Final Financial System Inquiry Report

SUBMISSION
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Self Managed Super Fund Association

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Introducing the SMSF Association (formerly SPAA)

The SMSF sector continues to grow and evolve, and is now the largest super sector in terms of asset size and boasts around one million trustees. In the wake of these momentous events, the SMSF Professionals' Association of Australia Limited (SPAA), after much discussion following recent results from stakeholder research, has decided to change its name to better reflect our growing sector and vibrant organization.

The new name is the SMSF Association.

The overwhelming consensus has been that we need something simpler and more intuitive, and nothing, we strongly believe, better fits this requirement than the SMSF Association.

In making this decision, we are aware of the status the SPAA brand has gained over the past 12 years, especially with government, regulators and across the financial services and superannuation industries. But the truth of the matter is that the name "SPAA" often confuses the wider SMSF community.

Given our mission is to lead the entire SMSF sector, it is critical we have a brand that instils confidence and trust and clearly shows where trustees can get the best professional advice.

We are proud of the success of the SMSF sector, and SPAA's pivotal role in this, and look forward to an exciting future under our new banner – the SMSF Association.

Our submission on the Financial System Inquiry Final Report is guided by the beliefs of our association's beliefs. These beliefs are:

> *We believe that every Australian has the right to a good quality of life in retirement.*
>
> *We believe that every Australian has the right to control their destiny.*
>
> *We believe that how well we live in retirement is a function of how well we have managed our super and who has advised us.*
>
> *We believe that better outcomes arise when professional advisors and trustees are armed with the best and latest information, especially in the growing and sometimes complex world of self-managed super funds.*
>
> *We believe that insisting on tight controls, accrediting and educating advisors, and providing accurate and appropriate information to trustees is the best way to ensure that self-managed super funds continue to provide their promised benefits.*
>
> *We believe that a healthy SMSF sector contributes strongly to long term capital and national prosperity.*
>
> *We are here to improve the quality of advisors, the knowledge of trustees and the credibility and health of a vibrant SMSF community.*

We are the SMSF Association.

Executive Summary

The SMSF Association is pleased to be afforded the opportunity to respond to the Government's consultation on the Financial System Inquiry (FSI) Final Report. As leaders of the $568 billion SMSF sector we have focussed our submission on the recommendations that will affect SMSFs and their advisors.

As explained below, we have deferred making significant comment on the taxation issues affecting superannuation raised by the FSI until engaging in the Tax White Paper process.

Resilience

Superannuation fund borrowing

The SMSFA does not support the FSI's recommendation to ban the use of limited recourse borrowing arrangements by superannuation funds, instead proposing a suite of measures that can mitigate build-up of risk in the superannuation system. These measures include:

- Bringing LRBA advice under the AFSL regime.
- Increasing ASIC resources.
- Limiting the use of guarantees.
- Tightening related party borrowing rules.

Superannuation and retirement incomes

Objectives of the superannuation system

We support the FSI's recommendation to seek broad political agreement for the objectives of superannuation and support that the main goal for the superannuation system should be focussed on the provision of retirement income. An adequate review mechanism for superannuation is also integral to providing policy stability.

The retirement phase of superannuation

The SMSFA does not oppose the FSI's comprehensive income product for retirement (CIPR) approach to improving retirement income and supports the recommendation that SMSF trustees not be included in the CIPR requirement.

In addition to a product based solution, such as the CIPR, we believe the Government needs to consider developing greater coordination between the retirement income, social security and tax systems to encourage sustainable and appropriate drawdowns on retirement income.

We support removing impediments to retirement income product development but stress the need to maintaining product neutrality between different types of retirement income products.

Choice of fund

We support the FSI's recommendation to provide all employees with the ability to choose the fund into which their Superannuation Guarantee contributions are paid.

Consumer Outcomes

Product issuer accountability and a regulator product intervention power

We support the FSI's recommendation to improve product issuer and distributor accountability and to develop a limited product intervention power but stress the need to balance this with allowing innovation.

Facilitating innovative disclosure

We support this recommendation and believe that current disclosure arrangements have not improved consumer understanding of financial products.

Align the interest of financial firms and consumers, and, raise the competency of advisers

The SMSFA supports these recommendations and is currently working with the Government in regards to its implementation of the report from the Parliamentary Joint Committee on Corporations and Financial Services' inquiry into proposals to lift the professional, ethical and education standards in the financial services industry.

Rename 'general advice' and require advisers and mortgage brokers to disclose ownership structures.

The SMSFA supports the recommendation to rename 'general advice' so that consumers can better understand the nature of general advice.

Regulatory System

We support the FSI's recommendations generally to encourage greater accountability and transparency of financial system regulators.

Taxation Issues

The SMSFA will be addressing taxation of superannuation and savings in detail in the upcoming Tax White Paper process and will defer making detailed comment to engaging in that process. We have provided a short summary of our views on the FSI's taxation issue observations.

Resilience

Recommendation 8 - Direct borrowing by superannuation funds

Remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds.

The SMSF Association does not support this recommendation of the FSI.

We understand that the FSI made this recommendation in order to achieve two key objectives:

1. Prevent the unnecessary build-up of risk in the superannuation system and the financial system more broadly.
2. Fulfil the objective for superannuation to be a savings vehicle for retirement income, rather than a broader wealth management vehicle.

We believe that the use of limited recourse borrowing arrangements (LRBAs) by superannuation funds is consistent with this second objective (and can be a successful strategy to build retirement savings). However, we acknowledge that it is necessary to prevent any build-up of unnecessary risk in the superannuation system although we do not believe that this has occurred under the current LRBA laws. Accordingly, we believe the Government can achieve this objective by implementing a series of alternative measures rather than banning the use of LRBAs.

These alternative measures are:

- Bringing LRBA advice under the AFSL regime.
- Increasing ASIC resources.
- Limiting the use of guarantees.
- Tightening related party borrowing rules.

Bring LRBA advice under the AFSL regime

The SMSFA believes that superannuation fund trustees should be protected by the *Corporations Act 2001* financial consumer protection framework when they enter into an LRBA. The SMSFA considers that proposals to introduce a consumer protection framework should be expedited in consultation with relevant professional groups. Draft regulations produced by the previous government have contained a number of shortcomings and in our view require further development. In the SMSFA's view, consideration should be given to ensuring that structural advice on LRBAs should be provided by a licensed adviser.

We believe that inclusion of LRBAs in the AFSL regime will help ensure SMSF trustees are being properly advised on both the risks and the benefits of LRBAs and the suitability of the strategy for their fund. The licensing of these arrangements is also entirely consistent with the views expressed by the Super System Review Panel (the Cooper Review) which concluded such consumer protection measures were appropriate in light of the 2007 amendments to the borrowing provisions.

Further, bringing LRBAs into the AFSL regime will ensure that providing advice on LRBAs falls under the Future of Financial Advice (FOFA) provisions. This will mean that the best interest duty obligations and the ban on conflicted remuneration will apply to LRBA advice. Applying the FOFA provisions to LRBAs will outlaw any unprofessional remuneration, such as payments from property scheme promoters to accountants or financial planners, from applying to LRBAs.

Increased ASIC resources

Consistent with requiring that LRBAs be a licensed financial product, ASIC as the regulator of financial advice, needs to be appropriately resourced to police advice provided to SMSF trustees on LRBAs. Even without including LRBAs as a financial product, increased ASIC resourcing would allow the regulator to take more action on advice provided to SMSFs on LRBAs by unlicensed individuals (or poor advice provided by licenced individuals). This type of advice can come from mortgage brokers and real estate agents who recommend that an investment property be acquired through an SMSF.

Limit use of guarantees

Limiting the use of personal guarantees by SMSF members is another possible policy measure which could minimise risk in leverage used by SMSFs creating any systemic vulnerabilities.

Personal guarantees given by members of SMSFs allow the SMSF to undertake larger borrowings with higher loan-to-value ratios. While the SMSFA is comfortable that the vast majority of SMSF borrowing is being made within sensible LVR limits, prohibiting SMSF members from providing a personal guarantee for their SMSF's borrowings would it increase risks to the lender would make it more difficult for lenders to make risky and high LVR loans to SMSFs.

Without personal guarantees, an SMSF would need a greater amount to undertake investment via an LRBA in view of stricter lending policies that could be expected. This would limit the ability of property spruikers to use SMSF as an investment vehicle for using LRBAs to promote speculative property investments to investors. In particular, it would reduce the ability for property spruikers to encourage individuals to set up an SMSF with a small balance simply to purchase a property within the SMSF.

Tightening related party borrowings

Another possible policy solution to minimise risks associated with superannuation fund leverage is to tighten existing requirements for related party borrowing by SMSFs. Related party borrowings, which are permitted by the *Superannuation Industry (Supervision) Act 1993 (Cth)* (SIS Act), allow the SMSF to borrow from related parties via an LRBA. These borrowings, while needing to be on an arm's-length basis in accordance with the SIS Act, can allow for SMSFs to undertake more risky and higher LVR arrangements and also allow for SMSFs to borrow on a zero interest basis.[1]

A possible solution is to tighten the use of related party borrowing via an LRBA could be to require funds to have a commercial rate of interest as part of the loan arrangement. We believe that this maintain the integrity of LRBAs.

Grandfathering of existing arrangements

If the Government was to follow the FSI's recommendation to prohibit borrowing by superannuation funds, then appropriate grandfathering arrangements need to be provided for two key arrangements:

1. Existing LRBAs; and
2. Where a contract for the purchases of an assets will use a LRBA at a future date.

<u>1. Existing LRBAs</u>

Where a trustee has an existing LRBA in place, the LRBA should be grandfathered under the current law so they are not retrospectively effected by a law change.

Grandfathering of existing LRBAs should extend to the refinancing of an existing LRBA so that borrowers are not locked into uncompetitive loan arrangements if market conditions change (e.g. interest rate movements),

<u>2. Where a contract for the purchases of an assets will use a LRBA at a future date</u>

A trustee may have entered a contract to purchase an asset, but an LRBA will not be formally in place until the contract settles, which is when the loan will be funded by a lender. This is common place in off-the-plan purchases, where the buyer enters a contract for the purchase of a property but settlement does not occur until the property development is complete and the loan is then funded at that point in time.

Providing this type of grandfathering will give trustees certainty where they have entered contracts which are to be funded by a LRBA.

While we believe that these alternative proposals should allow the Government to mitigate any potential risks that could arise from LRBAs we also believe that some of the reasoning put forward by the FSI to ban borrowing is inaccurate.

<u>*Prevent the unnecessary build-up of risk in the superannuation system and the financial system more broadly*</u>

The SMSFA acknowledges certain risks can be created by gearing within superannuation, whether through indirect gearing by investing in geared investment structure or directing

[1] The Australian Taxation Office stated at the June 2012 meeting of the Superannuation Technical Sub-group of the National Tax Liaison Group that a related party could lend to their SMSF at a zero interest rate without contravening the SIS Act (i.e. the zero-rate does not contravene arm's length investment requirements or count as a contribution to the fund).

borrowing. However, we do not believe that direct gearing through the use of LRBAs is occurring in an excessively risky manner that may create vulnerabilities in the superannuation and financial systems. .

In regards to SMSF use of LRBAs the SMSFA does not believe there is an excessive use of LRBAs by SMSFs. The most recent ATO statistics show that as of December 2014 SMSFs had a total of $9.382 billion out of total SMSF assets of approximately $568 billion invested via the use of an LRBA.[2] This represents 1.65% of all SMSF assets. This proportionately small level of investment via LRBAs does not pose a systemic risk to the Australian financial system nor to the volatility of the real estate market.

Further, the SMSFA's discussions with major lenders in the SMSF lending market show that the majority of loans made to SMSFs are being made with responsible lending practices. In effect, banks have tighter lending policies and have experienced lower levels of default than loans made for other purposes.

The SMSFA has worked with the major lending institutions to obtain SMSF lending data, as at November 2013, representing a sample set of 14,783 LRBAs. This data set was considered by the major lenders to account for approximately 90% of all non-related lending LRBAs in SMSFs. The SMSFA was able to review the data and was able to ascertain that the average loan to an SMSF is approximately $311,000 with an average loan-value ratio (LVR) between 60% and 75%. The average value of the properties was $450,000. We believe that this indicates that the vast majority of SMSF LRBAs are being made soundly and responsibly.

Further, recent discussions with the SMSFA members who assist SMSF trustees to borrow from major lenders in relation to LRBAs have noted that lenders are implementing stricter lending criteria in regards to:

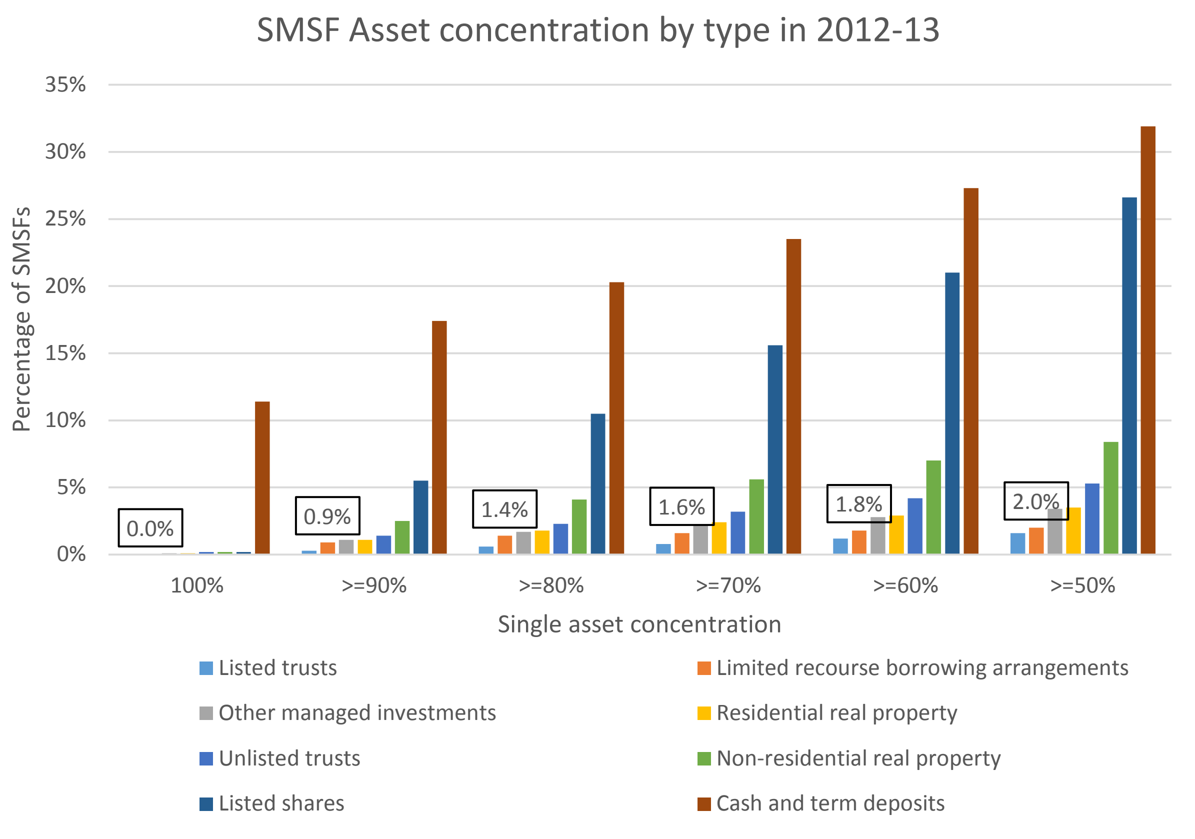
- Requiring SMSFs to have substantial balances before a loan is made (i.e. over $150,000, with some lenders now requiring at least $250,000).
- Assessing loan serviceability on rental income alone (not looking at other SMSF income or contributions to superannuation).
- Restricting lending to established properties (i.e. not lending for investment in off-the-plan developments and special purpose properties such as fast food outlets and petrol stations).
- Not making loans for properties in new residential areas or new developments in established areas.

Further the FSI has put forward the idea that use of borrowing in superannuation funds – especially small funds – leads to less portfolio diversification and increased risk in the fund's assets. Recent ATO data does not support this idea. Data taken from the ATO's *Self-managed superannuation funds: A statistical overview 2012-2013*, shows that only a very minor percentage of SMSFs have an LRBA as a significant percentage of their total investment portfolio. The ATO statistics indicate clearly that SMSFs investing predominately

[2] ATO, Self-managed super fund statistical report – December 2014

in a single geared asset is a very rare situation. It shows portfolios are relatively diverse with LRBA's part of the fund's overall asset allocation.

This is illustrated in the following chart:



Source: ATO, Self-managed superannuation funds: A statistical overview 2012-2013 , 2014

The SMSFA believes that any risks created by direct leverage in superannuation funds are only occurring at the extreme fringes of borrowing behaviour.

When used in the right circumstances and structured correctly, there should be little concern that SMSF trustees are using LRBAs inappropriately as part of an investment strategy for their SMSF. However, we are concerned that the recent increase in promotion of LRBAs by certain real estate promoters has an undeserved and unrepresentative impact on the integrity of the SMSF sector. The SMSFA is aware of increased property spruiking by real estate agents and property developers targeting SMSF trustees to use LRBAs.

In order to improve the quality of advice provided to SMSF trustees on LRBAs, the SMSFA has published a set of best practice guidelines for SMSF lending and SMSF advice.[3] We believe that by improving the standards of advice and disclosures to SMSF trustees that investment decisions on leverage will be made from a fully informed position.

[3] http://www.the SMSFA.asn.au/media/240887/the SMSFA_lrba_best_practice_guidelines.pdf

The LRBA Lenders' Best Practice Guidelines ("Lenders Guidelines") have been developed from established best practice within the banking industry. The Lender's Guidelines establish lending industry standards that can complement individual LRBA credit policy and practices regarding LRBA lending to SMSFs and should encourage and reinforce prudent lending to SMSFs.

The Lenders' Guidelines require lenders to make appropriate disclosures to SMSF trustees that are considering an LRBA. Further, lenders are required to recommend to the SMSF trustee that they seek appropriate specialist SMSF, financial and legal, advice in regards to their SMSF entering into an LRBA. However, at the same time recognising the limited role and responsibilities of lenders in this process.

The LRBA Best Practice Advice Guidelines ("Advice Guidelines") create a best practice standard of advice that should be provided to SMSF trustees considering the use of LRBAs should they elect to seek personal advice. The Advice Guidelines have been developed from established best practices in advice to SMSF trustees on LRBAs.

The Advice Guidelines should ensure that when an SMSF trustee seeks appropriate advice regarding the suitability of an LRBA for their particular circumstances, they receive advice from a competent and appropriately licensed adviser who allows them to make the most appropriate decision for their SMSF. Obtaining such advice should help to ensure LRBAs are only being used by SMSF trustees after understanding the nature of the investment strategy and the risks associated with it.

Fulfil the objective for superannuation to be a savings vehicle for retirement income, rather than a broader wealth management vehicle.

The FSI Final Report did not present significant evidence that the use of direct borrowing by superannuation funds was shifting superannuation from a retirement income vehicle to a general wealth management vehicle.

As illustrated above, LRBAs can be used as part of a diversified SMSF portfolio to build retirement savings, with very few SMSFs currently having poorly diversified portfolios concentrated on the gearing of assets. Also, the use of LRBAs to purchase commercial property can be an important retirement savings strategy for small business owners, who accumulate most of their nest-egg through their small business.

SMSFs are required to consider diversification under the investment strategy covenant in subparagraph 52B(2)(f)(ii) of the SIS Act. If there is concern that the use of LRBAs is causing poorly diversified SMSFs, greater scrutiny of funds' compliance with the investment strategy covenant could be implemented.

Increased scrutiny should only seek to ensure that funds are actively creating and reviewing an investment strategy that takes diversification into account. Increased regulator scrutiny should not extend to prudential standards for SMSFs or asset class limitations as this would be contrary to the flexibility and control central to SMSF trustees choosing to take control of their retirement savings.

Superannuation and retirement incomes

Recommendation 9 – Objectives of the superannuation system

Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term.

The SMSF Association supports this recommendation but does not believe that legislated objectives will assist in delivering greater stability to superannuation policy. We believe that stability can be brought to superannuation by removing superannuation policy decisions from the annual Federal budget cycle, and instead, tying them to a longer-term review cycle.

We support the FSI's recommendation that the primary goal of superannuation is "to provide income in retirement to substitute or supplement the Age Pension". We believe setting an overarching goal for the system will help ensure that any future changes to the superannuation system are made in a way that does not impede the superannuation system from achieving its essential aim.

To promote policy stability and remove superannuation policy from the annual budget cycle, we believe significant changes to the superannuation system (i.e. changes to contribution caps, changes on taxation of benefits or earnings) only be undertaken as a result of a longer-term review of superannuation settings. We have previously suggested that the Intergenerational Report would be an appropriate vehicle to tie a periodic review of the superannuation system to.

The Intergenerational Report is required under the *Charter of Budget Honesty Act 1998* to be completed every five years and released by the Treasurer at the time. As the Intergenerational Report assesses the long term sustainability of current Government policies over the 40 years following the release of the report, with a focus on demographic change, it is a sensible vehicle on which to base superannuation policy changes.

Having the Intergenerational Report released once every five years will allow the Government, industry and consumers to take a "health check" on the superannuation system. This would allow stakeholders to assess whether the system is achieving its goals and whether any adjustments/changes to policy settings are required. In-built with this process should be orderly and timely consultation with participants in the superannuation system.

This would allow the superannuation industry and consumers to have confidence that changes to superannuation will only be made with a long-term focus rather than in an arbitrary manner or with short-term Federal Budget goals as a key motivation.

If the Intergenerational Report was not chosen to be used for this purpose, we would encourage the Government to consult with industry and key superannuation system stakeholders to find another appropriate review mechanism. We believe reviewing the system and measuring how it is achieving its goals before policy changes are made is critical to policy stability for superannuation.

***Recommendation 11* – The retirement phase of superannuation**

Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.

The FSI's recommendation that superannuation fund trustees provide members with a comprehensive income product for retirement (CIPR) is not the SMSFA's preferred approach to managing retirement income outcomes, we do not oppose the recommendation. We support the FSI's recommendation that SMSF are exempt from electing to decide on a CIPR. We also support the FSI's approach of avoiding mandated or compulsorily selecting of longevity products for retirees.

Our preferred approach is to develop greater coordination between the retirement income, social security and tax systems to encourage sustainable and appropriate drawdowns on retirement income. Australia needs a coherent policy to manage the challenge of an aging demographic rather than a "silver bullet" that pushes retirees into retirement income products aimed principally at managing longevity risk. Policy options to encourage better management of retirement savings that address retirement income and longevity challenges should be considered holistically.

A coordinated policy approach across the retirement income, social security and tax systems would create a principles based system to encourage the steady drawdown of retirement savings. This would provide retirement income and at the same time manage longevity risk. Minimum and maximum drawdowns that are part of the SIS Act and *Superannuation Industry (Supervision) Regulations 1994 (Cth)* (SIS Regulations), social security income support means testing (i.e. Age Pension means testing) and tax settings (i.e. taxation of retirement benefits) would need to be amended to manage the associated risk and permitted drawdowns.

This policy would encourage the gradual drawdown of retirement savings from retirement onwards by making sure that the social security system and tax system do not allow retirees to benefit from social security and tax preferences where their actions do not align with the goals of the retirement income system.

Policy options that could align with this type of coherent policy principle framework could take the form of:

- Reintroduction of maximum annual drawdown levels in addition to minimum drawdown levels.
- A more comprehensive approach of introducing maximum drawdown ceilings beyond which there are tax or social security disincentives would apply if

withdrawals above those maximums are made. Large or regular lump sums would be caught and discouraged by such a policy.

- Re-design of minimum drawdown requirements which are currently being explored in the Government's retirement income stream discussion paper process.
- Clawback of some tax-preferences on death of unused capital amounts which could be used to encourage drawdowns and discourage superannuation being used as part of estate planning strategies.
- Politically tolerable grandfathering introduced in stages.

We believe that a product-neutral approach that encourages retirement income streams through the right policy settings will result in optimal outcomes for retirees. Products that meet set drawdown parameters with the aim of achieving the retirement income system's goals for managing longevity risk ensures retirees drawdown on their retirement savings appropriately. If necessary they may qualify for relevant social security and tax concessions.

The SMSFA supports removing impediments to product development that can address longevity risk for superannuation fund members. Key to supporting this aspect of the recommendation is to maintain product neutrality so that any changes to legislation to encourage appropriate product development. Any focus on encouraging further development of retirement income products should result in neutrality and equity between different products so that retirees are able to choose a retirement product that best suits their needs.

There have been certain impediments identified, particularly in the SIS regulations which should be removed. The SMSFA would be concerned if the outcome of removing legislative impediments distorted the neutrality and equity between retirement income products. Decisions by consumers should be made on managing retirement income and longevity by choosing a product that best suits their needs rather than one which provides favourable tax or social security outcomes.

Any changes to regulations to allow the development of annuity or deferred lifetime annuity (DLA) products should ensure that similar approaches to managing longevity risk can be maintained in the account based pension/SMSF environment. For instance, if DLAs are to benefit from a tax exemption on investment earnings through the deferral period, then SMSF trustees should be able to setup deferred market linked income streams within the fund and receive equivalent tax treatment for their assets that are put aside in the fund during the deferral period. A deferred market linked income stream has the same purpose and intent as a DLA – that is, to defer the consumption of capital to a later time and manage longevity risk. Therefore they should receive the same regulatory treatment as other products that receive the same retirement income outcome.

Ensuring this type of neutrality occurs across different retirement income products is essential to promoting competition, innovation and reducing distortions in consumer decision making.

We are concerned that the FSI has only recommended product neutrality in regards to the CIPR and development of more innovate products are related to the age pension means test. The FSI Final Report states:

> "In principle, the means test should not discourage products that manage longevity risk, should aim to provide neutral treatment of products with longevity risk protection, and should not make it difficult for individuals to smooth their income and consumption over retirement."

This recommendation that neutrality be limited to products with longevity risk protection is too narrow. All retirement income products – whether they have a longevity risk management component or not – should be product neutral so that retirees choose products based on how they meet their retirement income needs, not on whether they have a favourable aged pension means test outcome.

The SMSFA strongly believes that tax or social security concessions should not favour a category of products over other retirement income streams. Maintaining a level playing field between retirement income products ensures the integrity of the retirement income sector and fosters competition between product providers to drive efficiency and innovation.

In addition to maintaining product neutrality in the retirement income sector, the SMSFA believes that giving annuity based retirement income products tax or social security advantages requires consideration of the inherent risks inherent of the products. We acknowledge that an allocation of capital towards annuity-type assets can be an appropriate part of a well-diversified retirement savings portfolio but these products should not be seen as a simple panacea to managing retirement income needs and risks.

One of our key concerns about incentivising investment in annuity type products is that retirees will often have a lower income in retirement when using an annuity product. Annuity products result in the product provider accepting the investment risk for the product in exchange for a premium for accepting the risk and providing a guaranteed income stream. Retirees lose out on increases in their income when investment returns on assets supporting the annuity exceed the guaranteed income entitlement. Over the longer-term, we believe this will result in lower retirement income for retirees who manage retirement income through these products.

Lower retirement incomes for retirees will flow through to affecting government expenditure on supporting retirement incomes through the Age Pension. Shifting retirees to lower incomes associated with annuity products may counterintuitively increase the need for Government assistance later in life rather than reduce it. Therefore it is necessary to allow development of a range of retirement income products which address the issue of changes in longevity.

A risk associated with an annuity type product is that it can dislocate the allocation of superannuation capital as retirees are not motivated to seek returns which can fund their retirement income needs. Instead capital is allocated on a basis that covers the risk of an annuity product provider's obligations to retirees that have purchased one of their products. This may result in suboptimal allocation of capital, stymying the most efficient use of the superannuation capital pool.

Another significant concern in passing investment risk from a retiree to a product provider is the exposure of the trustee to counter-party risk. This is especially relevant over longer time horizons which would be involved in annuity of deferred annuity products. DLAs have a high degree of tail-risk created by the variability in life expectancies (especially, later in life).

Any failure of product providers to meet their obligations to trustees over the term of their product would surely result in questions as to whether Governments will either guarantee products or bail product providers out. This was evident during the global financial crisis where, in some cases, guarantees were not supported. The political reality of this situation creates an implicit guarantee for annuity type retirement products. These results give rise to moral hazard and increase risks in the financial system.

We believe these factors, and other issues previously outlined in our submissions to the FSI need to be carefully considered by the Government when removing impediments to retirement income product development.

Recommendation 12 – Choice of fund

Provide all employees with the ability to choose the fund into which their Superannuation Guarantee contributions are paid.

The SMSF Association supports this recommendation and believes that the choice to have Superannuation Guarantee contributions directed to any fund of choice is a sensible recommendation. This choice should extend to employers contributing to an employee's SMSF if that is the employee's choice.

Additionally, providing choice to all employees should allow members of defined benefit funds to choose where there salary sacrificed voluntary contributions are allocated.

Extending choice to all employees may spur employees to make a choice of shifting to a new superannuation fund. It will be important for employees to seek financial advice on this choice, especially as it will likely effect their insurance policies held through superannuation.

Consumer Outcomes

Recommendation 21 – Strengthen product issuer and distributor accountability

Introduce a targeted and principles-based product design and distribution obligation.

Recommendation 22 – Introduce product intervention power

Introduce a proactive product intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment.

The SMSFA supports moves to develop policy to improve product issuer and distributor accountability and to develop a limited intervention power for regulators to use where there is risk of significant consumer detriment.

However, we note the importance of not stymying innovation or overly circumscribing consumer choice when improving safeguards for investors.

Recommendation 23 – Facilitate innovative disclosure

Remove regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers.

We acknowledge that current disclosure requirements have not been successful in improving consumer understanding of the process they are investing. Accordingly we support moves to remove regulatory impediments to more innovate approaches to consumers.

Recommendation 24 – Align the interests of financial firms and consumers

Better align the interests of financial firms with those of consumers by raising industry standards, enhancing the power to ban individuals from management and ensuring remuneration structures in life insurance and stockbroking do not affect the quality of financial advice.

Recommendation 25 – Raise the competency of advisers

Raise the competency of financial advice providers and introduce an enhanced register of advisers.

The SMSF Association supports these recommendations and is currently working with the Government in regards to its implementation of the report from the Parliamentary Joint Committee on Corporations and Financial Services' inquiry into proposals to lift the professional, ethical and education standards in the financial services industry

Recommendation 40 Rename 'general advice' and require advisers and mortgage brokers to disclose ownership structures.

The SMSFA supports this recommendation.

We believe that a clearer distinction between factual/sales information and financial advice which is tailored to an individual's circumstances would assist consumers in understanding the nature of the advice/information they are being provided with. Such a split would see current factual information or general advice fall under factual/sales information while personal advice would be considered as financial advice. This would lead to consumers having greater awareness of whether they are receiving financial advice that takes into account their personal circumstances and financial goals or whether they are being provided with factual information or sales information which only explains the features of a product or is marketing a product.

Therefore, in this regard, we would support the proposed renaming of general. While it is important to ensure consumers understand the nature of advice they are receiving, it still should be recognised that there are forms of general advice that are useful to consumers, especially factual information which would not be categorised as either "product" or "sales" information.

In addition to renaming the existing general advice category it would be prudent to reconsider where the "dividing line" between sales and product information and personal financial advice falls. For instance, should the provision of product information allow explanation of the general benefits and risks of a product, or should it be limited to merely explaining the features of a product without any subjective information being provided (i.e. this is a good product because…)?

We note that there will be flow on effects that will need consideration as a result of the suggested change. For example:

- Reviewing and upgrading the current educational requirements to be appropriate to provide product/sales information.
- Introducing a simpler licensing requirement for those providing product/sales information.
- Reviewing professional indemnity insurance for anyone providing purely product/sales information.

Regulatory System

Recommendation 27 – Regulator accountability

Create a new Financial Regulator Assessment Board to advise Government annually on how financial regulators have implemented their mandates.

Provide clearer guidance to regulators in Statements of Expectation and increase the use of performance indicators for regulator performance.

Recommendation 28 – Execution of mandate

Provide regulators with more stable funding by adopting a three-year funding model based on periodic funding reviews, increase their capacity to pay competitive remuneration, boost flexibility in respect of staffing and funding, and require them to undertake periodic capability reviews.

Recommendation 29 – Strengthening the Australian Securities and Investments Commission's funding and powers

Introduce an industry funding model for the Australian Securities and Investments Commission (ASIC) and provide ASIC with stronger regulatory tools.

The SMSFA generally supports increased transparency and accountability of Australia's financial system regulators.

We support the appropriate resourcing of regulators to ensure thy have the capabilities required to regulate the complex areas they are responsible for.

Recommendation 31 – Compliance costs and policy processes

Increase the time available for industry to implement complex regulatory change.

Conduct post-implementation reviews of major regulatory changes more frequently.

The SMSFA supports this recommendation and believes it is important that governments recognise the cost of constant regulatory change and that this cost is passed on to consumers in most cases.

Taxation Issues

The SMSFA will be addressing taxation of superannuation and savings in detail in the upcoming Tax White Paper process and will defer making detailed comment until engaging in that process.

Superannuation tax concessions

Generally, we recognise the need to ensure that the taxation setting for superannuation are equitable, sustainable and effective in delivering improved retirement incomes for Australians. However, we note that it is critical that these objectives are balanced with providing an incentive for people to save for retirement. Considerations of having a simple and an efficient tax treatment of superannuation must be considered too.

The SMSF Association views the superannuation tax concessions as essential to the policy design of the Australian superannuation system which encourages Australians to save a reasonable amount for a sustainable retirement. The superannuation tax concessions provide an incentive for people to forgo current spending in favour of saving for retirement. It is widely accepted that most people are myopic in their consumption decisions and tend to under-save, preferring current consumption over savings (future consumption). Providing incentives, such as the concessional treatment of contributions and earnings compensates taxpayers for deferring the use of income to save for their retirement. The tax concessions also compensate people for locking away their income for an extended period. Income can be inaccessible in superannuation for timeframes in excess of 40 years for many savers.

Balancing the need to provide and incentive for people to save for retirement with other considerations, such as more equitable targeting of the superannuation tax concessions is vital to ensuring a robust and effective retirement income system.

Differentiated tax treatment of savings

The SMSFA recognises that the differentiated tax treatment of savings in Australia have an effect to distort investment decisions. A more neutral treatment of savings may result in better investment allocations.

However, we believe that the special treatment of superannuation in regards to the taxation of savings is warranted because of the following:

- Superannuation provides an incentive for people to forgo current income for retirement savings.
- Superannuation preservation rules mean that people cannot access their savings unlike other forms of savings held outside of the superannuation environment.
- Superannuation have strict investment rules under the SIS Act, unlike other forms of savings.

Negative gearing and capital gains tax

The SMSFA agrees that the asymmetric tax treatment of borrowing costs results in a tax-subsidy for negatively geared investments can distort investment decision making and should be considered as part of the Tax White Paper process.

Dividend imputation

The SMSFA does not support the FSI's assessment of dividend imputation and the use of franking credits by superannuation funds as undermining Government revenue. We previously provided our view on this issue to the FSI and will provide further views as part of the Tax White Paper process.