29 August 2014

Head of Secretariat
Financial System Inquiry
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FINANCIAL SERVICES INQUIRY – INTERIM REPORT

Dear FSI Panel Members

Thank you for the opportunity to provide a response to the Financial System Inquiry's Interim Report. This submission outlines our comments and, where appropriate, provides recommendations in relation to the SMSF and the broader superannuation, financial advice and retirement income sectors.

By way of background, Dixon Advisory provides administration and advice services to 4,500 self managed superannuation funds with a combined asset base in excess of $4 billion.

Overwhelmingly consumers find the complexity, continuous regulatory and policy changes and capacity to manage costs across superannuation, retirement policy and financial advice systems significant barriers to achieving a satisfactory outcome. Given the extensive number of reforms introduced over the last decade, the complexity and cost of further reform needs to be carefully considered against the materiality of benefit.

Superannuation, one part of our three pillar retirement system is gradually succeeding in reducing the number of people receiving full Age Pension. The 2014 National Commission of Audit report shows the number of full pensioners reducing by 30% over the next 40 years as the impact of a maturing superannuation system grows people's retirement capital.

The Government commissioned Cooper Review in 2010 undertook extensive research into the Superannuation system and made recommendations across a number of areas to improve the efficiency of the system and the outcomes for members. While the significant recommendations - My Super and Super Stream – have already started to make a positive impact - as these measures are cemented further gains will be realised to the consumer.

The Future of Financial Advice reforms, tightening of the licensing conditions for accountants and the introduction of the Tax Agents Advisers Act have introduced significant improvements to the framework for and protections around financial advice. While some remaining aspects of these laws such as the register for advisers are yet to be finalised, consumers are expected to benefit. Importantly addressing the minimum education standards for Advisers remains a critical outstanding element to improving advice standards in Australia and forms a core part of our recommendations.

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Overall our recommendations focus on:

1. Introducing a minimum education standard of Undergraduate Bachelor degree plus approved professional accreditation standard (i.e. SSA, CPA, CFP, CA) for Advisers.
2. Increasing the number of people benefiting from the lower cost super products introduced as part of MySuper. The Inquiry should recommend standardised terms and conditions and portability for personal insurance held within super accounts. This will remove the significant barrier to the take up of super choice. An auction for default fund status is not supported due to the short term focus and market distortions this would create.
3. General advice should be renamed to product information. The term financial advice should only be able to be used to incorporate personal advice. This will provide consumers with a more intuitive understanding of the interactions they have with a financial adviser or employee of a financial services firm.
4. Given the extensive reforms recently introduced and the complexity and cost of more reform, changes should be contained to areas that are most likely to have a material impact to consumer protections or advice standards.
    a. That is the benefits of the MySuper and FOFA reforms should be allowed to progress through the system before further changes are proposed.
    b. Additional regulatory distinctions between independent versus other advisers, needs to be carefully considered against the materiality of benefit.
        i. The Corporations Act already restricts the use of ‘independent’ to circumstances where a person (or the person’s employer) receives a commission, volume bonus, or other benefit that may reasonably be expected to influence the advice.
    c. As there has been no evidence of systemic risks or failure in the fund administration sector there is no rationale for fund administrators to obtain an AFSL, particularly before existing reforms have finalised.
5. Limitations on establishing SMSFs should not be mandated as there a range of factors including better performance, flexibility and control offered by SMSFs that may justify establishing a SMSF.
    a. The cost estimates provided by Rice Warner to inform the Inquiry about operating expenses for SMSFs are overstated and should not be used as a representation of current operating costs.
6. Borrowing in SMSFs should continue to be monitored by lenders who control the integrity of the system.
7. Practical guidance, support and endorsement of ‘scaled advice’ by the regulator should be provided to encourage consumers to access lower-cost, effective financial advice.
8. Tax deductions for initial financial planning advice fees could be offered to encourage Australians to consider accessing financial advice and strategically organising their finances.

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9. Investigate and consider how the potential for technological advancements to contain the costs of providing advice and increase accessibility can be maximised whilst protecting consumers.
10. There should be no removal or changes to the imputation credit system as any changes would undermine the strength of the Australian financial system.

If you have any questions regarding Dixon Advisory's submission, please do not hesitate to contact me on 1300 883 158.

Kind regards

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Self Managed Superannuation Funds

2-126: Operating Expenses and Limitations on Establishing an SMSF

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?***

SMSFs have consistently delivered higher returns than the APRA regulated super fund sector. According to Rice Warner's report which shows SMSFs had a seven year average return 3.4% higher than APRA super funds between 2005 and 2011. According to the ATO's annual report, SMSFs have also outperformed large super funds for the four years ended 30 June 2007, 2008, 2009.

In addition to better performance, SMSFs can provide a number of advantages, including greater flexibility, control and competitive fees compared to APRA-regulated funds. Imposing limitations on establishing SMSFs does not reflect the range of reasons that contribute to making a decision on the suitability of superannuation product.

Publicly available market research shows that the annual fees referred to in the Inquiry are over-stated. Operating costs are overstated by approximately 60-70% for low service full administration providers and approximately 170-180% for high service full administration providers.

The Inquiry should also consider the range of service arrangements in the market that lead to lower operating expenses. For instance, costs can be lower in an SMSF where the service provider caps their fees once a fund reaches a certain balance.

While generally SMSFs are more cost effective when a combined balance has accumulated to around $200,000 - $250,000 the following examples demonstrate some of the other factors that may benefit an individual such that a SMSF becomes attractive even prior to reaching a minimum balance

Example 1: Investment Control

With a combined balance of $250,000, two Trustees, both 55 years of age with an average salary are looking to consolidate and grow their super over the remaining 10 years of their careers. It will be effective for them to use concessional contributions, spouse splitting and commence multiple pensions as part of a transition to retirement strategy. Using a basic APRA regulated fund would see them selling and buying out of investments as they implement the annual retirement strategies. This may impact on their investment decisions as well as incurring unnecessary tax. Further, using other higher cost APRA regulated funds that do provide the flexibility to implement these strategies tax effectively is likely to be more costly than an SMSF.

Example 2: Competitive Fees

With a combined super balance of $100,000, a small business owner couple, both 52 years of age, plan to make modest concessional contributions over the next three years and build their knowledge across the inner workings of SMSFs. When they sell their business in three years they expect to have a large amount to contribute. In the interim, they intend to use only government guaranteed cash accounts in their SMSF as they want very low risk, highly liquid investments to balance out the risk they take in managing a small business. Their annual costs will be very low and no more than what they would pay for establishing and running another entity such as a discretionary trust.

Example 3: Greater Flexibility and Control

With a balance of $200,000, the Trustee is a 50-year-old looking to build wealth in a tax-effective manner. They have a modest level of investment knowledge but have the goal to build this through self-education and assistance and knowledge from an investment advisor. The adviser discusses and explains the investment and portfolio management service which incorporates personal advice on investment decisions and the construction of a portfolio as well as regular economic and market commentary and invites to seminars.

Superannuation and Leverage

2-117: Leverage

The Inquiry would value views on the costs, benefits and trade-offs of the following policy option or other alternatives:

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

Restoring a general prohibition on direct leverage in superannuation funds is unnecessary as the regulations, existing lender requirements and limited tax benefits of gearing sufficiently protect lenders and customers.

Introducing a minimum education standard for Advisers and allowing lenders to continue to monitor the integrity of the system is the most appropriate way forward.

Direct leverage of SMSFs is a very small part of the financial system, accounting for $2.3bn of the $4.9 trillion in total lending for residential property. Lenders still retain control over borrowing conditions, and have the discretion to approve the borrowing.

The recent introduction of the 'best interests duty', tightened conflict of interest standards and scheduled changes to the accounting-advice licensing regime are all steps towards protecting consumers interests in establishing this strategy.

A prohibition on lending inside SMSF's would also negatively impact small businesses who use leverage within the SMSF to fund their real business premises. Self-employed individuals do not have compulsory superannuation and their business is generally their primary source of wealth creation opportunities. In many cases self employed people forego personal income for the benefit of building a sustainable business.

The economic consequences of a failed investment (future tax revenue and increased call on benefit payments) is just as likely to be borne by the government regardless of whether the investment was structured outside or inside super.

The low exposure to borrowing in an SMSF reflects how the tax benefits of gearing in an SMSF are relatively small compared to personal owner-occupied or investment property purchases and that lenders already impose significantly tighter lending conditions on SMSF borrowings, including:

- loans must be made on a non-recourse basis;
- lenders must investigate both the viability of the SMSF borrower and fundamental merits of the investment;
- limited degree of leverage (usually between 60-80% of the property); and
- a requirement for SMSF Trustees to obtain separate legal, tax and financial advice, making the application and documentation process more rigorous than a standard loan.

Further controls include restrictions on the improvement of property and its possible uses as well as annual scrutiny by auditors to assess compliance with regulations.

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Stability of superannuation policy settings

2-114: Fee Competition and MySuper

The rationale for MySuper was established following significant investigations undertaken by the Government commissioned Cooper Review published on 30 June 2010.

The launch of MySuper products from 1 July 2013 combined with a raft of technological changes has driven product development and innovation. This includes the first super account with no administration or management fees. MySuper has already increased competition within the market and as a result fees across a range of fund options have significantly reduced.

To drive competition further within the default super fund market and to increase the number of consumers who take advantage of the cost effective innovative super accounts as they come onto the market, the Inquiry should focus on addressing the major barrier to moving between super funds – insurance portability.

Introducing insurance portability between superannuation funds would remove or reduce the most significant cost of leaving a fund, simplify the switch decision and drive further fee competition in the market.

This could be achieved by allowing insurance policies to be transferred to the new super fund and standardising the terms and conditions for default insurance policies held within superannuation funds. These improvements would also enable advisers to provide more cost effective and efficient advice to consumers with smaller balance accounts looking to consolidate.

2-122 Imputation credits and tax-free superannuation

The comments in the interim report note that:

"Due to refundable imputation credits and tax-free superannuation in retirement, a growing proportion of company tax collected could be refunded to superannuation funds and retirees over time. Although this is of enormous benefit to retirees, it may erode one of the largest sources of revenue for the Australian Government at the same time expenditure pressures are increasing".

The fact that some investors including charities and superannuation funds may end up receiving a full or partial refund of the company tax paid is not a valid reason to change the imputation system. The tax rates within super are available across all types of super products (industry, retail, wrap and SMSFs) but not all administrators pass these benefits onto their members due to opaque reporting. The imputation credit system is also not the reason corporate bond markets are struggling but rather historically low interest rates.

Changing the income taxation arrangements for the entities receiving the refund, for example by levying an income tax on charities and pension funds would cause market distortion. This was demonstrated most clearly in the one year that the government denied access to imputation credits to super funds because they were tax-free entities. Market arbitrage in that short period helped tax-free investors to restructure their portfolios to replace dividend paying shares by assets including convertible notes and property assets.

The Australian tax system already provides a large financial incentive to invest in assets, including the family home and unincorporated assets yielding tax favoured capital gains. Even the threat of removal of imputation credits would trigger a rash of short selling and liquidation of portfolios of shares paying large fully franked dividends. It is also likely to encourage investing offshore and domestically in trust structures or other entities to avoid double taxation of dividends.

Since 1988, the value of imputation credits has been capitalised into share prices and any future government removing or significantly reducing the value of imputation credits would create volatility in the share market. Further, given that the four pillar banks all pay large fully franked dividends, removing the imputation credit system would weaken their fundamental strength and ability to raise equity capital.

Financial Advice

3-72: Accessibility of Financial Advice

The Inquiry seeks further information on the following areas:

- ***What opportunities exist for enhancing consumer access to low-cost, effective tax advice?***

Encouraging more Australians to seek financial advice is expected to reduce the burden on the public purse, as tax-payers can make more informed decisions about their finances, particularly when saving for retirement.

A critical step to managing the cost and complexity of the existing advice regime, where costs are ultimately borne by the consumer is to contain further regulatory change to areas that are most likely to have a material difference in protecting consumers or improving advice standards.

Scaled advice provides the flexibility to access financial advice on one or a limited number of topics. Advisers providing scaled advice must still address any relevant critical issues so the client's best interests are not compromised. While there is demand for this type of advice from consumers, further guidance and support from ASIC and external disputes organisations on scaled advice would provide more confidence to consumers about the value of this type of advice.

Offering tax deductions on initial financial planning advice fees may act as an incentive for individuals to take initial steps to strategically organising their finances through a financial planner, by alleviating some of the cost barriers to accessing financial advice.

- ***What opportunities are there for using technology to deliver advice services and what are the regulatory impediments, if any, to those being realised? What are the potential costs or risks of this form of financial advice, what measures could be take to mitigate any of these risks?***

Immediate investigation and consideration is required to consider how existing regulations interact with online and electronic mediums.

Noting the significant upfront costs borne in establishing a robust interactive on line presence, the potential for technological advancements to contain the costs of providing advice will be contingent on sensible and practical regulations.

Technology has moved quickly with advice and information around financial concepts and products already being accessed through a range of online mediums. Investigations should include enhancements to protect consumers who may access information and advice via online mechanisms including online discussion boards, chat rooms, YouTube, and interactive rules-based applications or websites.

The benefits include opening up further channels for interaction with advisers, sharing information and enhancing consumer knowledge and engagement. However, an unregulated forum environment poses risks including providing inaccurate or misleading information to consumers.

3-73: Independence

The Inquiry seeks further information on the following areas:

- ***Is there a case to more clearly distinguish between independent and aligned advisers, and what options exist for doing this?***
- ***Would consumers be likely to understand the difference between aligned and independent advisers and, if so, to what extent would this be likely to factor into a consumer's decision to take the advice?***
- ***Would consumers be likely to be sensitive to differences in the price of independent or aligned advice***

Given the extensive reforms recently introduced and the complexity and cost of further reforms, regulatory distinctions between independent versus other advisers needs to be carefully considered against the materiality of benefit.

The Corporations Act already restricts the use of 'independent' to circumstances where a person (or the person's employer) receives a commission, volume bonus, or other benefit that may reasonably be expected to influence the advice. ASIC is active in monitoring and enforcing this legislation through enforceable undertakings, issuing stop orders, public warning notices and pecuniary penalties. Not withstanding this, it is clear financial advice firms that are owned by major financial institutions should disclose ownership arrangements in a way that is clear and transparent to clients.

The current structure of interrelated advice business ownership is expected noting the small size of the Australian economy relative to global counterparts. Encouraging consumers to make decisions about selecting an adviser based on business ownership, does not assure the quality of advice will be superior and deflects attention from the importance of education and qualifications in driving the quality of advice.

The best interests duty and putting the client's interests first became mandatory under FOFA legislation from 1 July 2013. The Tax Agent Services regime applies to financial planners from 1 July 2014 with a three year transition period. This requires those licensees and many of their authorised representatives who provide a 'tax (financial) advice service', to register with the Tax Practitioners Board (TPB). There are education and experience requirements for planners to register with the TPB as well as continuing professional education (CPE) for tax (financial) advisers.

Reforms which are expected to make a material difference to quality of advice and enhance protection for consumers such as mandating a minimum education standard of an undergraduate Bachelor degree plus approved professional accreditation with a recognised professional body (i.e. CFP, SSA, CPA, CA) are supported.

Business ownership is not necessarily an indicator of quality of advice. Recent concerns with bank owned financial planners are well documented but between 2008 and 2013, independently-owned network of financial advisers and accountants, Professional Investment Services (PIS) was found to be negligent in its provision of advice, failing to adequately explain the risks involved investments, offer alternatives and advised clients to invest in the failed Westpoint Group companies and Queensland olive farm investment scheme. Further, between 2011 and 2013, PIS, who has a relatively small client base was involved in 162 FOS cases compared to FOS cases for bank-owned Commonwealth Financial Planning (CFP) recorded at 94 cases and 31 for Macquarie Bank (MBL).

3-74: General Advice

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options:

- ***No change to current arrangements***
- ***Rename general advice as 'sales' or 'product information' and mandate that the term 'advice' can only be used in relation to personal advice.***

A clearer distinction between factual/sales information and advice is expected to assist consumers in having greater awareness of whether they are receiving advice that takes into account their personal circumstances and financial goals or whether they are being provided with information which explains a product or arrangement.

General advice should be renamed to product information. The term financial advice should only be able to be used to incorporate personal advice. This would provide consumers with more intuitive understanding of the interactions they have with a financial adviser or employee of a financial services firm.

Regulatory Architecture

3-108: Conduct Regulation – Fund Administrators and Technology Service Providers

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

- ***No change to current arrangements.***
- ***Impose AFSL requirements for providers of fund administration and technology service of sufficient scale.***
- ***Apply market integrity rules for licensed securities dealers that provide investor services substantially similar to market participants of a licensed financial market.***
- ***Introduce a mechanism to allow a heightened level of regulatory intensity to be applied where risk arises outside the conduct perimeter.***

The findings of the Cooper Review in 2010 considered the issue of having fund administrators registered and found that there are myriad of issues which would arise should fund administrators be required to obtain an AFSL.

There has been no evidence of systemic risks or failure in the fund administration sector. This sector is also currently going through a period of significant change with the SuperSteam package of reforms and a three year transition period for changes to licensing regime for recognised accountants who provide advice about SMSFs.

Therefore any changes should only be considered once this sector emerges from its current phase of reform but should continue to be regulated by the ATO and APRA with a focus on improving the education standards and professional accounting qualifications as opposed to ASFL requirements.

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Retirement Income

4-08: Retirement Incomes and Ageing

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

A spectrum of options to achieve the objectives of the retirement income system and position Australia to manage the challenges of having an ageing population:

- ***Maintain the status quo with improved provision of financial advice and removal of impediments to product development.***
- ***Provide policy incentives to encourage retirees to purchase retirement income products that help manage longevity and other risks.***
- ***Introduce a default option for how individuals take their retirement benefits.***
- ***Mandate the use of particular retirement income products (in full or in part, or for later stages of retirement).***

Individuals who have saved inside superannuation should not be treated differently to those who save outside of superannuation. Self funded retirees should not be penalised for their disciplined savings by restricting or mandating the way in which they use their accumulated capital.

The existing account based pension system not only provides flexibility for managing the drawdown of retirement savings to provide income streams but can be used to manage longevity risk. Retirees in general also make decisions to try and preserve their accumulated savings to fund living expenses across their retirement and should be able to choose a retirement product and rate of draw down that best suits their needs and lifestyle choices.

Implementing policy incentives, default options for retirement benefits, and/or mandatory retirement income products is likely to discourage Australians to save through super. Noting the small size of the Australian investment market, the cost of funding annuity style products is ultimately likely to be borne by the Australian Government and result in no net savings compared to funding those people who live beyond their capital from the existing Age Pension system.

There are other methods for managing longevity, inflation and investment risks during the pension phase – particularly through informed financial advice and appropriate asset allocation strategies. Advice is important in helping people understand their retirement phase income stream and manage realistic expectations. Additionally the structuring of investments within a portfolio can significantly improve the outcomes for retirees. In particular managing through the retirement risk zone by taking a dynamic approach to asset allocation and risk profiling can protect capital and increase sustainability of draw downs.