6 August 2021

Director
Retirement, Advice, Investment Division
The Treasury
Langton Cres
Parkes ACT 2600

Email: superannuation@treasury.gov.au

Dear Sir/Madam,

SMSF ASSOCIATION SUBMISSION – RETIREMENT INCOME COVENANT POSITION PAPER

The SMSF Association welcomes the opportunity to provide this submission in response to the Government's position paper for the proposed introduction of a retirement income covenant. The Association welcomes measures that seek to increase member engagement with their superannuation and importantly planning for their retirement.

It is essential that any measures introduced are practical, fit for purpose and do not create administrative burden or significant additional cost. These considerations are equally important across all segments of the superannuation sector.

The proposed model, in practice, will not apply in a similar manner across the sector. This is a product of the nature, size and structuring differences that exist across the large APRA funds as compared to SMSFs. When drafting the legislation and any associated regulations, careful consideration will be needed as to how it will operate within the respective environments.

The large APRA funds have sizable pools of members which can readily be dealt with under the proposed cohort model. The provision of general information and the preparation of a broad strategy is seemingly fit for purpose in this environment.

Issues emerge for SMSFs, given the nature of the structure and relationship between the trustee and its members. The ability to formulate and give effect to a broad strategy, that is not intended to be member specific or advice to members becomes problematic. How can they divorce themselves from these two roles?

Consideration of the operative environment that applies to SMSFs must inform the structuring of the model to apply to SMSFs. This will be essential to the covenant's success in achieving its core policy objective.

Likewise, consideration must be given for SMSF trustees who are not advised by a financial adviser. Those that are advised will be receiving strategic advice, and actively considering the requirements of their fund's investment strategy as well as the core components the retirement income covenant seeks to address. However, a gap emerges for trustees who are not advised.

Investment Strategies in Practice

We have historically observed issues with the operation and function of the investment strategy covenant. This is despite SMSF trustees being highly engaged and actively involved in the management and operation of their fund.

Firstly, neither the legislation nor the regulations prescribe that the investment strategy must be in writing. For a period, this resulted in only some funds having documented investment strategies. Those that were complying, the strategy documents were often inadequate.

Activities by the ATO as regulator and increasing audit standards over time has seen industry move towards the unified approach for the documenting of investment strategies.

Secondly, a biproduct of initial moves to compel the documentation of investment strategies, saw largely ineffective investment strategies produced on a large scale. A tick a box type approach and extensive use of templated and standardised investment strategies, was widespread. Clearly this did not meet the policy objective of the investment strategy covenant.

Active campaigns by the Australian Taxation Office as regulator has seen a significant shift in the way in which investment strategies are documented and implemented. Whilst things have come a long way, there is still some room for improvement.

Investment strategies are important documents. Equally important is the process around preparing and reviewing the strategy, ensuring it is fit for purpose and meets the required objectives. The process of preparing and regularly reviewing investment strategies is seen as an opportunity to review and reflect upon the current and future operations of the fund and needs of fund members.

In the main, SMSF trustees, demonstrated through their actions and decisions, were in effect, performing the functions required by the investment strategy process. However, the documenting of investment strategies and associated processes has been essential in demonstrating that those activities are taking place and trustees are meeting their statutory obligations.

The documenting of investment strategies has also highlighted circumstances where there may be deficiencies or other concerns.

The legislative framework and operative provisions of the retirement income covenant for SMSFs, need to ensure a high level of compliance, that the strategy is relevant to the fund and its members, and that issues such as templating or generic strategies and tick-a-box processes are avoided. The result should promote active engagement, trustee and member education, and considered retirement planning.

However, the pathway to compliance with the covenant should not be onerous, increase red tape, cost, or complexity for SMSF trustees.

Presently, trustees seeking assistance or advice on the construction and preparation of an investment strategy must seek advice from a licensed financial adviser. This may be a financial adviser or an accountant licensed to provide advice under an accountants limited license, who hold the appropriate authorisations.

Unlicensed accountants or SMSF administrators are unable to advise SMSF trustees on what types of investments or returns should be included in their investment strategy. They are limited to providing:

- Trustee's factual information on what needs to be included in the investment strategy
- Help or guide trustees to document the trustee's chosen strategy in a compliant manner
- Help trustees review their fund to ensure that it complies with the investment strategy
- Advise trustees if the SMSF is operating outside of its documented strategy.

They are prohibited from preparing or providing a customised investment strategy for the trustees or from recommending that trustees amend or modify their strategy or underlying investments. These actions would constitute financial advice.

Financial Advice – Need and Access

Uniquely, SMSF members and trustees are one and the same. They do not have the same arm's length relationship to that of an APRA fund trustee and the cohort of members that need to be considered in their retirement income strategies.

The position paper notes that the formulation of retirement income strategy will not constitute financial advice to fund members. This will be essential for APRA fund trustees. However, the practicalities and how it will likely work in practice, substantially differs for SMSF trustees.

The SMSF population comprises of 23.5% single member funds and 69.6% two member funds.[1]

When we consider the nature of the SMSF structure and the close relationship between the trustees and members, it will be difficult for the trustee to consider the *"broad actions they will take to assist their members to balance key retirement objectives"* as suggested in the position paper.

SMSF trustees are in a unique position to the APRA trustees, as they hold full knowledge of the member's personal financial affairs. Of concern here, is that the nature of that close relationship will cause SMSF trustees to be held to a higher standard. Would trustees be required to use their knowledge of the member's personal affairs to structure an appropriate strategy?

To what extent or degree would the trustees be required to seek financial advice? Further, what additional cost would be incurred, or compliance burden imposed?

The alternative outcome is a general strategy that is meaningless and becomes a tick a box exercise.

How will unadvised trustees be expected to comply with the covenant?

Most trustees are not professional advisers or sufficiently qualified, without support, to prepare a compliant retirement income strategy. Education resources, detailed regulator guidance and access to toolkits and calculators will be essential.

If the preparation of a retirement income strategy will require the trustees to seek financial advice, problems will arise due to the limitations on obtaining advice. Those limitations being access to advice and cost.

[1] Australian Taxation Office: *Self-managed super funds – A statistical overview 2018-19* (QC 64920)

The financial advice sector is undergoing significant reform, and as a result we have seen:

- A significant reduction in adviser numbers
- Changes in business models and ideal client definitions
- Limited ability to obtain scoped or limited advice
- Increasing costs of providing and obtaining advice.

This is seeing increasing numbers of individuals unable to access essential advice.

The costs of providing advice continue to increase due to the increased costs to advice businesses. Significant increases in adviser levies, professional indemnity insurance premiums, and the increasing regulatory and compliance environment has significantly increased the work involved in servicing clients in a compliant manner.

These issues have also seen a significant reduction in appetite or ability to provide limited or scoped advice to clients.

Whilst we agree that SMSF trustees should be actively encouraged to seek financial advice, there will also be many, for various reasons, that choose not to do so. As noted above, there are also significant barries for those seeking advice in accessing and obtaining that advice when it is desired.

We acknowledge that the broader financial advice framework is outside the scope of this position paper. The Government's planned review into the quality of financial advice to be conducted in 2022 is noted. Nonetheless, the issues on access to advice will impact many SMSF trustees in meeting the covenant obligations.

Accountants and SMSF Administrators - Expectations

The Corporations Regulations 2001 sets out limited exemptions to the provision of financial advice. These exemptions, along with the definitions of factual information versus general advice, continue to cause confusion.

Often, there is the expectation by trustees that the accountant or administrator for the SMSF can assist with the preparation of a fund's investment strategy and other matters. It is anticipated that Trustees will similarly seek advice and assistance on the retirement income strategy with similar expectation from these professionals.

Although intended to be general in nature, the retirement income strategy is required to consider retirement income products to suit the needs of members in the retirement phase. This will require contemplation of various pension and income stream products. It is noted in the position paper that the range of available products will continue to grow and expand.

An unlicensed accountant under Corporations Regulation 7.1.33A can only provide broad asset allocation advice. This is limited to one (1) or more of the following:

(a) shares;
(b) debentures;
(c) debentures, stocks or bonds issued, or proposed to be issued, by a government;
(d) deposit products;
(e) managed investment products;

(ea) foreign passport fund products;
(f) investment life insurance products;
(g) superannuation products;
(h) other types of asset.

Importantly, this does not extend to class of product advice. Class of product advice extends beyond the broad asset allocation advice and can only be provided by an adviser authorised under an Australian Financial Services Licensee ("AFSL").

'Class of product advice' means financial product advice about a class of products that does not include a recommendation about a specific product. For example, an accountant covered by a limited AFS licence could provide class of product advice about mining shares or shares in the ASX 100, as long as that advice did not include a recommendation about a particular mining share or a particular share in the ASX 100.[2]

Similar issues arise where we look to the requirement for trustees in addressing the objectives. The example provided in *Box 4: Examples of identifying trade-offs between objectives* sees the trustee consider a strategic investment methodology to be used to manage risk, the development or offering of retirement income products and how it will benefit members in meeting their retirement income requirements.

Likewise, when we consider the need for trustees to *"regularly and comprehensively review the appropriateness, effectiveness and adequacy of their retirement income strategy including the assumptions underpinning it."*

The advice required by trustees in meeting these obligations will likely extend beyond the provision of factual information and would be classed as financial advice.

Consideration needs to be given on the broadening of advice landscape to assist trustees meet their obligations. A practical, consumer centric approach is needed.

A review of the advice that can be provided by accountants is urgently needed. Particularly with regards to the winding up of a SMSF where it is apparent that the SMSF is not appropriate for the individual in their circumstances or no longer fit for purpose.

Further, there needs to be clear and specific guidance on how accountants or SMSF administrators can assist their clients to comply with the retirement income strategy covenant, and importantly, not be deemed to have provided financial advice.

Other SMSF Considerations

Whilst we have concerns on how the implementation and practical operation of the retirement income strategy will impact SMSF trustees, we also see opportunities for the SMSF sector. There are several key components that should be included and specifically considerations by SMSF trustees.

[2] ASIC INFO 216

SMSF Specific Obligations

The covenant should require trustees to consider the life cycle of the SMSF and its appropriateness for the members. Matters to be considered and documented could be extended to include:

- Proposed SMSF end date
    - Consider the exit strategy for members
    - Documenting trigger events such as member age or balance in the fund
    - Wind up plan for the fund
- Trustee's plan for management of loss of capacity
- Documenting whether valid enduring powers of attorney are in place.

The inclusion of the above components will bring these important issues to the fore. Just like the member insurance considerations for investment strategies, the inclusion of these issues in the covenant acts as a vital prompt for these essential conversations. Incorporating them into the covenant for SMSFs will play an important role in ensuring that trustees have properly considered and prepared for these life events.

Again, we see the availability of regulatory guidance materials, for SMSF trustees, could explain the importance of considering the life cycle of the fund, as a necessary component of complying with the retirement income covenant.

Longevity Risk & Drawdown Patterns

The Association supports the proposed inclusion of longevity risk in the retirement income strategy. The position paper discusses the issue of members being under funded during retirement and not drawing on capital. In practice the converse is equally important, where members have no situational awareness on how current spending habits are impacting their future available retirement income.

Whilst we acknowledge the over-riding policy objective to encourage members to appropriately utilise their retirement savings, SMSF trustees also need to consider future capital needs. Future housing, medical care or aged care needs may require the reserving of ready capital.

It is unclear how SMSF trustees can comply with the development of specific drawdown patterns without seeking advice. Further, as both the member and trustee, the SMSF trustee will have discrete control, subject to benefit payment rules, on how, what and when payments are made. They already actively manage their personal cashflow requirements.

Clearly some form of toolkit or calculator with comparison tool will be needed to provide any prompts necessary to assist trustees to comply with the underlying requirements of the covenant. However as noted above, this must also allow broader capital requirements to be considered.

Intersection With Existing Investment Strategy Covenant

There is an element of overlap between the proposed retirement income covenant and the current investment strategy covenant on investment composition and risk. Having to address some of these concepts separately may cause confusion or duplication.

The position paper suggests that in assisting members balance the retirement income objectives, actions could include undertaking specific investment strategies.

The *Superannuation Industry (Supervision) Regulations 1994,* regulation 4.09(2) states:

> *(2) The trustee of the entity must formulate, review regularly and give effect to an investment strategy that has regard to the* ***whole of the circumstances*** *of the entity including, but not limited to, the following:*
>
> *(a) the* ***risk*** *involved in making, holding and realising, and the likely return from, the entity's investments,* ***having regard to its objectives*** *and expected cash flow requirements;*
>
> *(b) the* ***composition*** *of the entity's investments as a whole, including the extent to which they are diverse or involve exposure of the entity to risks from inadequate diversification;*
>
> *(c) the liquidity of the entity's investments, having regard to its expected cash flow requirements;*
>
> *(d) the ability of the entity to discharge its* ***existing and prospective liabilities****;*
>
> *(e) whether the trustees of the fund should hold a contract of insurance that provides insurance cover for one or more members of the fund.*
>
> [Emphasis added]

One would argue, where you have a single or two-member fund in retirement phase, the objective of their investment strategy is for the meeting of their retirement income needs. This is the desire of the trustees and is required under the investment strategy covenant in ensuring the fund can discharge existing and prospective liabilities. An obligation to pay member benefits is a liability on the trustee.

We appreciate the policy intent, but are of the view, that including the longevity consideration alongside a robust investment strategy would accomplish this objective. The consideration of risk, for example, should shift when a fund moves from accumulation phase and into retirement phase.

With this in mind, SMSF Trustees should be able to contemplate their retirement income strategy and investment strategy together, should they choose to do so.

Transitional Period

A two-year transition period should be incorporated into the measures. This allows time for trustees to seek advice and implement an appropriate strategy, education of industry, preparation and publication of regulator guidance and materials, and for auditor obligations to be properly considered and set out.

During the transitional period, SMSF trustees would be required to document a retirement income strategy from the operative date, however an educative approach will be needed. Similarly, auditor obligations should be limited to confirming the presence of a retirement income strategy, where the trustees are required to do so, during this phase.

SMSF Auditor Obligations

One aspect that must be carefully considered is the obligations that will fall upon SMSF auditors when auditing SMSFs and the scope that would apply to the retirement income strategy.

The extent to which the ASIC approved SMSF auditor will be required to examine a retirement income strategy should not result in the auditor having to extend the scope of the audit outside the

SMSF. Any expansion of scope will significantly increase the complexity of the audit process along with the time and cost incurred.

The retirement income strategy is required to considers the total income sources available to fund members in retirement. Whilst this naturally includes the member's superannuation interests and associated retirement income products, other sources of income will also need to be included.

Therefore, it is conceivable auditors will be required to review additional information that may be included in the financial statement or member statements. Any additional reports or statements included will become auditable and require examination.

One simple example is where a member's statement includes a statement of the value of insurance benefits or member death benefits. The voracity of the figures reported fall within scope of the audit and must therefore be verified.

What obligations would fall upon the auditors to verify the trustee's retirement income strategy?

Will the auditor be required to consider information or matters external to the superannuation fund in determining whether the trustees have complied with the retirement income strategy? Have trustees appropriately considered the needs of the fund members? The investment strategy covenant provides a useful comparison. Under the Auditing and Assurance Standards Board *Guidance Statement GS 009 Auditing Self-Managed Superannuation Funds* auditors are required to:

- Assess that the trustees have properly considered all the circumstances of the SMSF.
- Assess whether the investments made during the period are invested according to the documented investment strategy as approved by the trustees.
- Conduct their enquiries independently and to communicate any material matters to the trustee directly.
- Obtain evidence as to whether the trustees have reviewed or modified their investment strategy during the period to accommodate the SMSF's changing needs and changes in the investment environment.

They are not required to:

- Assess whether the investment strategy is adequate to meet the long-term investment needs of the SMSF, noting accordingly in the audit report issued.

However, auditors have been successfully litigated against where SMSF trustees have suffered a loss. We have also seen a higher standard, and a broadening of scope imposed by the Courts where clients are not considered to be 'financially sophisticated.'

> *"Mr McGoldrick was a very experienced accountant and auditor who was engaged for the purpose of **protecting the fund and its trustee against financial risks** that included the very type of risk that eventuated".*[3] [Emphasis added]

[3] *Cam & Bear Pty Ltd v McGoldrick*, the NSW Court of Appeal

These issues will need to be carefully considered and detailed guidance provided to ASIC approved SMSF auditors as to their role and obligations with regards to their audit of the trustee's compliance with the retirement income covenant. Particularly given the history with investment strategies, and the door potentially ajar to the consideration of the personal financial position of members, and if the retirement income strategy is appropriate for those members, thus broadening the scope of what the auditor would ordinarily be expected to consider.

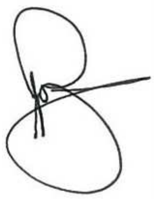
Summary of Recommendations

1. The legislation should prescribe that the retirement income strategy formulated by trustees be in writing.
2. To minimise unnecessary red tape, complexity, and confusion, and to avoid low-value add practices such as templating, generic strategies and 'tick-a-box' processes, consideration should be given to the development of education materials for SMSF trustees including the development of toolkits and retirement income calculators.

   This educational material should clearly articulate the purpose of the retirement income strategy and explain the need for SMSF trustees to document an exit strategy and their strategy for managing the loss of capacity of a member and noting whether valid enduring powers of attorney are in place. This material could also explain the circumstances under which components of the retirement income covenant could be covered off by the fund's investment strategy.
3. The obligations that will fall on SMSF auditors to review the SMSF trustee's compliance with the retirement income covenant, should not result in the auditor having to extend the scope of their audit beyond the SMSF. Detailed guidance should be provided to SMSF auditors as to their role and obligations regarding their audit of the trustee's compliance with the retirement income covenant.
4. The SMSF industry should be afforded a two-year transition period to enable the SMSF industry and regulators time to prepare and for adequate resources to be made available for trustees as noted above.

Should you have any questions about our submission, please do not hesitate to contact us, and we thank you again for the opportunity to provide this submission.

Yours sincerely,



Peter Burgess
Deputy CEO/Director of Policy and Education
SMSF Association

ABOUT THE SMSF ASSOCIATION

The SMSF Association is the peak body representing SMSF sector which is comprised of over 1.1 million SMSF members who have more than $700 billion of funds under management and a diverse range of financial professionals servicing SMSFs. The SMSF Association continues to build integrity through professional and education standards for advisors and education standards for trustees. The SMSF Association consists of professional members, principally accountants, auditors, lawyers, financial planners and other professionals such as tax professionals and actuaries. Additionally, the SMSF Association represents SMSF trustee members and provides them access to independent education materials to assist them in the running of their SMSF.