50 Pirie Street, Adelaide SA 5000
Toll free: 1800 808 354

Postal address:
GPO Box 99812 Adelaide SA 5001

T 08 8216 4200
F 08 8212 6747
E admin@cavendishsuper.com.au

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Financial System Inquiry

GPO Box 89

Sydney NSW 2001

Email: fsi@fsi.gov.au

Response to the Financial System Inquiry Interim Report

Cavendish Superannuation Pty Ltd (Cavendish) welcomes the opportunity to make a submission in response to the Financial System Inquiry Interim Report. As a leading provider of Self Managed Superannuation Fund (SMSF) administration and education, we believe our insights, observations and experience in the SMSF sector can make an important contribution to the Inquiry's Final Report to the Treasurer.

As noted in the Interim Report, the SMSF sector has experienced exponential growth over the past decade, both in terms of the number of SMSF members and funds under management.

We believe the growing number of SMSFs is a positive sign that more Australians are actively engaging with their retirement savings. By fostering greater levels of engagement, SMSFs have a positive impact on retirement incomes and ultimately drive better outcomes for consumers who choose this option.

However, the SMSF sector is not without its challenges and vulnerabilities. As noted in the Interim Report access to direct leverage could, without appropriate controls in place, expose the SMSF sector to higher levels of asset price volatility. Inadequate adviser training and SMSF advice competencies can also lead to situations where consumers are advised to establish SMSFs where it is not cost-effective or appropriate for their needs.

Cavendish Superannuation Pty Ltd
ABN 30 007 778 341
Tax Agent Registration No. 54040001
Australian Financial Services Licence No. 276133

Our submission provides further information on the specific SMSF areas listed in section 2-123 of the Interim Report. Given their critical importance to the integrity and future growth of the SMSF sector, we also provide our views on the use of leverage and advisers competency standards in sections 2-115 and 3-63 respectively. Our responses are detailed in the attached.

About Cavendish

Cavendish Superannuation Pty Ltd is an Australian company, wholly owned by the AMP group, providing specialist SMSF services to individuals, investment advisers, financial planners, stock brokers and accountants.

We are a leading industry provider with over $5 billion of funds under administration. We deliver our services through a variety of channels - direct to fund trustees, via financial advisers and accountants, or as a back-office providing fully-badged compliance administration outsourcing to external institutions.

Cavendish is committed to raising the standard of professional advice in the SMSF sector. In conjunction with the University of Adelaide's International Centre for Financial Services (ICFS), Cavendish offers a SMSF specialist course for professionals wanting to provide accredited and competent SMSF advice. Since its inception in 2011, over 600 advice professionals have completed this course.

Formed in 1993, Cavendish, over the last two decades, has experienced the rapid growth of the SMSF sector first hand.

We would be happy to provide further information or to discuss any questions you may have about this submission.

Yours sincerely

Natasha Fenech
Managing Director
Cavendish Superannuation Pty Ltd

Contact Number: Tel: (02) 9257 3207

Leverage (section 2-115)

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

Restore the general prohibition on direct leverage of superannuation funds on a prospective basis.

Quantifying the risk of systemic failure

Based on our own observations, we agree the use of leverage in the SMSF sector to finance asset purchases is embryonic but growing. Leverage magnifies risk on both the upside and the downside and we accept the widespread use of traditional style leverage investments could expose the SMSF sector, and the broader financial system, to unacceptably high levels of asset price volatility and systemic risks.

However, we believe there are important differences between “traditional style” leveraged investments and limited recourse borrowing arrangements (LRBAs). These differences mean the level of systemic risk posed by direct SMSF leverage is not the same as the level of systemic risk posed by direct leverage outside of superannuation.

For regulated superannuation entities, section 67A and section 67B of the *Superannuation Industry (Supervision) Act 1993* (SIS Act), imposes significant restrictions on superannuation funds which borrow to invest. These restrictions are designed to reduce the investor risks associated with leveraged investments.

For example section 67A of the SIS Act prohibits any legal right of recourse against the assets of the fund should the trustees default on the loan. The rights of the lender against the fund as a result of default on the borrowing are limited to rights relating to the acquirable asset. The acquirable asset also must not be subject to any charge (including a mortgage, lien or other encumbrance).

The policy intent of section 67A is to prohibit borrowing arrangements over multiple assets that can potentially allow the lender to choose which assets are sold in the event of a default on the loan. The narrow concept of a “single acquirable asset” means LRBAs are most commonly used for direct property acquisitions rather than a collection of direct equities or other securities which have, or may give rise to, multiple legal rights and therefore multiple assets in breach of section 67A.

Given the majority of LRBAs involve the acquisition of real property, we don’t believe the issue of “margin calls” which was raised in the Interim Report is relevant or should be of material concern to the Inquiry.

Section 67B of the SIS Act also imposes severe restrictions on the replacement of assets in a LRBA. These restrictions are designed to prevent lenders requiring the trustee to replace an asset within an arrangement if its value falls below a certain level, with an asset of greater value than the outstanding loan. It also means property development and other ventures which have the effect of changing the character of the asset are prohibited once the LRBA is in place.

Based on our own observations and experience, the LRBA policies of most financial institutions appear conservative. Many institutions require investors to obtain independent financial advice before the loan will be approved and the limited recourse nature of the loan normally requires a lower than normal loan to valuation ratio (LVR). AMP Bank, who provided LRBA statistics for this submission, decline/cancel around 25% of all LRBA applications received. AMP Bank, and many other lenders, mitigates their own risks in a number of ways, including by limiting the size of the loan, LVRs and imposing rules on the security property type and location.

AMP Bank also require all originators (both advisers and brokers) to separately complete an accreditation program on their LRBA products before their LRBA applications will be accepted. Trustees are also required to obtain a formal legal review of their trust deed and other documents and provide AMP bank with certification of their legal and SIS Act compliance. We believe the LRBA lending practices adopted by AMP Bank are not that dissimilar to most other lenders who are active in the LRBA space.

Given the legislative restrictions imposed on LRBAs and the conservative lending practices of the major financial institutions, we don't believe the systemic risk posed by leveraged investments outside of superannuation is comparable to the systemic risk posed by LRBAs. We believe the systemic risk posed by LRBAs is significantly lower than leverage investments outside superannuation.

Growth in SMSF borrowing

The Interim Report makes reference to the strong growth of LRBAs in recent years. We have also noticed an increase in the use of LRBA by SMSFs, but the rate of growth has been much more subdued than that noted in the Interim Report. For example, Multiport, who provided statistics for this submission, reported only a 4% increase in the number of SMSF with LRBA during the 6 month period ended 30 June 2014.[1]

The most recent ATO statistics, estimate that the total amount of assets held by SMSFs in LRBAs increased from $2.59 billion to $2.78 billion during the 12 months ended 31 March 2014[2]. This represents a 7% increase in the total value of LRBA assets held by SMSFs during that period. As at 31 March 2014, 0.50% of total SMSF assets were held in LRBAs.[3] We while we accept the ATO statistics are only estimates, and the actual rate of growth of LRBAs is likely to be higher, even if the rate of growth was double that reported by the ATO, the total value of LRBA assets held by SMSFs would still be small and insignificant as a proportion of total SMSF assets[4].

While there appears to be strong and growing interest in LRBAs, it doesn't necessarily follow LRBAs are growing at the same rate. One reason for this is the conservative and stringent LRBA lending practices of most financial institutions. AMP bank for example have declined or cancelled over 456 LRBA applications received over the past 2 years because the application has failed to satisfy their LRBA lending criteria.

We believe there is ample time to implement the consumer protections measures outlined in this submission (see below under "other alternatives") and to assess the effectiveness of these measures before the total value of LRBAs held by SMSFs becomes a concern. In the interim, there appears to be adequate controls and checks in place which, in the main, appear to be stifling reported unscrupulous sales practices and overzealous investors. In our view the introduction of further consumer protection measures, as outlined below, will see the growth of LRBAs kept to controllable and sustainable levels.

[1] Multiport Pty Ltd is wholly owned by the AMP Group. Multiport provides investment, SMSF and managed account administration services to a broad range of individuals, companies, trusts SMSFs and charitable foundations. The Multiport Investment Patterns survey covers just over 2,000 SMSFs, and is a sample of the SMSFs Multiport administers and the investments they held at the completion of each financial quarter. Funds are administered on a daily basis which ensures data is based on actual investments and is completely up to date. The assets of the funds surveyed represent approximately $2 billion

[2] ATO SMSF statistical report, March 2014.

[3] ATO SMSF statistical report, March 2014.

[4] Much of the information in the ATO's statistical tables is estimated, based on data reported to the ATO. The estimates have been based on data provided by SMSFs reporting their financial position as at 30 June of the relevant financial year.

Benefits of an LRBA

While most attention has focused on the risks of LRBAs and the inappropriate promotion of these arrangements, we believe when used in the right circumstances, LRBAs can provide important benefits for superannuation fund members.

The ability to magnify investment gains enables superannuation fund investors to accelerate the growth of their retirement savings. This is particularly important for superannuation members who have not had an opportunity to adequately save for their retirement in earlier years. The superannuation contribution caps impose limits on the contributions that can be made to superannuation on a tax concessional basis each year. This restricts members with broken working patterns being able to make catch-up superannuation contributions later in life.

Without the option of a LRBA, many superannuation members may find it more difficult to catch-up and achieve an adequate level of retirement savings.

Although in a practical sense the single acquirable asset rules that apply to LRBAs favour the acquisition of real assets as opposed to other types of securities, in a legal sense the law makes no distinction.

If the LRBA provisions were repealed would superannuation funds also be prohibited in investing in traditional instalment warrants which have embedded leverage? Prohibiting superannuation funds from being able to invest in instalment warrants would deny superannuation funds access to a well-developed market and widely accepted investment option. The original intent of the LRBA laws was to legitimise investing in instalment warrants, which have embedded leverage. But if superannuation funds were permitted to invest in instalment warrants, and no other form of leveraged investment, where do we draw the line between instalment arrangements with embedded leverage which are permitted and those which are not?[5]

Repealing the LRBA provisions, with some exclusions for traditionally traded instalment warrants, would in all likelihood result in superannuation funds, including SMSFs, being permitted to invest in some assets at the exclusion of others. The primary purpose of the modifications to the SIS Act in 2007, which gave rise to LRBAs, was to legitimise investing in instalment arrangements in a manner which avoided these discriminations.

Other alternatives

Rather than repealing the LRBA provisions, we believe the perceived risks and vulnerabilities these provisions present could be more appropriately addressed by tightening some of the current legislative provisions and introducing consumer protections measures previously released in draft format by Treasury.

The purpose of the draft amendments to the *Corporations Regulations 2001,* released for public comment in February 2012, were to bring LRBAs by superannuation funds into the Government's financial consumer protection framework. The draft Regulations, if implemented, would make LRBAs a financial product under the *Corporations Act 2001* (the Act) and would extend the consumer protection available to investors under the Act to superannuation funds when purchasing LRBAs.

The primary intent of the proposed Regulations was to stamp out unlicensed and unqualified LRBA advice being provided to superannuation funds. The proposed Regulations, if implemented, would ensure superannuation entities, including SMSF trustees, would have access to consumer protections, such as product disclosure, indemnity insurance or dispute resolution mechanisms.

[5] That is arrangements which involve an up-front payment to the issuer with the balance being repaid in periodic instalments.

It seems inconceivable to us that the LRBA provisions would be repealed in the face of reported inappropriate and unlicensed overselling, without first implementing these proposed Regulations and then, some time after, assessing their effectiveness.

To further strengthen these consumer protection measures, and subject to appropriate transitional rules being in place, we believe at least one party to the arrangement should hold a recognised SMSF accreditation.

We would welcome contributing our comments to the creation of a framework for Corporations Act oversight in determining advice and licensing requirements for the various participants in these arrangements.

While we believe the LRBA provisions in the SIS Act underpin an appropriate and measured approach to leverage by superannuation funds, the rules should be modified to prohibit related party borrowings as part of a LRBA. The ability of related parties to lend money to their SMSF on non-commercial terms is an overly generous concession which erodes the integrity and ultimately the confidence in the SMSF sector. Furthermore, we believe a requirement to engage an arm's length lender will ensure all LRBAs are subject to appropriate and conservative lending disciplines.

Self-Managed Superannuation Funds (section 2-123)

The Inquiry seeks further information on the following areas:

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

- Should there be any limitations on the establishment of SMSFs?

We do not believe the high operating costs of some SMSFs is reason for concern. The cost of establishing and running an SMSF is only one factor which should be considered when determining whether an SMSF is appropriate for the needs of the individual.

There are many situations where an SMSF may be the right option for the individual despite the fact the cost of establishing and running an SMSF far exceeds the costs of other superannuation structures. For example, individuals may have access to unique investment opportunities which can only be accessed via an SMSF and which justifies the high running costs of an SMSF. Other individuals with blended or complex family structures may have unique estate planning needs which can only met by establishing an SMSF.

Conversely, there are many situations where the operating costs of running an SMSF would be significantly lower than other types of superannuation structures (because the individual may have a large superannuation balance), but an SMSF is not the right option for the individual. The individual may lack the time, knowledge and desire to be an SMSF trustee.

We believe cost, when considered in isolation, is not an appropriate proxy for determining whether or not an SMSF is right for an individual. There can be many differences between the features and services of an SMSF versus an APRA regulated fund which are often reflected in the costs charged to members. Therefore, a direct cost comparison between SMSFs and APRA regulated funds can be difficult and requires a holistic and balanced assessment of these services and features and how they relate to the client's specific circumstance. The SMSF disclosure regime should encourage this holistic and balanced approach.

Even if cost was a reliable indicator of the suitability of an SMSF, the average and medium value of SMSFs has been steadily rising over the past decade, suggesting instances of SMSFs being established with lower balance is on the decline (see table 1 below).

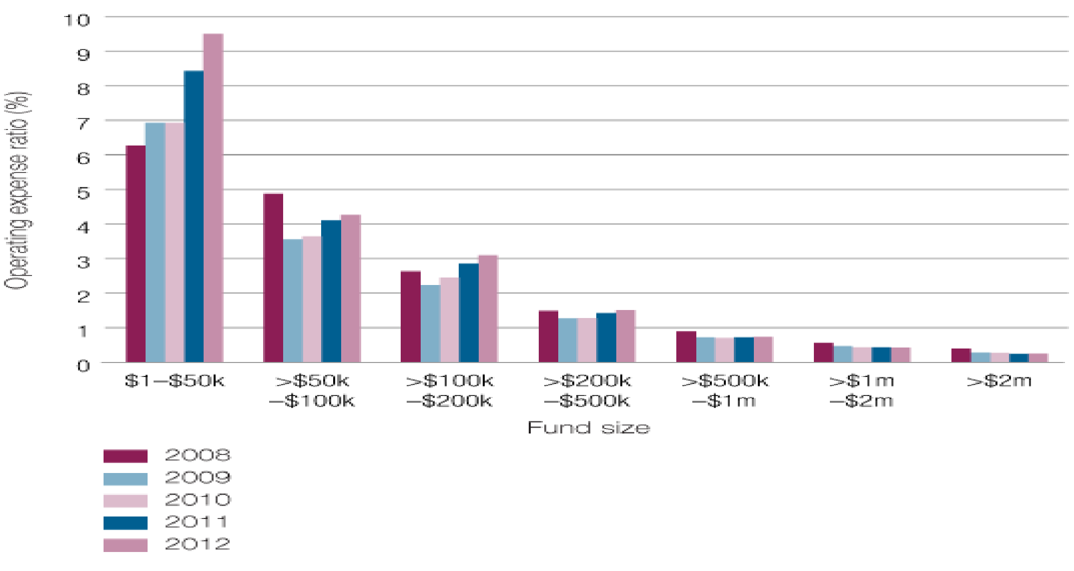
Table 1 – Average and median SMSF asset balances[6]

Average and median asset sizes

	2008	2009	2010	2011	2012
Average assets per member	450,913	428,016	458,356	494,133	486,602
Median assets per member	268,819	252,655	270,835	290,340	292,203
Average assets per SMSF	853,710	813,446	872,238	936,771	928,724
Median assets per SMSF	484,088	453,669	485,920	518,674	518,428

In the most recent SMSF statistical overview report released by the ATO (the 2011/12 report released in late 2013), based on data collected from annual SMSF returns, the ATO found that the majority of SMSFs had an estimated operating expense ratio of 1% or less (65% of SMSFs in 2012), the highest proportion (41%) of which had an estimated operating expense ratio of 0.25% or less (see graph 1 below).

Graph 1 – SMSF operating expenses ration by fund size[7])



The estimated operating expenses in the above graph suggest the points at which an SMSF becomes cost-effective compared with an APRA-regulated fund is likely to be significantly lower than those

[6] ATO 2011/12 SMSF Statistical Overview, Table 12: Average and median asset sizes.
[7] ATO 2011/12 SMSF Statistical Overview, graph 19: SMSF operating expense ratio by fund size.

referred to in the Rice Warner report. Alternatively, it could indicate a large number of SMSFs undertake a significant proportion, or all, of the administration functions themselves. Either way, when compared to the findings of the Rice Warner report, it highlights the subjective nature of estimating and comparing the operating costs of an SMSF from an industry wide perspective.

We don't believe it is appropriate for limitations or minimum balance limits to be imposed on the establishment of SMSFs. As highlighted above the breakeven points with APRA regulated funds can vary greatly and are highly dependent on the individual circumstances of the individual. Setting a minimum SMSF balance requirement is likely to be arbitrary and a highly subjective exercise. In many situations individuals who establish an SMSF with a low balance have the capacity to grow their superannuation balance considerably over the short to medium term so for these individuals, having to satisfy an arbitrary minimum balance limit would provide no benefit.

Furthermore, many SMSFs are established with a low nominal contribution amount to enable the SMSF to be established and to facilitate the transfer of their superannuation funds from an APRA Regulated fund. If a mandatory minimum balance requirement was introduced, consideration would need to be given to applying the minimum balance threshold over a period of time.

We believe the most appropriate way of ensuring SMSFs are being established in the right circumstances is to ensure individuals have access to competent SMSF advice.

Adviser competence (section 3-67)

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

- Raise minimum education and competency standards for personal advice (including particular standards for more complex products or structures, such as SMSFs) and introduce a national examination for financial advisers providing personal advice.

We believe the quality of SMSF advice has improved significantly over the past decade. However, more needs to be done to ensure all individuals have access to quality and competent SMSF advice when needed.

Cavendish, through their association with the University of Adelaide's ICFS, offer a SMSF specialist course including 3 days of face to face supported learning for professionals wanting to provide accredited and competent SMSF advice. Since its inception in 2011, over 600 advice professionals have completed this course.

We support raising the minimum education and competency standards for advisers who provide SMSF advice. Advisers who provide SMSF advice should be required to undertake specialised SMSF education and training. This would increase the level of professionalism in the SMSF sector leading to increased consumer protection and greater confidence in the SMSF sector.

There are many providers of education events in the SMSF sector but the absences of specific training standards for SMSF education providers means there is often significant variation in the duration, scope and overall quality of these events. While the Financial Services Training Package does contain SMSF knowledge requirements, many of these knowledge sets are not specific to SMSFs and are often intermingled with other more generic superannuation knowledge and skill requirements by course providers.

We support ASIC's review of RG 146 and their goal of increasing the standards of training for financial advisers in ASIC Consultation Paper 212 and 215. However, we believe the approach to the approval and regulation of courses for RG 146 as outlined in these papers requires further consideration.

We support the introduction of specific knowledge sets for SMSF advice and believe professional associations (approved by ASIC) should be responsible for setting and monitoring these standards. We think the approved professional association would be in the best position to determine the competency, training and education requirements for SMSF advice professionals. This approach is more likely to raise SMSF advice competencies and professional standards to a level beyond a "minimum" level which is the current RG 146 approach.

Subject to an appropriate transitional period, Advisers wanting to provide SMSF advice should be required to complete an SMSF course which has been approved or accredited by the relevant professional association.