that any change in pension age must be linked to a change in the superannuation preservation age. Tests around superannuation withdrawals or contributions should be simplified.

To make superannuation more relevant and more attractive to some Australians, particularly the young, we suggest that a portion of superannuation savings be eligible to be used as a deposit for the person's primary residence.

Finally, we looked at the development of the corporate bond market and concluded that there was unlikely to be significant interest from retail investors/SMSFs, unless the interest payment on the bond was tax advantaged.

7.2 Our recommendations to the Inquiry are as follows:

a) That there be no material changes in regard to the regulation of SMSFs, or operating standards as set out in the *SIS Act* and associated Regulations;

b) That SMSF members not be eligible for any compensation scheme, and that the ATO take a lead role in advising Trustees of this situation;

c) That any change in the pension age be made in conjunction with a review of the superannuation preservation age, and due to the employment challenges older Australian face, that there will be an ongoing need for many individuals to access their superannuation monies before reaching pension age;

d) That the conditions of release for superannuation be simplified by removing all retirement and work-based tests;

e) That all age restrictions on superannuation contributions be eliminated;

f) That to help make superannuation more relevant, particularly younger Australians, a portion of superannuation savings be eligible to be used as a deposit for a primary residence. A model may be 'the lesser of 33.3% of a person's superannuation account, or 10% of the average home price', with the withdrawal to be paid directly by the super fund to the vendor of the home;

g) That if development of a corporate bond market is considered to be a priority issue, then:
    a. Government consider attaching some form of taxation advantage to an investment in corporate bonds (potentially, the interest income could come with imputation credits);
    a. Government commit to funding an extensive and ongoing investor education programme.

Paul Rickard
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31 March 2014