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Cooper Review Phase Three Structure

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1. Rice Warner Actuaries

1.1 About Us

Rice Warner is an Australian actuarial and management consultancy which provides advice to organisations within the financial services sector. Our people include some of the most experienced superannuation and life insurance professionals in Australia. This experience combined with our strong market knowledge and total independence provides the authority for our work.

Our advice is backed by a strong research capability supplemented by our public policy activities, including newsletters and government submissions. We are regarded as thought leaders within the superannuation industry.

We are an independent organisation with a strong work ethic. Further information about our business is available on our website (www.ricewarner.com) or can be supplied on request. Our Financial Services Guide, which describes the way we work, is also available on our website.

1.2 This submission

This submission is a response to the Phase Three *Structure* Paper released on 14th December 2009 by the Super System Review.

Our submission has an introductory section (“Key Observations”) which sets out some general commentary. The rest of the submission responds to the specific questions asked in the Issues Paper.

We appreciate that the Review will receive a large number of submissions covering a wide number of topics. We have limited our response to areas where we believe we can add a different perspective.

This report was prepared and peer reviewed for The Super System Review by several of Rice Warner’s consultants.

26th February 2010

2. Key Observations

2.1 SAFs

We consider that small APRA funds are relatively inefficient. We expect their numbers will decline as they provide little advantage over an SMSF. They remain viable for members residing overseas and for members who have restricted mental faculties. However, these cases could be just as easily accommodated in a public offer fund. (See section 8.2)

2.2 Other Small Segments

We consider Retirement Savings Accounts and Approved Deposit Funds to be anachronisms. Each category is likely to disappear over time. (See sections 8.3 and 8.4)

2.3 Life Insurance

Superannuation is an important vehicle for the provision of life insurance benefits. It enables all working Australians to receive a reasonable amount of cover at low cost and conveniently. We predict that insurance cover will grow further and that funds will begin to tailor benefits to member needs over time.

We do not consider the low historical Proceeds Ratio to be of major concern.

We consider it reasonable to continue to allow income protection (IP) benefits to be offered by funds even though it adds to complexity. However, the Government should consider allowing a premium of (say) 1% of salary to be paid in conjunction with SG contributions but into a separate insurance fund. This would remove IP from superannuation without reducing member benefits. (See section 10.0)

2.4 Post-Retirement

We consider account-based pensions to be appropriate to cover the retirement needs of most members. Members should have two investment strategies - one to cover liquidity needs and the other to provide long-term growth.

We are not in favour of compulsory annuitisation. However, we do consider it sensible to reintroduce maximum withdrawal values on account-based pensions to encourage retirees to preserve their superannuation for longer periods in retirement.

We do not consider it necessary to separate the management of accumulation and pension assets. (See section 11)

We recommend some regulatory and tax changes to facilitate development of a deferred annuity market, providing pensions at advanced ages, e.g. over age 85.

2.5 Integrity of the Superannuation System

We consider it desirable for custodians and fund administrators to hold appropriate levels of insurance (See section 12).

2.6 Participation in the System

A number of groups are disadvantaged for various reasons. Women have a number of barriers to saving for retirement, including higher life expectancies, lower average incomes, and broken periods of work. We consider it logical to raise the female SG rate to 10% as a means of partly addressing their higher longevity. We also recommend means of improving female superannuation savings. (See section 13).

2.7 Self Managed Superannuation Funds

Sections 17 to 22 cover this segment.

We introduce the concept of a Responsible Officer who will act as trustee on behalf of all members. (See section 17.1)

We consider that APRA should regulate the SMSF segment. (See section 17.4).

We consider that an SMSF should only invest in listed assets. (See section 19.3).

All SMSFs should have a detailed investment strategy. The auditor should check compliance with this strategy each year. (See section 19.4).

We consider that an SMSF should be allowed to have more than 4 members where all are related family. (See section 21.4)

8. Superannuation Sectors under the Choice Architecture Framework

8.1 Defined Benefit Funds

Should there be stricter funding standards set out in part 9 of the Superannuation Industry (Supervision) Regulations 1994 (SIS Regulations) so that there is greater protection for members and so that APRA could have a direct role in working with the employer to remedy the deficit?

No change is required.

Should actuarial reports be required more frequently than every three years? Should a mechanism be provided under the SIS Act with a view to protecting members' benefits against employer sponsor insolvency?

If there is a material change in financial circumstances, the actuary must be notified and should then undertake a further investigation. We consider this to be adequate and no further change is required.

As employers have a particular interest in defined benefit funds, should trustees of defined benefit funds (or sub-plans) be required to have employer representatives on their boards (assuming that equal representation is not otherwise required for that trustee board)?

Yes.

Are there other examples of legislation in recent years which has resulted in problematic application for defined benefit funds?

The three pillar system and the tax and legislative requirements are together structured to favour accumulation funds. It is unlikely that any employer would create a defined benefit fund in Australia and all existing ones will be closed in time.

8.2 Small APRA Funds

Why have small APRA Funds (SAFs) proven so much less popular than SMSFs?

Small APRA funds are not as attractive as an SMSF as members do not have the same level of control. In addition, the additional entity of the approved trustee adds to the complexity and costs of running these funds. Further, the investment strategies of all APRA-approved funds, including an SAF, are more restrictive than those of an SMSF.

Having said this, we favour strengthening controls over SMSF investment policy (see 19.3.1 below).

Why do SAF members choose these vehicles over SMSFs?

An SAF is useful for small partnerships which are unable to set up an SMSF if one member is an employee of another. They are also useful for members who are temporarily out of Australia and do not fulfil the residency rules for an SMSF.

What are the additional responsibilities in managing SAFs and how are the risk management frameworks in place appropriate for managing the risks of governing multiple SAFs?

A SAF has to be managed like any other APRA-approved fund. As these funds are by definition very small, the APRA regulations are a significant cost.

Do SAFs offer advantages for the retirement income system by comparison with SMSFs or other APRA-regulated funds?

Only in a small number of cases, namely members residing overseas or members being incapacitated and unable to make decisions. We consider people in this situation can be better catered for in public offer funds.

Are there structural impediments to their take up? If so, what are they and how could they be removed?

The improved flexibility of public offer funds means that there are very few advantages of running an SAF and we expect that they will decline further in coming years. It would be no loss if they disappeared.

8.3 Retirement Savings Accounts

Could RSAs be enhanced by removing the capital guaranteed nature of the product and allowing any prudentially regulated entity to provide an RSA? What would be the advantages and disadvantages of an enhanced version of this product playing a larger part in the superannuation system?

Retirement savings accounts have not been successful. They were introduced to allow Approved Deposit-taking Institutions (ADIs) to participate in the SG superannuation savings pool. As all banks have large wealth management subsidiaries with their own superannuation products, there is no longer any need for an RSA. Most are operated by credit unions which could easily access other forms of superannuation for their customers.

An RSA might be attractive to members seeking a bank guarantee but there is sufficient safety in the cash investment strategies of public offer funds to provide a valid alternative option.

The disclosed costs of running these funds are relatively low but the financial institutions offering them tend to have a high interest rate margin. As interest margins are not considered to be fees, the real cost is much higher than disclosed.

An RSA might be suitable for a small business trying to find an easier solution for one or two employees. However, these products are not an appropriate long term investment vehicle and the system would lose little if they were abolished.

8.4 Approved Deposit Funds

Do ADFs serve any residual purpose? In the interests of simplification, should this institutional class be closed to new members and the capacity to create new ones removed?

Approved Deposit Funds are an anachronism and the system would lose nothing if they were all wound up and discontinued.

10. Insurance and Superannuation

Superannuation is an important vehicle for the provision of life insurance benefits. The table below shows the significant amounts of death and TPD cover provided by all types of fund. Almost half of all life insurance premiums in Australia are made out of superannuation funds - and this percentage is growing.

Note that members of an SMSF requiring life insurance need to purchase a retail product. Ironically, they cannot transfer an existing life insurance policy owned by a member as that is deemed to be an asset - even if it has a zero surrender value! This should be remedied.

As Australians are generally under-insured, and don't go out of the way to buy life cover, we consider it desirable to continue to encourage Australians to purchase relatively inexpensive life insurance through their superannuation funds. As the majority of members do not have a financial adviser, it is probable that the life insurance in their super fund is the only life cover they have.

We strongly support provision of insurance within superannuation, as it provides:

- The benefits of wholesale rates to individual members;
- Cover to many who would not otherwise be insurable due to poor health or occupational risks; and
- A cheap distribution channel.

Table 1: Segmentation of Life Insurance Premiums

Market segment	Term 30/06/2009		TPD 30/06/2009		Trauma 30/06/2009		Income Protection 30/06/2009		Total 30/06/2009
	(\$M)	(%)	(\$M)	(%)	(\$M)	(%)	(\$M)	(%)	(\$M)
Wholesale									
Corporate Funds	133	3%	109	8%	-		92	5%	335
Industry Funds	620	15%	413	31%	-		192	9%	1,225
Public Sector Funds	191	5%	127	9%	-		56	3%	375
Employer Master Trusts	246	6%	164	12%	-		90	4%	500
a) Total Wholesale	1,190	29%	814	60%	-		431	21%	2,435
Retail									
Adviser Sold Superannuation	902	22%	198	15%	-		107	5%	1,206
Adviser Sold Non Superannuation	1,507	36%	308	23%	591	95%	1,429	70%	3,835
Direct	568	14%	32	2%	32	5%	80	4%	711
b) Total Retail	2,976	71%	538	40%	623	100%	1,616	79%	5,753
Total Market	4,166	100%	1,351	100%	623	100%	2,047	100%	8,187

10.1 Compulsory or Voluntary Insurance

Should the minimum level of cover required in a default fund (or a 'universal fund' under the choice architecture model) be tailored to other factors such as family situation and financial circumstances? Should the amount of cover be maintained or indexed presumably with the cost of cover increasing with age, or should a constant insurance fee be applied with the insured benefit decreasing with age?

It is not possible to set the minimum level of cover in a default fund to reflect members' personal circumstances. Superannuation funds do not know enough about their members to know what their insurance needs might be. However, the life insurance needs of members follow a broad life cycle. All members need income protection but young members do not need death and TPD cover until they have family commitments. Older members tend to require little life insurance once their children have grown up and they have paid off their mortgage.

Superannuation funds can provide a proxy to a member's needs for death and TPD cover based on their age and gender. As funds learn more about their members, they will be able to vary this default structure.

Funds also provide reasonable levels of voluntary insurance which allows individual members to select appropriate cover to meet their own personal circumstances. An increasing number of funds have set up tools such as online calculators to encourage members to estimate their own insurance needs. The funds provide simple means of purchasing the extra cover needed.

Should all members be able to opt out of insurance? Should funds be permitted, for example, to offer life insurance as an opt-in default for young, single members? Should commissions be payable on default fund life insurance? If so, why?

Members are able to opt out of insurance at present. We consider this to be a sensible structure.

If funds had life insurance as an opt-in default, most disengaged members would get no cover at all. Further, premiums would rise as life companies would be worried about selection against them. Obviously, those in very poor health would opt-in to claim the benefit. They would then be concerned if the insurers refused cover on the grounds of ill health. In all respects, an opt-in structure is inefficient for the fund, the member and the insurer.

Should default funds also be required to offer TPD cover in addition to death cover?

On balance, we think TPD should also be provided. However, we note that funds which provide long-term disability income benefits might not want mandatory TPD benefits.

What are the drivers of a fund's proceeds ratio?

We note the Review's concern that the proceeds of claims when expressed as a percentage of premiums (the Proceeds Ratio) is less than 50¢ in the dollar. This ratio is deceptive for a few reasons:

- We have had a lengthy period of declining mortality experience together with declining rates of morbidity (disablement). Thus claims have been lower than initially expected when setting premiums. Some funds have entered profit-sharing arrangements and they have received payments reflecting the favourable experience. Where funds do not have profit-

sharing, they have generally received very large discounts on renewal (up to 40%). Thus, the future Proceeds Ratio will be higher.

- There is a long-tail for disability claims. Insurers need to hold back reserves to pay for these. These reserves are built up from the premiums.
- Life insurance is complex and there is a cost to administer the underwriting of voluntary cover and claims processing.

We consider the Australian group life insurance market to be competitive and to offer good value. Notwithstanding the cost of providing group life cover, it is still considerably cheaper than the costs of providing a retail life insurance benefit.

However, we note that the retail sector has a lower ratio and this is largely due to commissions built into the retail insurance structure. If these commissions are in respect of advice, they will be separated under the proposed fee/commission regime, and that will lead to lower premiums (and therefore a higher claim ratio) in this sector.

Are there ways that death and TPD insurance could be provided more cheaply to members?

As funds merge, they will be able to access further economies of scale.

Are the apparently wide variations in proceeds ratios between fund types explained solely by occupational, socio-economic and demographic factors?

Occupational and demographic factors are largely taken into account in setting premium rates. The Proceeds Ratio will vary from time to time - while mortality rates are declining, there are still major variations in claims from year to year.

10.2 Self-insurance

Is it in the member's best financial interests for certain superannuation funds to continue to be allowed to self-insure death and TPD benefits? Should defined contribution funds ever be allowed to self-insure death and TPD benefits?

Many superannuation funds have reserves or access to capital. These funds should be allowed to self-insure their insurance benefits provided they have actuarial certification regarding sufficiency of the reserves together with appropriate reinsurance terms. The prudential requirements for self insurance should be equivalent to those for life insurers.

Is there any reason that defined benefit funds (and sub-plans) shouldn't be allowed to self-insure death and TPD benefits so long as actuarial advice is obtained on the funding needed and APRA is satisfied as to the financial strength of the employer? Would this lead to cost savings for employers and members?

Defined benefit structures should also be allowed to self-insure provided they have actuarial advisers supporting the funding position. APRA could set appropriate guidelines for this.

10.3 Income Protection

What is the right approach here?

There is no particular tax advantage for providing income protection within superannuation. The premiums are deductible for a company paying on behalf of an employee and they are deductible for an individual on their own life.

In fact, employer contributions to fund insurance are subject to payroll tax, whereas this is not the case for employer-provided, non-superannuation risk insurance. We recommend that employers be granted payroll tax exemption on superannuation contributions used to provide risk insurance for members.

It can be argued that disability income insurance reduces the amount available for retirement. While this is so, the availability of a large group of members within an insurance pool provides wholesale arrangements. These are much cheaper for members and also ensure that there is greater coverage of the population.

In addition, temporary total disablement is, arguably, the biggest risk facing employed people. An inability to earn an income can be more onerous than providing for one's family on death.

As income protection can be expensive, it would be appropriate to provide the cost of this separately from SG contributions to reduce the impact on members' retirement benefits. However, if income protection were taken out of superannuation, industry funds would find it difficult to collect contributions as they would have no mandate to do so.

If the government mandated that a fixed amount of salary, say no more than one percent, could be used to provide income protection benefits, this could be collected at the same time as the SGC but set up in a separate arrangement. The management of the insurance contract need not be handled by the trustees of the fund but could be under an entirely separate arrangement.

10.4 Other Pooling Ideas

Given the apparent cost of life and TPD insurance to the superannuation sector as a whole, are there more radical ways to address the need for super fund members to have life insurance?

The key issue is collecting enough premium from members without reducing contributions to the retirement savings account. Frankly, an additional amount of (say) 1% of salary should be collected to meet insurance costs.

How could super funds create sufficient risk pools to be able to underwrite such insurance themselves?

Superannuation funds can already pool risks with other funds and arrange a collective life insurance contract.

Several sub-plans of master trusts and industry funds do set up their own insurance arrangements based on the underlying risk profile of the membership.

We do not see that any changes are needed in this area.

11 Super in Post-retirement Phase

Should more be done to address financial risk in retirement, rather than just longevity risk? Alternatively, should more be done to ensure that post-retirement assets are not invested too conservatively?

As Australians approach retirement, they should be considering holding two buckets of money. The first is for liquidity and should hold enough to cater for their lump sum needs at retirement together with any pension payments over the first twelve months. The second bucket should be a long-term investment strategy similar to the balanced funds used in accumulation. This reflects that the pensioner will still have a lengthy life expectancy.

Many members will draw their pension over ten years or less so they will need to shift money from the long-term bucket into the liquidity one periodically.

We consider the current structure of retirement products is adequate provided that members are taught how to manage their draw-downs.

Would a similar system in Australia (compulsory lifetime annuities with flexibility) increase the attractiveness of guaranteed annuities for retirees?

We do not believe that compulsory annuitisation has any value in Australia. Annuities are subject to the interest rate at the time of retirement and the purchase price can vary considerably depending on the economic conditions at the time. Further, annuities are inflexible and most Australians prefer to retain their benefit in an account based pension structure. Annuities are also expensive because of the capital servicing cost.

The government wants to encourage people to keep their money in the retirement system longer. We note that most people retire with benefits under \$200,000 and they will generally receive a full Age Pension anyway. Therefore, there is no saving to the Government by dictating how they should take their benefit!

Nonetheless, it is probably desirable to encourage people to make their savings last longer where appropriate. This can be done easily by re-introducing maximum withdrawal values on account based pensions.

Further, if the Government is concerned about people keeping too much of their retirement benefit for estate planning, they could increase the tax on death in retirement for those without dependants.

What else can be done to improve the availability of retirement income stream products in the Australian markets (such as indexed annuities and deferred annuities)?

Obviously, increasing longevity is a real issue at retirement and it might be appropriate to consider mandating a deferred annuity commencing from an advanced stage, say age 85. This would take care of the longevity tail and would allow people to invest the balance of their superannuation money for a fixed term of about 20 years.

This approach might be suitable for retirement amounts above a threshold of (say) \$200,000. Members could buy the deferred annuity at the time of retirement supplemented by annual contributions deducted from their pension accounts.

If a deferred annuity is mandated, the tax on the accumulated reserves should be taxed at the pension rate (currently zero) rather than the accumulation rate (currently 15%). We also suggest that the value of the deferred annuity could be omitted from the assets test during the deferred period.

11.1 Collective Pension Schemes

Is there room for another model in Australian superannuation, being a model that sits in between the defined benefit model on the one hand and the defined contribution model on the other? Is such a model viable in the face of an ageing population?

These schemes have inherent cross-subsidies and are difficult to manage. We do not consider them appropriate for the Australian superannuation system.

11.2 Pension Components of Super Funds

Should it be mandatory for trustees to manage pension assets separately from accumulation assets? If not, why not? If yes, what are the specific benefits that would be derived and what additional costs might be incurred? Should there be limits to ensure member level diversification in order for income streams to be paid as required?

If members take an account based pension at retirement with a view to draw down the money over their life expectancy, then it is appropriate for them to remain in the long term default option used by accumulation members. There could be an argument to use a slightly different profile given the different tax position of the pension membership but the default option is broadly satisfactory.

However, where members want to draw their benefit over a shorter period which might include a lump sum at point of retirement, they should be moving into a more liquid investment strategy. It is not easy for trustees to know the intentions of members so it is appropriate to engage with them before they retire.

In practice, as discussed above, most members will end up with two accounts in their retirement years. They will have a cash based account for liquidity and a growth account for long term returns. The member needs to work out their draw down expectations so that they can allocate money appropriately to each account.

Whilst pension members will need different investment mixes than accumulation members, there is no need for trustees to hold pension assets separately from accumulation assets. The only requirement is that tax is applied appropriately to the two categories of assets.

Forcing trustees to hold separate asset pools for the two categories of member will create diseconomies of scale.

12 The Integrity of the Superannuation System

12.1 Security of Super

What, if any additional measures should be adopted to enhance the security of superannuation funds? What is a suitable definition of fund failure? Do we need a super guarantee corporation of other statutory insurance to cover a fund failure?

Apart from a few instances of small funds being subject to fraud, the majority of Australian superannuation funds have been secure. Of course, the huge amount of money will make funds a target from fraudsters over time.

We consider that administrators and custodians should hold a reasonable amount of capital reserves (minimum \$10 million) together with appropriate insurance. They should be regulated by APRA.

Where funds are self administered, they should use an arm's length custodian which is prepared to accept liability for errors and omissions. In other words, the custodian would need to be satisfied that the fund is well administered.

The availability of capital is a significant issue across the sector. For instance, if commercial funds have an error with unit pricing they are required to remedy it and recompense members from shareholders' funds. When not-for-profit funds have the same errors, the cost of remediation is borne by the members. Not-for-profit funds are higher risk in this regard.

The lack of capital also makes the not-for-profit funds cheaper because members are not charged for servicing prudential capital. The funds are cheaper in part because they are higher risk.

A super guarantee corporation or similar arrangement would provide a more level competitive environment and better protection for members, but organisations which are required to maintain significant prudential capital should not also be required to contribute to the super guarantee premiums.

12.2 Impact of Superannuation Fraud and Theft

What are the areas of greatest vulnerability of superannuation funds to fraud or theft? How is the industry best protected from systematic risk arising from a loss of confidence in the security of retirement savings?

The greatest area of risk is the payment of mandates to rogue investment managers. If a manager has access to funds and abuses the mandate, it is difficult for the trustee to find out until too late.

12.3 Use of Superannuation for Criminal Purposes

Should rollovers to SMSFs be designated services for the purpose of the AML/CTF Act? What mechanisms could be established to inhibit the repatriation of criminally

obtained funds from overseas into an Australian SMSF under the guise of extraordinary foreign investment returns?

No comment on this question.

13 Participation in the System

13.1 Indigenous Australians

Are there ways in which the superannuation system could better accommodate the needs of indigenous Australians?

Where indigenous Australians are integrated into the broader community, they are likely to have similar employment and income as other Australians. No particular support needs to be given to this group.

Where indigenous Australians are itinerate workers, located in remote rural areas or unemployed, they will suffer from the same problems as any Australian in that position. That is, they will have little if any superannuation.

We do not consider that the superannuation system need consider special treatment for indigenous Australians *per se*. It is the Government's responsibility to ensure that everyone in a disadvantaged group has the opportunity to participate in paid work whereupon their superannuation prospects will be the same as everyone else.

13.2 Women

Excluding issues of adequacy resulting from broken workforce participation and lower average incomes (which fall within the scope of the Henry review) are there specific issues which disadvantage women in their interaction with the superannuation industry? If so, how could these be addressed?

Rice Warner has addressed the issue of women in super in several previous submissions to the Government.

There are a number of simple steps which could be taken to improve the financial position of women with their superannuation:

- The Government could consider making a maternity bonus of (say) \$5,000 paid into the mother's superannuation account each time she has a child.
- The mandatory employer contribution of 9% could be paid during periods of maternity leave.
- Many women have periods of unemployment while they bear and raise their children. They should be eligible for the co-contribution during this period.
- The partners of women who are not earning whilst raising children should be able to make deductible salary sacrifice contributions on their behalf. Alternately, a couple is allowed double the concessional limits of two individuals - but one partner should be able to exceed their limit provided the couple as a whole does not exceed the joint limit.

Women live longer than men and therefore need to save a higher retirement benefit to spread over a longer retirement period. It makes sense to increase the SG to 10% for women to partly address this situation. However it is illegal to discriminate on the basis of gender even though this measure does address an inequity in society. Companies should be able to pay an extra 1% of salary into super for female staff to partly address their greater longevity.

Are there other clearly identifiable groups for whom specific provisions could and should be made within super?

Migrants should be encouraged to “catch up” by meeting higher levels of concessional contributions, as they will start their savings pattern later than other Australians.

14 Other Structural Issues

14.1 Allocation of Members to Default Funds: Role of Industrial Awards

Is the industrial relations mechanism the best way to allocate employees to a default superannuation fund? If not, what other mechanisms might be adopted to improve outcomes for members?

One of the major issues with our superannuation system is that most employees are not engaged with their super. Therefore, it is imperative that suitable appropriate default superannuation funds are used as the majority of working Australians will ultimately find themselves in these funds.

Superannuation is a component of the industrial award system and many awards set out the contribution rates and other terms which apply to employees within a company or an industry. Awards also set out the fund which should be used by employers as a default or a list of funds in some awards.

We consider that APRA should specify the minimum requirements for funds which are to be nominated as default funds. APRA should also maintain a list of funds that satisfy these criteria. An employer should then be able to select from this list - unless a narrower list is agreed in any particular Award. We discussed this further in our submission to Phase II of this Review.

14.2 Dispute Resolution

Would there be any value in the creation of a specialist superannuation court under Commonwealth legislation?

We do not consider this would add any value.

14.3 Risk-sharing

Should the Government assume some of this risk, given that it largely underwrites both investment risk and longevity risk in retirement by way of the age pensions? Should the Government provide some additional certainty to alleviate individual anxiety in volatile financial markets? How could this be offered without representing an undue burden on the Budget?

As more than 80% of Australians receive a full or part Age Pension during their retirement years, it can be argued that the Government already provides some protection against longevity risk in retirement. As the Age Pension is indexed to wages, the government provides investment protection too.

In our opinion, the Government need not provide any further assistance.

However, it makes sense to allow members to buy deferred annuities which will commence from an advanced stage, say 85. At present, the reserves built up to accumulate a deferred annuity are taxed at the superannuation rate, currently 15%. We consider that the tax rate

should be equal to the retirement rate (currently zero) and this will make the product more attractive.

Should the structure of superannuation include some defined benefit features, rather than solely an accumulation approach? Who could underwrite the defined benefit component?

Why would we want to further complicate the system by doing this?

Could default funds be required or encouraged to incorporate an investment fluctuation reserve into their default investment option, so as to allow a more aggressive investment approach without a commensurate increase in volatility? How might they address free-riding, where individuals select a fund after its investment reserve had been built up? How costly would it be to administer a scheme whereby entitlement to share in a reserve distributions vested progressively over a period of, say, five years?

Investment reserves were used by life companies to protect their capital guaranteed investment products and then by industry funds in their early days. Reserves are difficult to manage and the allocation to or from the reserve pool can be arbitrary - worse, it can be used to manipulate earnings rates. We are not in favour of a return to this system.

However, funds have the ability to develop different investment strategies to appeal to groups of members. They can provide capital protection in other ways too.

14.4 Capital Requirements

Given the important societal role that superannuation plays and the significant operational risks that all trustees must manage, as a matter of protection for members, should capital be required for all trustees of super funds other than SMSFs?

We consider that all public offer funds should have a minimum level of capital reserves. An appropriate amount for a fund which provides only defined contribution benefits might be something between 0.5% - 1% of the assets under management for the fund as a whole.

This reserve could be used to develop new initiatives of the fund (in place of shareholder capital). It could also be used to develop new computer systems, trial new means of engaging members and rectifying errors.

Higher capital requirements should apply for funds offering investment and other guarantees, including fixed rate annuities, as is currently the case for defined benefit funds

If so, what sort of risk factors ought to be considered in setting capital requirements? What amount of capital should be required? Should a public offer trustee without capital of its own be able to continue to rely on an approved guarantee of the fact that its custodian may have the \$5 million capital backing? Should a custodian be required to have the minimum capital requirement in its own right, rather than being able to continue to rely on an approved guarantee?

All arm's length custodians, administrators and approved trustees should be required to hold capital. APRA should set the right levels.

Should the capital required for custodians be related to the number of fund trustees that rely on that custodian in meeting the trustee's capital requirements, and the assets they hold?

APRA should assess the risks and determine the correct amount to be held.

14.5 Source of Permanent Capital

Would it assist super funds to be able to create a listed entity or entities which could hold longer-horizon assets, such as infrastructure, providing permanent capital for such investments?

Funds can already do this. Note several funds hold ownership in Industry Funds Management. These entities could be listed.

Are there impediments to this sort of structure under current settings? What other issues arise?

There are no significant impediments. The biggest issue is the potential conflict of interest if something goes wrong. Will trustees fire their own subsidiary if it is incompetent?

14.6 Legacy Products

To what extent are they a problem in superannuation? What measures can be taken to facilitate elimination of legacy products (and movement of legacy members) without material disadvantage, in circumstances where successor fund transfer might not be available?

Legacy products create additional administration and are usually inefficient in many aspects of their operation. They may need separate (obsolete) computer systems and the product design is not contemporary.

We consider that funds should be able to merge or move legacy products into a modern product:

- without generating a capital gains event; and
- without requiring the permission of the member.

The latter action would still need to be cleared by APRA.

This would facilitate simplification without any impact on member benefits.

14.7 Innovation

For example, is there any reason why super funds shouldn't be able to compete in the 'reverse mortgage' market (as this seems peculiarly compatible with the retirement income function of super funds)?

There are no impediments to superannuation fund trustees being innovative. They could partner organisations with capital if they are unable to develop products themselves.

The reverse mortgage market is not directly linked to superannuation funds unless they want to take equity or debt in residential property. They would also need to develop their advice channels as it is not prudent to take out a reverse mortgage without obtaining financial advice first.

Are there any specific impediments at present to super fund trustees developing new product offerings? If so, what are they?

There are no major impediments.

17. SMSF Governance

17.1 Trust model

Is the trust model appropriate for SMSFs? Does it still deliver the best outcomes for trustees, members and the broader community?

It is arguable whether the trust model is appropriate for an SMSF. After all, the trustees are holding their own money not that of anyone else. However, if the trust relationship were removed, it would have to be replaced with another entity with similar rules. On balance, it is better to maintain the existing structure.

Most SMSF trust deeds are taken off the shelf with little variation between funds. Consequently, it would be possible to have one universal deed applicable to every SMSF. This could be set up by APRA and amended periodically as legislation changes. This arrangement would simplify the management of an SMSF and make it easier for members and their accountants to follow.

It would be simple to have a supplementary set of rules for each fund which would be created at establishment (and modified with the consent of all members at a later stage). These rules could cover:

- The fund's investment strategy;
- The appointment of the Chair (or Responsible Officer as we have recommended later); and
- Any binding nominations of beneficiaries.

Are the current membership requirements in the SIS Act, requiring trustees to be members and all members to be trustees, still appropriate for SMSFs?

In practice, most SMSF transactions are made by a single person on behalf of all members. Despite the legal requirement to participate in all decisions as a trustee, many family members would trust this person and have little influence or understanding of the fund.

It would be sound to have one member nominated as a Responsible Officer (rather than called a trustee) to manage the fund on behalf of the other members. The management should be in accordance with pre-agreed parameters.

That member, in their Responsible Office role, should be responsible for meeting the fiduciary requirements of all members of the fund.

Does the trust model work effectively for single member SMSFs?

The structure would still work for a single member SMSF. Note that such funds could appoint an additional member at any time so may not always be a single member fund.

17.2 SMSF Trustees

Should their responsibilities be less onerous than for trustees of APRA-regulated superannuation funds? If so, which of their current responsibilities should be changed?

In general, the rules for trustees are appropriate for SMSFs. Each member is a trustee and therefore able to participate in their own interest. Nonetheless, the general requirement imposed on all trustees to act in the interest of all members provides a good governance foundation. The individual trustees are therefore in a similar position to the directors of a small company and this is beneficial.

The requirement that trustees act prudently is as appropriate for an SMSF as for large superannuation funds. The judgement as to what is prudent will in some circumstances be different. For example, an SMSF trustee may prefer to take higher risks with their own money than an APRA trustee would deem prudent. For instance, they might choose to have all their investments in Australian listed equities. While this is possible in an APRA-approved fund, the member cannot choose individual company shares (or derivatives) in most of these funds¹.

Does it remain appropriate to prohibit individuals in an employer/employee relationship from being members of the same SMSF except when they are relatives?

It is appropriate to limit membership of an SMSF to family members even though this is a narrower restriction than currently occurs.

If membership were broadened to include others, for example contacts at work, it would make policing of this sector much more difficult. For example, the trustee responsible for making day-to-day decisions (named the Responsible Officer by us) should then need a higher level of qualification as they are effectively giving financial advice to non-aligned persons.

As there are a large number of very small funds by membership, it is much more difficult for the regulator to monitor these funds. Consequently, broadening membership would increase the possibility of fraud occurring in these funds.

17.2.1 Trustee education

Given the obligations of being a trustee and the minimal barriers to entry, should there be some minimum level of financial and compliance knowledge required? Is there another way of addressing the issue of low trustee financial literacy, such as a mandated limitation on the products in which SMSFs, or some subset of SMSFs, are permitted to invest? Should trustees of SMSFs require some minimum level of training or accreditation to become better educated on their trustee obligations and how to invest? If mandatory education is not required for SMSF trustees (as ATO questionnaire data might suggest is the case - see below), should voluntary training be encouraged? If so, how would this best be achieved? Should the ATO have the powers to impose training or accreditation requirements on SMSF trustees where they have breached SIS Act requirements?

Imposing minimum education standards and qualifications on SMSF trustees would be difficult and would potentially render SMSFs impracticable. Most citizens would not have the

¹ There are a few industry funds which allow limited direct share investment. Also, some retail master trusts allow members to build a direct equity portfolio in conjunction with their adviser.

knowledge, experience or inclination to undertake the training necessary across all areas of superannuation practice - e.g. regulation, investments, insurance. As such they would be precluded from being trustees and therefore also precluded from being members - yet they would be fully able to conduct similar financial dealings on their own behalf outside superannuation.

It would seem more practical and more productive to focus on ensuring that trustees perform their duties prudently and in the interests of all members. They can then seek advice on the issues for which they are not qualified.

Modest financial literacy should not of itself be a disqualification from trusteeship. Many trustees of large APRA-regulated funds do not occupy their positions because of their knowledge of financial markets and products. This does not make them poor trustees.

The situation of SMSF trustees is similar to that of directors of small (possibly family) companies. Experience indicates that these directors generally fulfil their responsibilities competently. There is no reason to expect that trustees of SMSFs would perform less effectively in the interests of their members than directors of small companies do in the interests of their shareholders. The requirements for SMSF trustees should therefore not be more or less onerous than those for directors of small companies.

It is desirable for greater emphasis to be made on the need for trustees to seek proper advice when dealing with matters for which they are not directly qualified (possibly in regulation or legislation). When coupled with enhanced training and guidance on responsibilities, this would provide an appropriate regulatory framework. The ATO and ASIC provide education, training and guidance for directors as to their responsibilities and duties. Similar education, training and guidance for trustees of SMSFs would address most of the concerns.

17.3 Complexity

Do the current compliance requirements for SMSFs impede an individual's choice to manage their superannuation given the perceived complexity in operating an SMSF? If so, how could this be improved? Alternatively, given the complexities of managing a persons retirement savings, do the perceived complexities amount to a useful barrier of entry to the sector?

It is very easy to manage an SMSF with the assistance of an accountant and/or financial adviser. We do not perceive there to be any particular barrier to entry with thousands of accountants available to assist in establishing these funds. There are also a number of service providers for SMSFs which provide accounting, record keeping and compliance services at low cost.

We do not see any need for change in this area.

Is the complexity facing SMSFs any greater than super funds generally? If so, can you suggest any simplifications?

The complexities facing SMSFs are no greater than for super funds generally.

However, SMSFs do face some difficulties in managing their assets with respect to liquidity and excessive allocation to single assets. We consider all investments in an SMSF should be listed assets. Our reasoning is set out in Section 19 (SMSF Investments).

17.4 Regulatory Framework

17.4.1 Regulation

Should there be separate Acts for ATO-regulated funds and APRA-regulated funds?

As we noted in our response to Phase One of the review, there are now three distinct segments of the superannuation industry. These are the Not-for-Profit funds, the Commercial sector, and the SMSF sector. Each of these segments now exceeds \$300 billion in assets held for members, and each has its own characteristics.

While we consider there should be a single Act covering all three segments, we believe there should be different rules relating to each in areas where practices diverge.

17.4.2 Role of the ATO and other regulators

Are the ATO's regulatory powers strong enough, or appropriate, in the SMSF sector? Should the Commissioner of Taxation be able to issue directions to SMSFs (for example, to rectify contraventions)? Should the ATO have a prudential role similar to APRA? Is the ATO the appropriate regulator for SMSFs? And if so, does the ATO have any conflicts in fulfilling this role? If not, who would be the appropriate regulator?

It is appropriate that APRA regulate all superannuation funds, and that ASIC regulate those aspects relevant to it (for example, financial advice). This will eliminate any regulatory arbitrage which can occur at present.

It will also standardise penalties through the superannuation system. At present, the ATO applies tax fines for any non-compliance whereas APRA has wider powers.

We consider that the ATO should only be concerned with the collection of tax across all funds. This might require a different means for the ATO of dealing with the SMSF segment (as occurs now). However, regulation should revert to APRA.

If APRA were to resume regulation of all superannuation funds including SMSFs, the need for separate rules for the three segments of the market is particularly important. This is especially the case with respect to investment policy for SMSFs.

The regulatory arrangements for SMSFs come under the SIS Act and there are not provisions in this Act for the use of agents or intermediaries as there are for other aspects of the ATOs dealings (such as tax agents). Could the current regulatory regime be improved by the introduction of similar arrangements for SMSF administrators, auditors and others?

As many member trustees have a limited knowledge of superannuation, it is reasonable for them to delegate administration functions to their accountant. The suggested change is appropriate and would merely legislate what is existing practice for most funds.

Given the current widespread use of service providers with delegated powers in both the SMSF and APRA-regulated sectors, what advantage would accrue from such a change?

The situation of these service providers would be clarified. Their responsibilities *vis a vis* the responsibilities of the SMSF trustees would be clear to both groups. This would allow accountants and others to expand their services which would be beneficial for members.

Would it be in the interest of SMSF members to legislate that responsibility for some actions rested with parties other than the trustee or is the current structure where trustees are ultimately responsible for their actions the right setting?

Delegation would be reasonable if standards similar to those applicable to APRA-approved funds were applied.

Is this segregation efficient and appropriate? Could efficiencies be achieved if the ATO were responsible for SAF reporting and data collection activities, and APRA and ASIC continue to regulate approved trustees of SAFs?

APRA should regulate all funds. If the ATO has relevant information which it collects from tax returns, it can pass this onto APRA.

17.4.3 Dispute mechanisms

Should the SCT's jurisdiction be extended to resolve disputes between SMSFs and third parties affected by a decision of the SMSF trustee?

We consider that the SCT should be responsible for any disputes of SMSF members. There could be disputes between members of these funds - or with an insurer or other service provider.

Given that all SMSF members are also trustees, is there any need for an external complaint mechanism other than a court?

Disputes do occur between family members, and especially so when money is concerned. Hence, there will be circumstances of conflict between member/trustees of SMSFs. The provision of an arbitration framework and system would be beneficial to deal with these cases. The SCT may be an appropriate provider of this arbitration framework.

Is the exclusion of SMSF members from the financial assistance provisions of SIS still appropriate?

No. A member might lose money due to the fraud of another member, and they should be eligible to receive compensation for this.

For disputes with the ATO, is there a need for a simpler resolution mechanism than the initial internal ATP review followed by access to the Administrative Appeals Tribunal if still dissatisfied? If so, what model could be adopted?

N/A

17.4.4 Penalties

Is the existing penalty regime that applies to SMSFs appropriate? Would a sliding scale of administrative penalties, that are applied against the trustees (jointly and severally), or enforced third party custody of fund assets, be more appropriate or useful adjuncts to the existing powers?

The penalties for an SMSF should be in line with penalties applicable to APRA-approved funds.

17.4.5 Compliance Coverage

Given the significant portion of retirement benefits under the control of an ever increasing number of SMSF trustees, what level of oversight is required?

We do not have a view on the appropriate level of compliance coverage. If the number of funds with errors and omissions is high, we believe the ATO should focus more on the auditors of these funds. It is likely that there will be a pattern of non compliance related to individual auditors rather than to the size of any particular fund.

There may be benefit in a compulsory reporting system for fund auditors when they have an unsatisfactory audit outcome.

Should this be higher? Given the community interest in the efficient operation of SMSFs, should the supervisory levy, currently set at \$150, be increased to, say \$500, to match the level applying to SAFS to fund higher levels of regulatory oversight?

The higher level for an SAF reflects the much lower number of funds in this segment. There are efficiencies in regulating a large number of funds and we would expect the levy to be lower than for a SAF.

However, a rise of a few hundred dollars is unlikely to impact much on the costs of running an SMSF (apart from the uneconomic small ones).

17.4.6 ATO Binding Rulings

Would there be any benefit in extending the legally binding ruling system to the SIS Act, which would be equivalent to the private ruling system for income tax? Should this extension also be applied to products marketed to SMSFs?

It makes sense for all legally binding rulings to be constant over all types of superannuation fund. These should be set by APRA for all funds.

18. SMSF Operation and Efficiency

18.1 Economies of Scale

Are SMSFs disadvantaged compared to APRA-regulated funds by their lack of scale because they cannot adequately defray fixed costs and cannot access certain investment products of markets or can only do so at uncompetitive prices? If so, are there any measure that could be taken to reduce this disadvantage?

There is a divergence of views as to the minimum appropriate size for an SMSF. It is difficult to see the advantage in managing an SMSF unless it has assets of at least \$200,000, but preferably at least \$500,000. In many instances the decision on establishing an SMSF is not taken because of cost. The members may well be happy to pay higher fees for greater control.

As everyone establishing an SMSF would discuss it with their accountant, it makes sense to require accountants to show potential members a simple statement setting out the fees that would be charged on an SMSF for different sizes compared to the fees of placing the fund in a large industry fund default investment strategy. At present, there is no easy way to make such a comparison of price between fund types.

Larger SMSF funds are much cheaper to run than APRA regulated funds. Many funds invest primarily in Australian equities and they incur minimal fees by investing through online stockbrokers. These funds can access international equities through exchange traded funds (ETFs) and many use term deposits or cash management trusts (CMTs) to diversify their investments.

Although these bank products are relatively expensive compared to the cost of purchasing similar debt instruments within APRA-regulated funds, this is more than outweighed by the saving in administration costs and other investment costs. The bank CMTs effectively provide the transactional backbone for the SMSFs at modest cost.

18.2 Technology

Can more technology be applied to the operation of SMSFs to drive down costs, improve efficiency in administration and improve regulation? If so, how could it be applied? Could such an environment be developed for SMSFs? If so, what would it look like? Who could develop it, and how could its uptake be driven?

Even though the average SMSF is small relative to an APRA approved fund, the costs are remarkably low on a per capita level. However, the segment is fragmented and would benefit from an improved underlying investment structure.

The major investment platforms (mainly operated by the wealth management subsidiaries of the major banking groups) have the potential to provide a full service for the SMSF segment.

However, it would appear that these vehicles are priced at too high a level for most SMSF funds, since the majority of SMSFs make other arrangements.

We consider that the CHES system of the ASX could be modified to provide an SMSF administration and reporting facility. A number of ETFs can now be purchased through CHES and some managed funds will be available in the near future. This will provide an SMSF with all of the investment diversity it needs (though records of term deposits will be separate). There

is an increasing move of fund managers to provide their erstwhile unlisted vehicles on the ASX. Encouraging this trend would improve the efficiencies of the system both for execution/transaction and for record keeping.

A standard form of investment administration though CHESS would simplify the system and aid accountants and auditors. The ATO (and APRA if appropriate) should be allowed viewing access to CHESS for the purposes of reviewing compliance of any SMSF.

The use of tradeable instruments would also ensure liquidity and allow for management of concentration risk. Encouragement for the further development of ETFs and similar instruments and the use of the ASX as an investment platform for SMSFs would drive down costs and provide useful competition to current providers.

18.3 Data

Could more comparable questions be incorporated into the ATO and the APRA annual returns to enable better comparisons to be made, such as in the classification of asset classes and operating and performance figures?

The best way of providing comparable data for SMSF and APRA segments would be to have a standard researcher such as the ABS develop and manage all surveys.

For SMSF data to be meaningful, how quickly does it need to be reported? Would a shorter timeframe be achievable or appropriate?

An SMSF is not interested in peer returns. The major reason for collecting data is to compare returns against other segments and for policy setting. We consider annual comparisons are sufficient.

What other data or research on SMSFs is required and who should provide this?

The ATO already provides a reasonable amount of information on the composition of the SMSF segment.

Is the ATO or APRA the most appropriate entity to collect and provide data in the marketplace, or should other market participants (non-government) be collecting and publishing data?

We consider the Australian Bureau of Statistics (ABS) should be the sole provider of statistics about all superannuation funds.

18.4 Accounting Standards

Should SMSFs be required to complete general-purpose financial reports so that assets are annually marker-to-market?

SMSF funds should be required to provide assets marked- to-market in their annual financial reports. Where the funds hold unlisted assets, they should be valued independently at least annually. (See our comments in Section 19 re appropriate assets for an SMSF).

18.5 SMSF Costs

Are SMSF trustees aware of the cost of operating their SMSF and do they understand the cost of alternative structures? What is the best method of comparing the cost of running an SMSF with the cost of other options? Is there appropriate disclosure of costs by service providers or through other avenues?

Most SMSF trustees are aware of the costs of running their fund. Many of those who have exited commercial funds have done so because of the fees.

The biggest problem in respect of comparing costs with alternatives is a source of comparable costs for other funds. This is not a problem specific to SMSFs. It is a problem of consistent disclosure of costs across the superannuation market.

A central collector and publisher of data would assist greatly in providing this consistent disclosure. Should the agency be the ABS (as we recommend), it could produce a table of indicative costs for member accounts of different sizes across the market. The SMSF trustees would then be able to compare their costs to the alternatives in dollar terms and as a percentage of fund assets.

Perceptions also exist that cross subsidisation is occurring within accounting practices, which obscures the true costs of running SMSFs - is this true in your experience?

This is unlikely given the large number of accountants involved in the SMSF sector. However, where an accountant prepares various tax returns for a client, there could be an overall economy. For example, an accountant could prepare husband and wife tax returns, a family business tax return and an SMSF.

Are establishment and ongoing compliance and maintenance requirements inefficient for SMSF trustees? If so, in what areas, and what could be changed or improved?

N/A - We are not sure of the purpose of this question.

19. SMSF Investments

19.1 Custody

Would third party custody of fund assets have a role to play in removing the instances of illegal early release (and other breaches of the SIS Act) in the industry? For new SMSFs, should custodial arrangements be mandated for at least an initial period, or universally? Alternatively, could SMSFs that contravene compliance requirements be required to place the fund's assets into custody (i.e. transition to a SAF) for a certain period or indefinitely?

Compliance of SMSF arrangements could be improved by requiring the accountant and auditor to be involved at the time these funds are established. The nominated Responsible Officer (as we have defined the role) should be personally liable for certain breaches such as the illegal early release of superannuation monies. The accountant should explain the rules to this trustee and ensure they sign off that they are aware of the arrangements.

It would be practical to give the accountant power of attorney for the first twelve months a scheme is in operation and require their signature before withdrawal or transfer of any funds.

The regulators should monitor accountants and auditors to ensure that they are aware of the requirements of the compliance requirements for these funds.

In the event that there is any systematic abuse of the fund, the trustee, accountant and/or auditor should all be banned from working in this segment. It is difficult to be prescriptive about investments of an SMSF given the variety of circumstances of members.

The situation of SMSFs in this regard is similar to the situation of tax payers paying the appropriate tax. The vast majority do so correctly and appropriately. Illicit activity should be dealt with by means of criminal and civil sanction for the small number who choose to act in this way rather than by onerous structural restrictions on everyone.

19.2 Asset Allocation

Is this optimal for SMSF members given the different liquidity requirements of the two phases? If not, what could be done about it?

We consider that each fund should have a detailed investment strategy and the auditor should check annually that this strategy is followed. Unless the trustee can demonstrate financial expertise, the strategy should be approved by a qualified person.

Although the pension phase requires liquidity for the drawing down of the pension benefit, it also requires growth for future years. This issue is one that faces all funds, not just the SMSF segment. Ensuring that each fund has an investment strategy appropriate to its circumstances - and that this is being followed - is a sufficient discipline.

What can be done to improve the access of SMSF members to quality information and advice? Would it assist SMSF members if there was more information available to help them understand asset allocation, diversification and other investment concepts? If so, how could this be delivered?

The key is to set a sensible investment strategy at the outset and to monitor it for changes in any member's circumstances. We consider there is an adequate market in the provision of investment and financial advice available to members who require it.

Does this reflect a particular vulnerability for SMSFs in the face of commission-driven marketing by financial advisers? Does it reflect a structural weakness in SMSF operations or simply the different risk appetite of SMSF investors?

There is a reasonable argument for limiting investments in an SMSF to listed assets (see Restrictions below). These will be properly researched and will be part of a transparent marketplace.

Further, the investment strategy should be written in a way that provides diversity of assets and limits exposure to high risk investments. The auditor should monitor this annually for compliance.

SMSFs do not appear to be particularly vulnerable.

19.3 Restrictions

Should SMSFs be required to invest funds in a certain manner within a specified time period or should it be left to the judgement of trustees? Should there be restrictions on the investment that can be held by SMSFs? If so, Should restrictions be mandatory or encouraged through incentives?

The investment strategy should determine the type of assets appropriate for the fund. It could state the individual limits on the size of any particular holding or restriction on any asset class. For example, a fund wanting to invest in derivatives should have to set this out in detail within the investment strategy policy.

The strategy should also set out the parameters for changing or tilting the asset allocations.

It must also be borne in mind that the SMSF assets are only part of the assets of the members. It may well be appropriate for the SMSF assets to be biased in some way as part of an overall investment plan.

19.3.1 SMSF Assets

Should SMSF investments be restricted to what might be regarded as 'financial assets', such as listed equities and managed funds?

A restriction to financial assets has a number of attractions. As mentioned, the system would be simpler if investments were limited to listed assets. Members wanting exposure to higher risk unlisted assets can still invest in them, but not within their superannuation fund.

As existing funds have unlisted assets and collectibles, these assets could be frozen but no new ones added.

On the other hand, why should SMSFs be restricted when a wider range of investments is available through APRA-regulated funds?

In practice, the range of assets available in an SMSF is much broader and includes collectibles and residential property. These impose liquidity and concentration risk for the funds and would be more appropriate if held outside superannuation.

Assets like infrastructure and commercial property can be provided to SMSFs via listed vehicles - and increasingly are available.

Should SMSFs be permitted to continue investing in these assets or should they be phased out overtime?

It is not clear what "these assets" are. For collectibles, residential property and the like, no new purchases should be allowed. However, it is reasonable to nominate a period, say 5 years, over which existing assets should be sold.

Expansion into "special opportunity" investments via listed instruments should be encouraged.

19.3.2 Leverage

Should leverage which places at risk an amount greater than the initial capital investment be permitted in SMSFs? If so, are the current exceptions to the borrowing prohibition suitable or have the most recent changes, which have allowed for instalment warrant arrangements for assets other than shares, gone too far?

We consider that direct leverage of superannuation is against the spirit of the SIS legislation. These instruments should not be permitted within SMSF superannuation.

Members should restrict their leveraged investments to non-superannuation assets.

However, the restrictions on SMSFs should be no more onerous than the restrictions on large funds many of which also invest in leveraged structures via fund managers.

19.3.3 In-house Assets and Dealing with Related Parties

Should the in-house asset investment concessions, allowing trustees limited investment in related parties, continue within SMSFs?

Restrictions on in-house assets are sensible. Limited access is probably appropriate as it mirrors similar opportunities for large funds which invest member funds in related service companies controlled by the trustees. If access is prohibited for SMSFs it should be similarly prohibited for all funds.

Are there benefits to the superannuation system or the broader economy in allowing SMSFs to partially finance trustee's related businesses?

It would be prudent to remove the ability to invest in in-house assets over a reasonable time frame, say 5 years.

The sole purpose test is a sensible test for superannuation funds. An investment that does not satisfy this test should be removed.

19.3.4 Acquisition of Assets from Related Parties

Are there exceptions, generally where an ambiguous market valuation can be established, still appropriate for SMSFs?

The transfer of assets must take place at fair value. If this is not able to be determined, the transfer should not take place. Assets which have ambiguous market valuations generally fall into the category of assets which we have indicated should probably not be allowable investments for SMSFs. Restricting investment in these asset categories would remove many of the problems with ambiguous valuations.

19.4 Investment Strategies

Is there benefit to be gained in seeking to increase the regulatory burden here or should it be presumed that self-interest will prevail to see the appropriate investment strategies undertaken?

We consider that each fund should have a very carefully designed and detailed investment strategy. As most members will not have financial expertise, the strategy should be drawn up in conjunction with an expert who should sign off that it is appropriate.

The strategy should be reviewed annually to ensure continued relevance. Further, the auditor should ensure that the fund has invested in accordance with the strategy in each year.

20. SMSF Sector Participants

20.1 Accountants

20.1.1 Accountants' licence exemption

Should all SMSFS be required to use at least one key service provider licensed by ASIC? Is the existing accountants' exemption appropriate and should it be maintained, or should it be broadened as per the recommendation by the Parliamentary Joint Committee on Corporations and Financial Services (PJC) report- recommendation 31(8.61)?

The reality is that accountants provide retail clients with advice about financial matters including taxation and superannuation. It remains a grey area whether some of this advice ought to be provided under an AFSL or whether the accounting qualification is sufficient.

We consider it critical that the policy on investment strategies be issued by a licensed adviser in cases (the majority) where no trustee has sufficient expertise. If accountants provide advice on establishing an SMSF, they could become licensed to issue this document or they could partner somebody who is licensed.

As an SMSF customer should also know about life insurance and superannuation strategies generally (for example, the right level of contributions to make), it would make sense if the accountants working with SMSFs were all authorised representatives of an ASFL. Then there could be no grey area.

20.2 Auditors

20.2.1 Timing

Should this time period be reduced or should administrators, who could have more active involvement with SMSFs, play a greater role?

SMSF audits can occur several months after the period end date. The reason for this is that the audit process follows the ATO taxation process.

There is no particular reason why an SMSF should be deferred longer than (say) a personal tax return. Most could be audited by the end of October following the end of financial year with extensions granted to the following 31st May if required.

We do not agree with PJC recommendation 30 that an SMSF should be audited only every three years. Members of these funds need to know on a continuous basis that they are in agreement with the legislation.

Should the requirement for annual audits be retained or should they be less frequent? Would this have any impact on cost, given that approved auditors would, under the PJC recommendation 30 (8.45), need to review multiple years at a time instead of a single year?

An SMSF should continue to have an annual audit.

20.2.2 Competence

Are current professional requirements and audit accounting competency standards adequate? Should minimum standards be mandated or should the accounting bodies continue to develop them? Do approved auditors in general have the necessary level of skill and expertise to audit SMSFs? Do the existing Codes of Ethical Conduct and Australian Auditing Standards provide the appropriate framework for audits of SMSFs? Should it be mandatory to be a member of a professional accounting association in order to conduct SMSF audits? Should the category of membership be tightened to recognise the specialised competency required of SMSF auditors?

We agree that an SMSF auditor should have the necessary skill and expertise to perform this task. However, the onus should be on the accounting professional bodies to ensure that auditors meet the standards.

The regulator should discuss appropriate standards with the accounting bodies.

20.2.3 Independence

Given the key role auditors play, how independent should auditors be from those who administer SMSFs, prepare their financial accounts or annual returns, or provide financial advice? Do the current independence standards provide sufficient guidance or protection for members and other stakeholders?

We are not concerned about the independence of auditors from parties involved with an SMSF. Provided the auditors fulfil their duty appropriately, we are comfortable with the current arrangements. There may be cost savings in having an accountant and auditor from the same firm.

However, the regulator should check the compliance and credentials of those accounting practices with both the accountant and auditor.

20.2.4 Registration

Should approved auditors be registered? If so, which organisation should have responsibility for registering and regulating approved auditors? Should registration also involve competency and training requirements?

We agree that approved auditors should be registered. Furthermore, they should only be registered after they have demonstrated that they are skilled and experienced enough to perform these tasks.

20.2.5 SMSF Establishment

Would the SMSF system benefit by having an approved auditor verify that a fund was appropriately established before it could be registered with the ATO? Would there be value in having an approved auditor attest that the fund's deed satisfied the SIS requirements, that all members were trustees or trustee directors, and that none of the members was a disqualified person? Would this reduce the number of new illegal release schemes?

We agree that an auditor should verify that a fund has been established properly before it can commence to take any contributions.

20.2.6 Penalties

Are the current penalties applicable to approved auditors who breach their obligations appropriate?

This should be discussed with the accounting professional bodies.

Is a more flexible penalty regime, such as the imposition of administrative penalties or time limited suspensions warranted?

This should be discussed with the accounting professional bodies.

20.2.7 Compliance audits

Is this observation correct? If so, how could the compliance component of the audit be improved?

In our experience, many auditors do not know enough about SIS to audit a fund for compliance.

In order to become an approved auditor for SMSF purposes, the auditor would need to demonstrate that they know about the SIS compliance components and to take them into account in signing the audit.

Approved auditors should demonstrate their knowledge (possibly through a course set by the professional accounting bodies).

20.3 Advisers

Should competency standards be increased (i.e. beyond ASIC Regulatory Guide 146 standards) for financial advisers who provide advice to SMSF members?

We believe that the establishment of an investment strategy is complex and not all financial advisers would be able to provide this service.

We note that RG146 imposes obligations on licensees to ensure that authorised advisers have the necessary qualifications to provide the advice for which they are authorised. This is sufficient for this purpose. There should be a specific requirement in regard to appropriate qualifications to provide advice on investment strategies.

Therefore, there should be a separate licence condition provided to people giving this advice. On all other aspects of an SMSF, any authorised representative with the power to provide advice on superannuation should be able to provide advice to these funds and their members.

Is there justification for a different charging model for advice to SMSF members?

No.

21. SMSF Structure

21.1 Existing structure

Would either of these approaches save costs and benefit new SMSF members?

We believe it would be prudent to have a standard trust deed issued by APRA (not the ATO). The fund would operate in accordance with superannuation law and a set of governing rules specific to its members.

21.2 Other Structures

21.2.1 Small APRA Funds

Could aspects of the SAF model be incorporated into SMSFs, such as a hybrid structure where trustees are comprised of both members and an independent trustee?

An SAF is largely redundant today. They are more expensive than an SMSF without adding any particular additional value.

The main reason for maintaining an SAF is for members who are not residents in Australia or for retirees who no longer have control of their mental faculties.

Instead, should all SMSFs be registered with an SMSF administrator, rather than having an external trustee?

We cannot see any advantage in this suggestion. Many SMSF trustees are better able to administer their fund than the service providers.

21.2.2 Separately Managed Accounts and Wraps

Could these be viable alternative structures to SMSFs? If so, what would need to be done?

These are different investment vehicles with individual allocation of assets to the owner of the assets. In an SMSF, the assets are still pooled between members.

21.3 SMSFs in Later Life

As trustees age, is the potential impact of them becoming mentally incapacitated greater in the SMSF sector than for other superannuation funds and other types of financial products?

As people age, there is an increasing risk of them becoming mentally incompetent. This risk is no higher for SMSF trustees than for other trustees. The risk is that there will be only one trustee and that that trustee becomes incompetent. There is currently no process for relieving the trustee of their responsibilities.

The arbitration and dispute processes discussed above would provide a forum for dealing with incompetent trustees who did not voluntarily move aside.

There may need to be regulations or protocols established to allow for external control of the affairs of an SMSF in these circumstances while it is moved to another structure - eg APRA regulated pension provider.

The test should be based on competency rather than age.

Is there an age where the trustees of an SMSF need to be encouraged to move their retirement income arrangements out of their own hands or at least into simpler products needing less active management?

The issue is competency and not age. A focus on competency with mechanisms to deal with the proper movement of funds should a trustee be found to be incompetent should be the approach.

21.4 Number of Members

What purpose does the current limit serve? Is four members the right number? Why not seven or ten?

There is no logical reason why the membership of an SMSF is limited to no more than four. Provided that members are closely related, there should be no reason why the limit could not be increased to cover all family members.

Conceivably, this could be a big group if it included husband and wife together with their siblings, their partners and all their children.

A contrary view is that a fund of this nature provides a concentrated family risk if there is any financial loss as it affects all members of the family not just one or two individuals.

If SMSFs are truly a matter of personal choice and personal responsibility for financial wellbeing in retirement, why have any pooling?

There is still value in pooling investments. For example, only one online share trading account is required. Further, it is easier to buy larger blocks of assets rather than have many small parcels for each member.

If the membership limit were to be increased, should other conditions such as family relationships be imposed on fund membership?

Yes. We believe it is beyond the scope of these funds to develop into mini master trusts for unrelated parties.

21.5 Barriers to Entry

Should there be barriers to entry in either sense? If so, what barriers?

Our concept of a Responsible Officer would require certain standards which could be set by the Regulator. This would ensure that there are sensible barriers to entry from people who are clearly not qualified to run these funds.

21.6 Minimum Monetary Balance

In light of these figures, is there any justification to mandate a minimum balance for establishing an SMSF, perhaps by imposing controls on the persons authorised to established SMSFs? If so, what is the appropriate level and why? Alternatively, can this issue be addressed through education and the publication of better data?

Price is not the only determinant, however, we believe that an SMSF is more cost effective if it has a minimum balance of at least \$200,000 and preferably \$500,000.

It makes sense to set a level where members are provided with a “health warning” on cost. It is then up to the member whether they are prepared to pay extra for the control they seek.

22. Other SMSF Issues

22.1 Early Release on Hardship Grounds

Should SMSF members in these instances be required to get regulator approval before accessing their superannuation on hardship grounds?

The early release on hardship grounds should be extended to SMSF members (or abolished for all members, if more appropriate). APRA should make the decision as it does for the funds it regulates.

22.2 Illegal Early Release

What weaknesses exist in the governance framework and what controls could be implemented to reduce the likelihood of such frauds continuing to occur?

The early release of funds should require the authorisation of the fund auditor. Regulations, and possibly legislation, should impose specific penalties on the member/trustee should funds be released without the auditor's approval.

22.3 Registration Process

Are there still too few barriers to SMSF establishment, which benefit scheme promoters? Can the SMSF registration process be further improved to mitigate the risks of illegal early release? If so, how?

We believe the introduction of an auditor at the time of establishment would eliminate most opportunistic setups and illegal releases.

22.4 Super Fund Lookup

Can 'Super Fund Lookup' be expanded to provide member details to enable APRA-regulated funds to verify that a requested rollover is to a SMSF of which the transferring member is a trustee? If available, should this information only be provided on a confidential basis so that the general public cannot access the member details? Would verification of bank account details, such as a bank audit confirmation by the recipient institution, act as a significant deterrent to would-be offenders?

In addition to using the Tax File Number for member identification and legislating that all transactions are electronic, each SMSF can be entered into the system with its own unique ID to ensure validity.

Allowing verification via a central database would assist the process. The database should not be available for general viewing.

The verification of bank account details would limit fraud.

22.5 Penalties - Scheme Promoters

Would it be more appropriate for the ATO to deal with both the participants and promoters? Can tax penalty promoter laws be amended to include promoters of illegal early release schemes?

Early release schemes have many similarities with tax avoidance schemes. In many ways, they are in fact tax avoidance schemes. The model developed for tax schemes is an appropriate model for illegal early release schemes.

22.6 Life Insurance Default

The SIS Act does not require an SMSF to offer death or disability insurance to its members. Does there need to be an insurance default in the SMSF sector, for example similar to the minimum insurance cover required for default funds? How could this be achieved? Would compulsory death or disability insurance be inconsistent with the self-managed character of an SMSF? Could the extra scale and reduced distribution costs that such a default could deliver enable the super industry as whole to strike a better bargain on insurance? How many SMSFs currently have life insurance for one or more of their members?

Members of an SMSF can still purchase life insurance, albeit on a retail basis. This is a relative disadvantage over public offer APRA funds. However, it cannot easily be overcome as the SMSF market is so fragmented with little opportunity for pooling life insurance benefits.