Financial System Inquiry
Second Round Submission
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This submission will focus on three questions raised by the Financial System Inquiry interim report:

- Restoring "the general prohibition on direct leverage of superannuation funds on a prospective basis"
- "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?"

Leverage in superannuation funds

Given that the Financial System Inquiry (FSI) interim report notes "leverage in APRA-regulated funds is small, with total borrowings of under $2 million reported each quarter over the past year" this submission will be limited to consideration of borrowing by SMSFs.

Borrowing by SMSFs has been a growing and changing area, which has also caused concern in some sectors. This includes the Super System Review (Cooper Review) panel, which recommended that a review of SMSF borrowing be conducted within two years – which would have been by 2012:

> "The 2007 relaxation of the borrowing provisions and the consumer protection measures that have recently been announced should be reviewed by government in two years' time to ensure that borrowing has not become, and does not look like becoming, a significant focus of superannuation funds."[1]

In the response to the Super System Review recommendations the government of the day said:

> "The review will enable consideration of whether borrowing by superannuation funds has become excessive, placing fund assets at risk, and whether such investments should be permitted to continue."[2]

However this review did not eventuate and the current government has stated that the review will not occur[3].

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1 http://www.supersystemreview.gov.au/content/downloads/final_report/part_two/Final_Report_Part_2_Consolidated.pdf
2 http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/government_response/recommendation_response_chapter_8.htm
3 http://www.smsmagazine.com.au/articles/no-separate-review-for-lrbas-in-smsfs-sinodinos

The Treasury department has twice conducted a consultation process on proposed regulations which would "make limited recourse borrowing arrangements financial products under the Corporations Act when entered into by regulated superannuation funds":

- 2012: Corporations Amendment Regulations 2012 (No.) - Limited Recourse Borrowings By Superannuation Funds (Instalment Warrants)[4]
- 2010: Exposure Draft - Corporations Amendment Regulations 2010 (No.) - Limited Recourse Borrowings by Superannuation Funds (Instalment Warrants)[5]

This is an important consideration, given that ASIC said "there were concerning pockets of poor advice. Much of this advice involved recommendations that investors set up an SMSF to gear into real property"[6]. However a conclusion, either for or against the measure, has not resulted from the consultations.

A review into SMSF borrowing would be better suited to considering this issue, with consultation to resolve any outstanding problems.

I would recommend that the panel strongly consider the submissions by a number of bodies, including the CPA, FPA and ICAA, in recommending that a review into borrowing by SMSFs be conducted. Such a review could consider all the relevant aspects of borrowing by SMSFs, including:

- appropriateness of borrowing in SMSFs
- cost effectiveness of the required structures
- financial stability implications
- impact on housing affordability
- level of consumer protections
- licensing of financial advisers
- licensing of real estate agents
- implications for SMSF liquidity and diversification

4 http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2012/Limited-Recourse-Borrowings-by-Superannuation-Funds
5 http://archive.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1829
6 http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep337-published-18-April-2013.pdf/$file/rep337-published-18-April-2013.pdf

Operating costs of SMSFs

The panel should give limited weight to statistics showing that some SMSFs experience high operating costs. I argue that these high costs are not a structural issue but a consequence of the stages the SMSFs are in when the statistics are collected.

The main concern is that SMSFs with small balances experience higher operating costs. However an SMSF with a small balance is more likely to be either recently established, or winding-up. These stages do not reflect the costs applicable to SMSFs during most of the years of operation.

Formation costs are incurred when an SMSF is established, largely relating to structuring and advice. But at this stage the balance of the SMSF may be low until, for instance, rollovers from APRA funds are received. As such the SMSF may report a small balance and a comparatively high administrative cost to the ATO. However this does not reflect the long term costs applicable to the fund.

Likewise an SMSF that is winding up would be reducing assets held – either by paying benefits out to members or their dependants, or rolling over into another fund. But the fund would report to the ATO, in the final tax return, that it held no assets but did incur administration costs. Depending on how the statistics have been collated this could skew the figures for operating costs of SMSFs.

This would also explain why, despite the high reported operating costs for some SMSFs, as noted in the FSI interim report "Rice Warner research suggests the average fee rate for SMSFs is lower than the industry average".

The Rice Warner report, *Costs of Operating SMSFs*[7], said that:

"In summary:

- SMSFs with balances of $200,000 or more can provide equivalent value to industry and retail funds provided the trustees undertake some of the administration.
- SMSFs with balances of $500,000 or more can provide equivalent value to industry and retail funds on a full service basis."

The report also found that "for balances of $250,000 or more SMSFs become the cheapest alternative provided the trustees undertake some of the administration".

These asset balances should be compared to the ATO SMSF statistical overview for 2011/12[8], which found that in the median assets per SMSF were $518,428, with median assets of $202,452 for newly established SMSFs.

7 https://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp216-RiceWarner-cost-of-operating-smsfs.pdf/$file/cp216-RiceWarner-cost-of-operating-smsfs.pdf

8 https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Annual-reports/Self-managed-superannuation-funds--A-statistical-overview-2011-2012

While the interim FSI report notes that almost a quarter of SMSFs in 2011/12 were under $200,000, this amount is declining - down from 27.7% in 2008/09 to 23.30% in 2011/12. This includes a declining trend in sub-$50,000 SMSFs, from 8.1% in 2008/09 to 6.7% in 2011/12[9].

Rice Warner also found that SMSFs were cost-competitive with APRA-regulated funds in the *FSC Superannuation Fees Report 2013*[10], and in some cases had significantly lower operating costs.

According to the report, SMSF total fees were 0.95%, which is lower than all fund-types in the retail category except Retirement Savings Accounts. SMSFs were also lower than Industry funds (1.07%), but higher than Corporate, Corporate Master Trusts and Public Sector funds.

Rice Warner also found SMSFs spent only 0.26% on operating costs, compared to 0.41% for industry super funds and 0.84% for retail personal super funds.

However the focus shouldn't be on costs to the exclusion of outcomes. For instance, though a corporate trustee increases costs, the Super System Review noted “it is widely accepted by professionals and the ATO that a corporate trustee is superior”[11]. However the ATO said that at the end of the 2013 financial year 75.79% of SMSFs had individual trustees. The use of individual trustees is also increasing among newly established SMSFs, up from 89.75% in 2011 to 90.43% in 2013[12].

While the operating costs of SMSFs should be monitored, which would be assisted by the publication of more complete statistics by the ATO, I don't think that it represents a structural issue that should give the panel concern.

9 https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Quarterly-reports/Self-managed-super-fund-statistical-report---March-2014/?page=2#Total_asset_range_table
10 http://ricewarner.com/media/96729/Rpt-FSC-Superannuation-Fees-Report-2013-FINAL.pdf
11 http://www.supersystemreview.gov.au/content/downloads/final_report/part_two/Final_Report_Part_2_Consolidated.pdf
12 https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Annual-reports/Self-managed-superannuation-funds--A-statistical-overview-2011-2012/?page=32#Table_6__SMSF_trustee_type

Should there be any limitations on the establishment of SMSFs?

The question of placing limitations on the establishment of SMSFs is highly dependent on the type of limitation, which could include:

- sign-off by an adviser
- an educational requirement
- a superannuation balance requirement
- a sophisticated investor requirement

While there is some concern that people aren't being improperly advised to set up SMSFs, I would argue that this could better be addressed through the existing advice frameworks, rather than a restriction on the set up of SMSFs.

I would also draw the panel's attention to the conclusion of the Super System Review, which considered several options for limitations on the establishment of SMSFs and found that:

> "it is inappropriate to implement any form of entry level 'gatekeeper' mechanism. A 'gatekeeper' mechanism would not resolve the underlying problem of inadequate advice being provided at SMSF establishment by advisers."[13]

A requirement for potential SMSF trustees to seek advice before setting up an SMSF is problematic when ASIC finds in a review of SMSF advice that 98.7% of files were less than 'good'[14]. Such a requirement would simply create another level of cost and compliance, without markedly increasing consumer protections.

People who choose to have an SMSF take on a much greater level of responsibility for their retirement savings than people in an APRA-regulated fund. However many trustees may not be fully aware of their obligations as SMSF trustees, and so an education requirement may be worth further consideration. However such a measure should increase trustee knowledge, instead of merely satisfying a 'tick-the-box' requirement.

SMSFs could also be limited based on the level of superannuation funds available or the amount of personal assets, such as the retail/wholesale investor tests. However this would be a blunt instrument, removing the ability of individuals to best judge the appropriate savings vehicle for their retirement and arbitrarily restricting access to the benefits of SMSFs.

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13 http://www.supersystemreview.gov.au/content/downloads/final_report/part_two/Final_Report_Part_2_Consolidated.pdf

14 http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep337-published-18-April-2013.pdf/$file/rep337-published-18-April-2013.pdf

I recommend to the panel that any limitation on the establishment of SMSFs should seek to improve the operation of the superannuation system, rather than simply limit the choices available to people in decisions about their retirement. Choice is an important aspect of the superannuation system and people should be encouraged to take an active interest in their superannuation.

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I have an interest in SMSFs, superannuation and retirement policy, and also write for the website SolePurposeTest.