The Melbourne SMSF Group

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Dear Sir,

Re: Submission Regarding FSI Final Report

The Melbourne SMSF Group is a non profit, self help organization providing a regular forum for SMSF Trustees to exchange information and ideas regarding the operation of Self Managed Super Funds. The group has been operating for 11 years, and in that time has grown, by word of mouth, to over 200 members.

We believe we fulfil a valuable role in fostering Trustee involvement and learning, and encouraging responsible SMSF management.

The key objectives of our group are to:

- Promote compliance with the SIS Act and Tax Legislation.
- Promote self education and sharing of information between SMSF Trustees
- Gain educational assistance from the ATO, Centrelink and other organisations.
- Promote clarity and simplicity in the practical operation of Self Managed Funds.
- Promote sound investment practice, and the preservation of retirement savings.
- Discourage the use of SMSFs where obviously inappropriate.

In response to your request for comment on the recommendations of the Financial Systems Inquiry, we wish to make the accompanying submission to raise a number of issues and offer suggestions for improvements to the operation of our financial system.

We offer these suggestions from a consumer perspective, and that of Australians prepared to fund themselves in retirement, rather that burden the public purse.

As far as we are aware we are the only organisation of our type in Australia. As a group run by SMSF trustees, for SMSF trustees, with no commercial affiliations, we are able to present an informed view from the SMSF Trustee perspective.

We would welcome the opportunity to provide further detail or comment to support any aspect of our proposal, if required.

Yours faithfully,

Viv Elliston (Chairman)

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Submission Regarding FSI Final Report

Comment on Inquiry's Recommendations

1. Introduction

The Financial Systems Inquiry and the Final Report has been a very welcome initiative and has produced many good recommendations for improving Australia's Financial System.

From our perspective some recommendations do not go far enough in addressing particular issues, and others are expressed in terms that are too general to clearly identify required improvements in a few critically important areas.

In this submission we would like to discuss some of these issues and offer more prescriptive suggestions for improvement. In particular we would like to address issues that are of particular interest to those willing to fund themselves in retirement, rather than burden the public purse.

We also view these issues from the perspective of the consumer who we believe needs to be afforded fair and honest treatment in any well-functioning and successful market economy.

2. Issues Raised in this Submission

We wish to raise the following Issues, discuss any concerns, and make suggestions that we believe will help to improve our financial system and make it fairer and more secure for all participants:

1. Fee Structure for Managed Investments
2. Allocation of Investment Risk for Managed Investments
3. Financial Product Salespersons and Financial Advisors
4. SMSF Borrowing Rules
5. Funding of Regulators and Consumer Organisations

2.1 Fee Structure for Managed Investments

2.1.1. Outlining the Issue

The Murray Report suggests that fees for managed investments have fallen in recent years and are now generally below about 1.8% of asset value, commenting that it was hoped that fees could be lowered further by increased competition. However no additional strategies were suggested to lower fees further.

We believe that the real issue is the flawed model around which the fees are established and being expressed, and that a much fairer arrangement with more appropriate incentives and greater accountability should be adopted.

It is common practice to base fees on a percentage of invested capital. Fees charged on this basis are not related to the work performed or the achieved earnings outcomes - and as such seem too arbitrary to be adequately justified.

Also, under these arrangements there is guaranteed reward for the Fund Manager, while investment risk and any losses are allocated to the client.

2.1.2. Concerns

It seems obvious that fees calculated as an arbitrary percentage of invested capital have no sound basis or financial justification. A model based on actual investment costs (if any) as well as investment performance would seem far more logical and fair.

We believe that the fundamental principal of calculating management and other fees as a percentage of invested capital needs to be changed. Such fee structures are heavily stacked against the interests of the consumer, and work to unfairly reward the Funds Management Industry regardless of actual costs or investment performance.

The current approach disguises the fact that fees represent a significant percentage of real earnings. Where investment performance is poor the Fund Manager may take 100% or more of any such gains. Even where investment performance is so poor that there are losses, a percentage of the client's capital is still claimed.

To clarify the above points consider the following arrangements:

1. Management fees charged at 2.5% of invested capital.
2. Investment Return of 8%
3. Inflation rate of 3%

This results in a real return on capital of 5% (8% - 3%).

So the investment manager is claiming 50% of the return earned on the client's capital (Management fees of fees of 2.5% of capital, on a return of 5%).

Expressed in this way it is clear that the Fund Manager is taking a very large percentage of investment earnings. We believe that charging fees on the current basis is inappropriate, and expressing them as "only 2.5% of capital", instead of 50% of earnings is very deceptive and misleading to consumers.

Such fees are also clearly excessive, and they should be exposed as such.

2.1.3. Recommendations

Allowing investment managers to access client capital for fees or any other charges should be prohibited. Investment managers are engaged to generate earnings and they should only be entitled to share in an agreed proportion of the earnings they generate.

The agreed percentage of earnings taken by investment managers in fees should also be applied to investment losses, so that investment losses are shared between investment managers and the Client.

Fees and charges should only be calculated and expressed as a percentage of real earnings (after inflation has been accounted for). We believe that this will expose the current level of fees to greater scrutiny and lead to appropriate pressures on financial institutions to justify charges or make greater efficiencies and consequent fee adjustments.

In support of the general sentiment expressed in the Murray Report that fees need to be reduced, we would urge the Government to effect legislative change to ensure that a fairer fee regime is implemented across the industry.

2.1.4. Additional Note:

We feel that the suggested figures for fees relating to managed investments may have been understated in the report, and that fees at the upper end of the scale may be higher than those indicated.

2.2 Allocation of Investment Risk for Managed Investments

2.2.1 Outlining the Issue and the Concerns

In addition to enjoying risk free income from client assets investment managers carry none of the investment risk. The investment manager cannot lose, while the client must pay fees regardless of earnings performance, as well as bearing any losses or below par returns.

This gross imbalance and guaranteed income also provides poor incentives for investment managers, and clients considering moving their funds elsewhere generally face the same arrangements.

From a consumer perspective this model heavily favours the investment manager / financial institution to such a degree that it can only be considered as grossly unfair.

2.2.2 Recommendations

The reward as well as the risk should be shared - and hence negative earnings (losses) should be borne by both client and the investment manager. It would seem appropriate for the agreed percentage of income used to determine fees should also apply to the investment manager’s share of any losses.

2.2.3 Further Comments on Potential Benefits

This arrangement should provide a strong incentive for investment managers to optimise investment risk because they also stand to share any losses. An investment partnership of this nature would seem to be a fairer arrangement and should provide healthier incentives for investment managers.

Financial institutions employing investment managers should also be motivated to ensure that relevant staff are well trained and competent, ensuring that the loss / reward ratio is optimised for the institution as well as the client.

It would also seem appropriate that financial institutions / investment managers be required to accumulate sufficient funds in good years carry any losses – or should be required to make up losses in subsequent years – or establish some other suitable arrangement.

2.3 Financial Product Salespersons and Financial Advisors

2.3.1 Outlining the Issue

Although there is some recognition in the Murray Report that use of the term “Financial Advisor” by those engaged to sell particular financial products may be misleading to consumers, the recommendations made only go a small way in addressing the issue.

There would seem to be a need to clearly differentiate between the following:

1. Professionals who offer completely unbiased financial advice and act totally in the best interests of their clients at all times.
2. “Financial Product Salespersons” who are remunerated for “selling” a particular financial product or service offered by the provider, and are motivated to put their interests before those of the client.

2.3.2 Concerns

Clearly the titles given to financial professionals carry a great deal of meaning, especially to those who may have limited understanding of how the industry operates. For this reason it is critically important that titles are not deceptive and that they clearly indicate the true function and motives of anyone who could impact greatly on their financial future.

The level of financial literacy in the general community is such that many consumers are not well aware that the term “Financial Advice” is frequently used in situations that are really product marketing exercises. Often clients also incorrectly believe that they are receiving unbiased advice that is in their best interests.

Although such salespersons may offer advice, it is clearly biased by financial incentives to deliver maximum benefit to the product provider at the expense of the client, and it is important that the consumer is aware of this fact.

Allowing salespersons heavily biased by the incentive of personal financial gain to operate under the guise of “Financial Advisor” is clearly very inappropriate.

It is perfectly understandable for financial institutions to want the freedom to employ strategies that heavily favour their businesses. However where there is such a large knowledge imbalance between the consumer and big financial institutions it is essential to provide adequate consumer protection – using legislative tools if necessary.

2.3.3 Recommendations

Use of the title “Financial Advisor” should be strictly limited to those who are able provide completely unbiased financial advice and who genuinely put the best interests of their client first.

Those remunerated for selling particular financial products or services on behalf of a product provider should be required to use a title that properly describes their activity. The term “Financial Product Salesperson” would seem to be an honest and accurate term to use.

Not only should “Financial Product Salespersons” be banned from posing as genuine Financial Advisors, they should also be required to clearly disclose how they are remunerated, and that their first priority is to act in their own best interests and those of the organisation(s) they represent.

2.3.4 Further Considerations

Taking a longer term perspective it would seem important for the Government to ensure that as many people as possible have adequate savings in retirement and are less reliant on government support. The effect of high fees and low rates of return on savings over an extended period can be very significant, and does not work in the best interests of the Government, the Taxpayer, or those prepared to fund themselves in retirement.

We welcome the recommendation that those offering “financial advice” to consumers should be required to attain a higher level of financial knowledge than is currently the case. However improved knowledge provides no guarantee that consumers will be given advice that is in their best interests – especially where improved knowledge may include improved marketing skills.

2.4 SMSF Borrowing Rules

2.4.1 Outlining the Issue

Although we see some benefit in allowing SMSFs to borrow money for investment purposes, we believe that current trends could be exposing superannuation savings to unacceptable risks. In balance we support the recommendation of the Murray Report to discontinue of this allowance.

2.4.2 Concerns

The following factors concern us regarding borrowing for property investment by SMSFs:

1. Highly geared property investments introduce the risk of very serious losses in the event of a major downturn in market value – possibly resulting in negative equity.
2. For many SMSFs property investment can represent a large percentage of fund assets, so there is real potential for serious loss of retirement savings.

3. The aggressive marketing of highly geared property investment schemes to SMSF Trustees by the Financial and Property industries is heavily biased towards making profits, rather than offering sound advice in the best long term interests of the SMSF.
4. Clearly those already in retirement with little opportunity to recover financially are particularly vulnerable where a high level of borrowing is involved. In this regard little or no discretion is exercised by most promoters of such schemes.
5. Many areas of the Australian property market have performed well in the past two decades, perhaps giving the false impression that returns are almost guaranteed – especially to the not so experienced.

2.4.3 Recommendations

Borrowing by Self Managed Superannuation Funds for investment purposes should be disallowed – however existing borrowing arrangements should be allowed to remain in place until such loans are paid off.

2.5 Funding of Regulators and Consumer Organisations

Our financial watchdog (ASIC) and consumer protection bodies (including the ACCC) provide a valuable safeguard and bring balance and greater safety to our Financial System.

As such they must be provided with proper protection and adequate funding to ensure that they can provide appropriate protection for consumers and smaller players – and to ensure that our Financial System remains safe and robust in the event of internal or external financial shocks.

Not only should funding be adequate, but there should also be ongoing funding certainty so that important longer term initiatives can be implemented without disruption or uncertainty.

It is critical that these essential organisations are Independent and able to act without fear of political influence or pressure. Measures should be implemented to provide greater certainty that they can always confidently take decisive action where required to protect consumer interests and the security of our financial system.