

FINANCIAL SYSTEM INQUIRY

CPA Australia's submission to the Financial System
Inquiry Interim Report

August 2014

BE HEARD.
BE RECOGNISED.



About CPA Australia

CPA Australia is one of the world's largest accounting bodies with a membership of more than 150,000 finance, accounting and business professionals working in over 121 countries across the globe.

We have a history that stretches back to 1886, and have been actively involved in Asia since the early 1950's. We currently have nine offices in Asia and more than 35,000 members working in the region.

CPA Australia is committed to a creative engagement with governments and their agencies on behalf of members and in the broader public interest to encourage the adoption of economic and social policies that foster improvements in Australia's productivity and global competitiveness.

BE HEARD.
BE RECOGNISED.



A note from Alex Malley FCPA, Chief Executive, CPA Australia

CPA Australia welcomes the interim report of the Financial System Inquiry.

Although it is recognised that Australia will remain an importer of capital over the medium term, we must remember that through advances in technology, Australia's financial services sector is a part of a much broader, global industry. The pace of change we have seen in the past few decades is also showing no signs of slowing down.

This submission elaborates on a number of the key issues that were identified in the interim report and which we believe remain key challenges for Australia's financial sector going forward.

The two areas that we believe are vital to get right now are the provision of consumer financial advice and the future of Australia's superannuation system and retirement incomes.

We believe it is imperative that a long-term vision for Australia's superannuation and retirement savings system is clearly articulated for what is now a \$1.8 trillion dollar industry – and growing. Without a clear vision for the future this sector will continue to move away from its original purpose of maintaining standards of living in retirement and has the potential to become a compulsory form of wealth creation with associated tax concessions. This is neither in the best interests of the nation nor the millions of Australians for whom those savings will be critical in the future.

In terms of financial advice, we support the separation of financial 'advice' and the provision of any 'product' recommendation. This separation would enable advisers to be able to provide non-product strategic advice in a more efficient and effective manner to clients as well as building much needed confidence, transparency and trust in this sector.

Along this same theme, we were concerned that the interim report failed to address the issue of consumer financial literacy, and it did not examine the significant effect and influence that Australia's current tax system is having on our competitiveness in this sector. We hope that these issues are better addressed in the final report.

In closing I would like to reiterate the call from our initial submission that this review go beyond simply examining the issues facing Australia's financial services sector today but that look to developing the global competitiveness of Australia's financial services sector over the next 10, 15 or even 20 years as we face the challenges of increasing globalisation and the influence of technology on the sector.

The decisions that will flow from this inquiry will be critical if Australia is to realise the oft touted vision of becoming a financial services 'hub' in the Asian region in this, the Asian Century.

A handwritten signature in black ink, appearing to read 'Alex Malley', with a flourish extending to the right.

Alex Malley FCPA
Chief Executive, CPA Australia

Contents

Superannuation	5
<i>Competition and default options</i>	6
<i>Portability requirements</i>	6
<i>Trust structure</i>	7
<i>Leverage</i>	7
<i>Stability of superannuation policy settings</i>	8
<i>Self-Managed Superannuation Funds (SMSFs)</i>	8
Retirement Income	10
<i>Lump sums</i>	10
<i>Superannuation income streams</i>	11
<i>Deferred income streams</i>	11
<i>Age pension</i>	12
Retirement income products	13
Consumer Outcomes	14
<i>Disclosure</i>	14
<i>Financial Advice</i>	15
<i>Independence</i>	16
Financing Small and Medium Sized Businesses	18
<i>Technological developments and information asymmetries in SME lending</i>	19
<i>Information gaps between lenders and SME borrowers</i>	20
<i>Reduced loan covenants</i>	20
<i>Venture Capital Limited Partnerships (VCLP)</i>	20

Superannuation

Observation

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.

CPA Australia agrees that super fund operating costs and fees appear high even though consolidation and administrative efficiencies should have had a downward influence on costs. However, we believe costs remain high due primarily to significant regulatory burden and multiple layers of investment management costs.

The cost of compliance has increased considerably for superannuation funds over the last decade due to greater SIS regulation, increased disclosure requirements, Australian Financial Services and APRA licensing, increased reporting requirements and the anti-money laundering / counter-terrorism financing rules.

Recently, trustees have faced additional costs with transitioning to the MySuper regime and the introduction of SuperStream, including a levy on the industry of over \$400 million. The superannuation industry has estimated the implementation of SuperStream will cost the industry close to \$1 billion including the levy.

The superannuation industry has experienced considerable consolidation and administration margins are being squeezed, yet any cost savings have been eroded by increased compliance costs.

The focus should be on the long-term value and net benefits provided to fund members, not simply on cost reduction. Cheapest isn't necessarily best. For example, the continual downward pressure on administration fees may result in administrators being under-capitalised and unable to properly invest in their infrastructure, which may lead to administrative errors or failures which are ultimately to the detriment of fund members.

Any measure of cost must take into account the services provided, range of investments, long-term investment returns, and the potential value to members.

Consideration must also be given to the impact of MySuper. Given the MySuper regime only commenced on 1 January 2014 and existing balances don't need to be moved until 2017, sufficient time must be given before the effectiveness of MySuper and its impact on costs and fees can be determined.

Competition and default options

The superannuation industry has endured many years of regulatory reform and a period of stability is needed before the effectiveness of the changes can be properly determined and to ensure continuing confidence in the superannuation system.

We agree with the Inquiry's view that it is too early to assess the effectiveness of the MySuper reforms in stimulating competition and after-fee returns. As such, we believe that there should be no change to the current arrangements.

Portability requirements

The Interim Report notes that the high demand for liquidity from superannuation funds may be reducing after-fee returns to members and that the three-day inter-fund portability timeframe may be contributing to higher allocations to liquid assets than required (p.xxiii).

We would argue that it is too early to determine whether the three-day inter-fund portability timeframe is (of itself) causing significantly higher allocations to liquid assets, as the new rollover standards only came into full effect from 1 July 2013.

Given the preserved nature of superannuation, liquidity management should be simpler than in banking, where depositors have an unlimited ability to exit.

Furthermore, as more superannuation members move from accumulation into pension phase, liquidity management at a fund level will become critical. Relaxing the three-day portability rule to compensate for poor processes and back office administration systems is not in the best interests of those members who depend on the smooth and regular payment of account based pensions.

As such, we believe that the push to replace or relax the three-day portability rule may be motivated by other factors, such as the funds seeking to retain members.

We submit that relaxing the three-day portability rules will only hamper the Federal Government's desire to improve the efficiency of overall superannuation system and make it harder for funds and members to identify and merge duplicate accounts and reduce the number of inactive and lost accounts across the system.

As such, rather than replace or relax the three-day portability rule, we would instead recommend that the compliance regime around its enforcement be enhanced with the objective of improving the efficiency of the superannuation system and minimising any potential detriment to members.

Trust structure

We believe the trustee model continues to be appropriate for all super funds, including public offer funds, particularly considering the compulsory nature of superannuation and the relatively low level of member engagement. Trustees' fiduciary responsibility under trust law provides a secondary safeguard to the trustee covenants and responsibilities required under SIS.

Leverage

Observation

If allowed to continue, growth in direct leverage by superannuation funds, although embryonic, may create vulnerabilities for the superannuation and financial systems.

CPA Australia acknowledges the Inquiry's concerns regarding the possible impact of leveraging on the systemic risk of the superannuation system. However, we believe these concerns are premature and influenced by the recent attention focused on the increase of SMSFs borrowing to invest in property.

At the moment, the number of super funds and the percentage of assets invested through leveraged arrangements are still relatively small, albeit growing. Leveraging is a legitimate investment tool and can form an important part of a long-term wealth accumulation strategy.

We believe the potential risk with the current growth in leveraging arrangements is not in the leveraging itself but in inappropriate usage resulting from investors receiving poor or no advice. As stated previously, our primary concern is with the appropriateness of the advice and the potential misinformation being provided by unlicensed advisers such as real estate agents, mortgage brokers and property developers. Ultimately, we believe property advice needs to be regulated investment advice.

Only after the immediate problem of inappropriate advice is addressed can the true impact of leveraging on the superannuation system be considered.

Stability of superannuation policy settings

Observation

Superannuation policy settings lack stability, which adds to costs and reduces long-term confidence and trust in the system.

As stated in our initial submission to the Inquiry, superannuation is a long-term savings vehicle that requires a long-term vision and direction. Unfortunately, successive governments have viewed Australia's superannuation savings as a 'honey pot' to dip in to when required. Constant rule changes and revenue grabs have undermined public confidence in the system and threaten Australia's long-term savings.

We believe it is imperative that a long-term vision for Australia's superannuation and retirement savings system be clearly articulated to provide a clear purpose and goal (e.g. poverty alleviation or maintenance of living standards in retirement) along with and how these goals can be achieved.

Importantly, superannuation needs to be removed from the political cycle given our long-term retirement savings goals.

We also believe that there is merit in establishing an independent body to oversee retirement savings policy, and that further serious consideration should be given to this.

Self-managed superannuation funds

Question

To what extent should the Inquiry be concerned about the high operating expenses of many SMSFs?

We do not believe concerns about SMSF costs are justified. With average and median balances per member increasing and the proportion of funds with balances of less than \$200,000 decreasing, average costs will continue to decrease over time.

Cost is not necessarily the primary driver for trustees in having a SMSF. There may be other reasons such as holding particular assets or business real property. Generally, SMSF trustees are aware of the costs involved and consciously make the choice to have a SMSF. Where the establishment of a SMSF is being recommended, the adviser would be required to compare the SMSF to the other options available as well as advise the estimated costs involved.

It should be noted that for SMSFs, each trustee needs to consider the fund's break-even point rather than economies of scale. A SMSF's breakeven point will depend upon how much work the trustee undertakes themselves compared to the various services than the trustee acquires.

Effectively, the only costs that must be incurred relate to the annual audit of the SMSF and its regulatory lodgment levy. All other costs are discretionary costs which the trustee may or may not incur. The cost of operating a SMSF is dependent on the number of functions outsourced to external providers.

Ultimately, it is the individual's choice to have a SMSF and to bear any additional costs associated with managing their fund.

Question

Should there be any limitations on the establishment of SMSFs?

CPA Australia is not of the view that there should be limitations on the establishment of SMSFs. However we do believe there may be some benefit in identifying a minimum balance and the cost assumptions involved with SMSFs as an educative guide, such as recently attempted with ASIC's CP216¹. People need to understand the break-even concept and how their discretionary costs can influence this. However, there is no justification for imposing a minimum monetary balance.

SMSFs are often established for reasons other than costs and there are perfectly legitimate reasons for establishing a SMSF with a small balance, such as holding particular assets or business real property or higher income investors looking to build up funds over time.

¹ASIC CONSULTATION PAPER 216 - Advice on self-managed superannuation funds: Specific disclosure requirements and SMSF costs

Retirement income

Observations

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

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

CPA Australia agrees that the retirement phase is underdeveloped and a long-term plan is needed. Maintaining the status quo is not an option. We need to move away from the lump-sum super mentality and encourage retirement income streams, particular for the later phases of retirement, and if necessary, to have these mandated as part of the system.

We do not believe that one single approach or product will provide the solution for all retirees. Most retirees will need to access a combination of the following options to satisfy their financial needs as they move through the different stages of their retirement:

- Lump sum benefit
- Superannuation income stream
- Deferred income stream
- Age pension
- Non-superannuation savings

Lump sums

As a minimum retirement income streams need to be encouraged over lump sum benefits.

However, it would be impractical to mandate against lump sums entirely. Retirees will require access to lump sum money at various stages of their retirement and for any number of reasons. Similarly, there would be no benefit in forcing retirees with smaller account balances to take an income stream as the income stream would be small with relatively high costs and no tax advantage.

One option to discourage large lump sums being withdrawn at retirement would be the introduction of a lifetime threshold (for example, \$250,000) with tax being levied on the taxable component of amounts withdrawn above the threshold. Amounts used to purchase or support an income stream would remain tax free while amounts commuted from income streams would count towards the limit.

Taxing benefits above a particular threshold would also help to improve the sustainability of tax concessions for superannuation and rebalance them away from high balance accounts.

A long lead time would be required to introduce such a reform, say 10 years, and then it could be applied to individuals born after a particular date, similar to how the increase in preservation age is being applied.

Superannuation income streams

An account-based pension remains the most flexible retirement income vehicle for retirees as it allows for variation in income levels (subject to an annual minimum), the withdrawal of lump sums and the payment of residual death benefits. However, these do not address longevity risk and discourage individuals from maximising their retirement income as many people take the minimum annual income permissible to minimise the risk their pension will expire before they do.

Introducing a taxable threshold for lump sum benefits would encourage the take up of account-based pensions but would not in itself address longevity risk concerns. There may be some scope to re-consider the minimum annual drawdown limits for older ages to reduce longevity risk but that still would not provide certainty over how long an individual's superannuation would last.

The other incentive to encourage the take up of account-based pensions is 'soft-compulsion'.

If MySuper is the default superannuation scheme for most Australians then it should automatically continue and commence a pension upon retirement. 'MyPension', for example, could commence at a prescribed age unless an individual defers it because they haven't retired yet or they 'opt-out' by taking a lump-sum benefit

Deferred income streams

To minimise longevity risk retirees should be encouraged to defer consumption of some of their retirement savings until later in their retirement years. This is best done through deferred income streams, such as deferred lifetime annuities, or an associated requirement that retirees demonstrate a guarantee of future income.

Annuities in Australia have traditionally been provided by life insurers through pooled arrangements with capital backing. However, considering the size of the superannuation asset pool and the size of some individual superannuation funds, it would be feasible for one or more superannuation funds to create a group self-annuitisation pool to provide lifetime annuities.

The primary drawback with encouraging deferred lifetime annuities to address longevity risk is that they would need to be compulsory to spread the longevity risk and investment risk, minimise anti-selection risk and reduce price pressure. Without compulsion it is unlikely the provision of deferred lifetime annuities would be commercially viable. To maximise the annuity pools, deferred lifetime annuities would also have to be non-commutable once purchased and have no residual death benefit.

While many of these characteristics may seem undesirable, compulsion should be considered in the context of reducing longevity risk and as such only a small proportion of an individual's

retirement savings (for example 20 per cent) would have to be locked away in a deferred lifetime annuity to provide sufficient income (possibly supplemented by the age pension) later in life. This would ensure there remains sufficient retirement savings available to meet immediate lump sum or income needs and any residual is payable on death. Importantly, there needs to be a cultural shift where deferred annuities are no longer considered investment products but as insurance products.

The largest disincentive to purchasing deferred lifetime annuities at the moment is their current tax treatment. To make them attractive and viable they must be given the same concessional tax treatment for earnings on their assets during the deferral period as other income streams.

Age Pension

As mentioned in our initial submission, the age pension has always been represented as a 'safety net' for those individuals who have not had the means to save sufficiently for themselves.

However, the age pension is now supplementing the compulsory system (or vice versa) to the point where some 80 per cent of retirees are receiving at least part of the age pension.

As the SG system matures this dependency needs to be wound back so that by the time the system has fully matured, around 2035, the age pension is only being provided as a genuine safety net for those members of society in genuine need.

We believe most of the policy settings required to engender a retirement incomes culture are tax related and as such it is more appropriate for them to be fully considered as part of the taxation White Paper process over the coming 12 to 18 months.

Retirement income products

CPA Australia agrees with the Inquiry's observation that there are regulatory and other policy impediments to developing retirement income products.

As mentioned in the previous section, the primary impediment to the purchase of deferred annuities is the tax treatment during the deferral period. If the purchase price was treated as an insurance premium instead of an investment product, with no tax on the earnings of the supporting assets during the deferral period, they would be considerably more attractive. Similarly, it would be beneficial if deferred annuities were exempt from the age pension assets test during the deferral period.

Greater flexibility is also required in the SIS pension and annuity rules, particularly around annual payment levels, indexing and residual benefits. The rules are also very confusing as a result of trying to accommodate the various income stream products available historically. CPA Australia would support a more flexible, principles based approach to the income stream rules.

Retirement income products could also be made more affordable by reducing the capital required for a life company offering these products. This would also have the effect of encouraging the market to develop products to manage longevity risk, although sufficient safeguards would have to be maintained.

If impediments to deferred lifetime annuities were removed, issuers of annuity products would still face challenges in sourcing long-dated investments to back them. We suggest that the Inquiry consider funding for such products and, in particular, increasing the maximum tenure of Commonwealth bonds and taking steps to encourage greater use of corporate bonds.

Consumer Outcomes

Observation

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.

Disclosure

As stated in our previous submission, since implementation over a decade ago disclosure documents have evolved into pure compliance documents that a financial adviser uses as part of their audit trail for protection from potential litigation.

The observations of the interim report, which note that these complex documents are doing little to enhance consumer understanding of the advice they are receiving, yet are they are costly to produce which in turn impacts access to advice, support this view.

While disclosure can have its limitations, it is still an integral component of the advice process though reform is required to ensure the documents can achieve their original purpose. The real benefit of financial advice is the advice itself and we need to ensure that we have a regulatory system that enables the free and open transference of relevant information between an adviser and their client.

One way to address this would be to separate the 'advice' and any 'product' recommendation.

This separation would result in advisers being able to provide non-product strategic advice in a more efficient and effective manner to clients and developing much needed confidence and transparency in this sector.

Further, such an approach would enable conflicts within the industry to be better disclosed to consumers. This could be achieved by requiring any adviser who is limited in the product recommendations they can provide because of restricted authorisation, to make this statement immediately before any product advice is provided, as well as disclosing any remuneration or benefit that they may receive if the client accepts the product recommendation.

While an adviser is already required to provide this information as part of the statement of advice (SOA), it is often difficult to understand and can often be overlooked by an unwary consumer.

Changing how this information is disclosed would not only place a greater emphasis on the adviser explaining why the product that they have recommended is in the best interests of the client, it would also ensure that the product recommendation is transparent as the client can immediately identify any benefit the adviser may receive. These elements combined, when

disclosed in a clear, concise and effective manner as already required by law, have the potential to make a powerful difference to how consumers are presented with the important information they need to make an informed decision.

Financial literacy will also play a key role, as without this a consumer will not be in a position to make an informed decision even if reforms are implemented to address conflicts and complexity. We acknowledge the work of ASIC and others in this regard but also believe that it is essential that financial literacy is strongly embedded within the national school curriculum to ensure that future generations have this important skill. Basic skills such as budgeting, saving, understanding debt and the time value of money are all fundamental to a person's financial well-being.

Financial advice

Observation

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.

CPA Australia strongly supports lifting the minimum training requirements set out in ASIC Regulatory Guide 146 *Licensing: Training of financial product advisers*. We believe that robust training for financial advisers is vitally important to ensure quality financial advice is consistently provided to the consumer.

This need is evidenced by the fact that the Parliamentary Joint Committee on Corporations and Financial Services are currently examining this issue and that the government has established an Industry Working Group who will also review current training standards. This group will also work on establishing a register of all licensed financial advisers, a move which is welcomed and supported by CPA Australia.

Importantly, we do not support a national exam for financial advisers. While a national examination may be an objective method to ensure all advisers can in fact demonstrate a minimum level of knowledge, we do not believe it will ensure a financial adviser has the requisite competency to perform their duties. Competency is the ability to perform tasks and duties to the standard expected in employment. An examination traditionally assesses an individual's knowledge. It does not assess the application of both the knowledge and skill required to adequately perform duties relevant to the role of providing financial planning advice and services in employment.

Rather, CPA Australia recommends that the current minimum level of education should be lifted from Australian Qualifications Framework (AQF) 5 – Diploma to AQF 7 – Bachelor Degree. To provide holistic financial planning advice there are a range of areas that a financial adviser needs to complete, which is beyond the current focus of financial planning, insurance,

superannuation and investments. There is estate planning, aged care, tax and structuring advice for example. Of note we do not support SMSFs being a separate specialist knowledge area, they are an integral component of the superannuation industry and this should be reflected in the topics required to be covered for superannuation.

A new core curriculum needs to be developed that fully explores the knowledge and skills needed to become a holistic financial adviser, which can then be used to build a new AQF 7 qualification specifically for the financial advisory sector.

It is important to note that the Australian Financial Services (AFS) licensing regime captures more than just financial advisers. It also captures stockbrokers, insurance brokers, advisers on carbon credits and those individual who sign Independent Expert Reports for example. Therefore consideration must be given to building additional qualifications that cater for these different streams to ensure that the training requirements ensure the right knowledge and skills are developed for the advice and services that will be provided.

Education is the foundation for being skilled to provide quality financial advice, however other elements such as learning how to deal with conflicts of interest, a critical issue for the sector, and ethical considerations are just as important. Therefore CPA Australia also recommends the introduction of a monitoring and supervision period for a period of two to three years. We believe implementing this new requirement will be valuable in developing financial adviser skills and to embed at the beginning of a person's career an appropriate ethical and behavioural framework. A key element of the accounting profession has been incorporating through its supervision and mentoring programs an ethical framework and culture early in an accountant's career development.

Ongoing professional development is also essential and while ASIC currently prescribe that all licensed financial advisers must undertake ongoing continuing professional development in the areas of advice they provide, there is no prescribed minimum. CPA Australia recommends that a minimum threshold is established for a given period, for example a triennium, which also includes the minimum amount of ongoing development that must be completed in any one year.

Independence

CPA Australia believes that there is a need to clearly distinguish between independent and aligned advisers.

It is well known that within the Australian market that around 80 per cent of the industry is aligned and or owned by a large bank or financial institution. This vertical integration consistently raises issues around conflicts of interest, through restricted approved product lists and the perceived or real bias towards in-house products. This association has also led to the general perception by consumers that financial planning advisers are 'product floggers' rather than trusted advisers and their independence is often in question.

The combination of separating the advice and product, as well as creating a distinction between aligned and non-aligned advice, one of the key objectives of a well-functioning market – transparency – would be created.

This would then provide a strong foundation on which to build confidence and engagement between the advisory industry and consumers. By establishing this model it is expected that this would lead to a fee for service advice model which is more aligned with that of a profession rather than an industry, eliminating the majority of the conflicts the industry currently grapples with when providing advice.

There will be challenges in ensuring a model can be created that is clear and meaningful to the consumer, however it is something that can be achieved.

Financing Small and Medium Sized Businesses

CPA Australia is of the view that financing conditions for the SME sector have improved substantially in recent years. This is evidenced both in our annual survey of small business, as well as anecdotally through our ongoing engagement with members and the sector. Our 2013 Small Business survey found that those businesses that put up a good business case are unlikely to experience difficulties in accessing debt finance. However, this is not to say that there aren't any businesses experiencing difficulties accessing finance.

For example, businesses with limited histories in particular have issues with accessing debt finance. In those circumstances equity financing, whether from the personal resources of the business owners or investors is often a more appropriate form of finance for such businesses.

However, while financing may be less of an issue at present, CPA Australia remains concerned about issues such as unfair contract terms for small business in favor of the lenders, as well as the risk that property markets in Australia pose for the SME sector, especially for those who have used property as a way of securing finance.

The global financial crisis and the response of lenders to this event clearly demonstrated where the power in the relationship between lender and SME borrower lies. While it was prudent for lenders to respond to the financial crisis with increased levels of security and borrower requirements, to tighten these conditions on existing SME borrowers with little or no communication actually damaged the relationship the lenders had with many SMEs.

This reaction has created reluctance within the sector to borrow to fund future growth. These additional borrowing requirements also increased the compliance costs SME borrowers incurred at a time when margins were already under pressure and required some SMEs to focus staff on meeting lending requirements, not on supporting the business during a difficult period.

We believe greater balance and certainty in the relationship between lenders and SMEs would lead to better outcomes for lenders and their clients, especially in times of economic hardship or crisis. This does not mean taking away the power of lenders to act when a business is in financial distress, but it can lead to better communication with SME borrowers, especially giving them adequate time to consider and respond to changes in reporting requirements.

All too often during the global financial crisis we heard SMEs agitated by lenders changing their lending requirements without notice, giving them no or little time to adapt systems and processes or offer their lenders potential alternatives. Many SMEs stated that their systems did not produce the information the lender sought, often because the information had no utility to the business (and nor could they see what relevance such information would have for a lender).

Unless greater balance in the relationship between SMEs and lenders is achieved, the breakdown in the relationships between lenders and SMEs that emerged during the GFC is likely to be repeated the next time a major economic downturn occurs, and this in turn will likely delay any recovery and place businesses again under unnecessary stress.

On this topic we would like to commend the government for identifying this issue and releasing its consultation paper on extending unfair contract term protections to small business (www.treasury.gov.au/ConsultationsandReviews/Consultations/2014/Small-Business-and-Unfair-Contract-Terms). We encourage the inquiry to look at this paper to inform its final recommendations in this area.

Policy option

Facilitate development of an SME finance database to reduce information asymmetries between lenders and borrowers

CPA Australia does not support this policy option as it is currently not clear what benefits, if any, would come from such a database.

The proposed option states that information for the database would come from tax returns and business activity statements. However, potential lenders typically require this information from a business that is seeking finance through the loan application process.

Further, as this information has been prepared for the purpose of complying with tax laws, not for applying for a loan, it may have limited value in assisting lenders during the credit assessment process. In short, we cannot see what additional value that this type of database would have in assisting a lender make an appropriate credit assessment.

Such a database may help lenders form a better macro-level understanding of different industries, however lenders already have access to this information through their existing client information and from commercial providers of business/industry information.

We are also concerned that establishing this type of database would impose additional compliance burden and costs on small business, with no discernible advantage to the borrower or lender.

If there is an information asymmetry between lenders and small business, a prudent lender has the obligation to seek that information as part of the loan application process before a credit assessment is made. We are not aware of any evidence to suggest that the current loan application process is not providing sufficient information on which to make an appropriate credit assessment of a SME business.

Technological developments and information asymmetries in SME lending

We do see merit in the ability of 'disruptive' technology to change the way that lenders compete, especially the established banks.

The continuing emergence of new, online and global loan options is well documented. Ondeck, CAN Capital and Kabbage all have potential to become disruptive technologies and become viable and appropriate future sources of capital for Australian small businesses. The model for

these businesses is that they evaluate a loan application based on actual businesses performance rather than the borrower's personal credit history.

Information gaps between lenders and SME borrowers

To address the information gaps between lenders and SME borrowers, this can be minimised through:

- lenders providing more guidance and tools to small business to assist them prepare their loan application. To this end, we are currently working with the Australian Bankers' Association (ABA) to develop a guide to assist small business with their loan application.
- The banks offering more small business focussed training to relevant staff so that they have better knowledge of small business and particular industries.
- Encouraging greater broker activity in SME finance.

Reduced loan covenants

The concern of members on loan covenants is focused on the lack of communication from lenders when they decide to vary or enforce the compliance requirements of those covenants.

While we believe lenders should have the authority to vary covenants, we also believe that it is important that lenders engage with the business before changing covenants to give the business time to develop systems to best respond to any new compliance requirements.

While the Australian Bankers Association's current code of banking practice covers small business, the rights and responsibilities afforded small business in the Australian code are significantly less than those in the small business banking codes of practice of Canada, UK and Ireland. Thought should be given to bringing the Australian code into line with the small business codes of those nations. Such a move would include requiring banks to give sufficient notice of changes in covenants, and this would go a long way to ease unnecessary tensions between business and lenders.

Venture Capital Limited Partnerships (VCLP)

In our experience the most vexing issue associated with most research and development activities is often the inability of a company to move from a start-up phase to the commercialisation of the new or improved product, process or service. In many cases the main problem is the access to appropriate funding, such as venture capital.

To remedy this limitation we believe that there is benefit in recalibrating the current tax rules associated with venture capital limited partnerships (VCLP) to allow for a full CGT exemption to apply to the disposal of an investment held in such a partnership, subject to appropriate eligibility criteria.

For example, to provide some rigour around this type of regime, any such entity may be required to meet specific governance standards set by Innovation Australia, have a minimum

funding of, say \$200 million to provide for a diversified investment portfolio and a possible further requirement that over 70 per cent of funds raised would need to be spent on eligible R&D activities that are undertaken in Australia.

Unlike the existing early stage VCLPs the fund's operation would not be limited to early stage development and commercialisation but related to any part of the life cycle of the innovation – from development to commercialisation. Furthermore, any entity (including a complying superannuation fund) would have the option of acquiring up to 50 per cent of the investment in any such limited partnership.