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This Week's Top Articles

Grandfathered commissions: what's it about?

Rick Cosier

Investment Trends recently released its 2018 Financial Advice Report, an in-depth survey of the appetite and use of financial advice among Australian adults. The Financial Services Royal Commission has profoundly affected perceptions of the financial planning industry and trust in financial planners and banks are at all-time lows.

Among the major issues at the Commission, fees for no service, charging fees to dead people and dud insurance policies are easy concepts to grasp. However, grandfathered commission is more difficult for most people to get their head around. Various groups have been vocally calling for blanket bans, and banks have been backing away from commitments made to financial planning groups in order to placate an angry population.

How did it all start?

The dictionary definition of grandfathering is to exempt someone or something from a new law or regulation. In the financial advice context, grandfathering concerns investment commission, superannuation commission and insurance policies linked to super accounts.

Let's step back. In the 1980s, financial institutions started marketing managed investments, where investors could access the share market by pooling their money in a managed fund with other like-minded people. The investment managers did not have a means of selling the concept: no sales force, no client service departments and no real way to communicate with potential buyers. Consequently, they enlisted the support of intermediaries. They charged the investor entry fees into the managed fund which they passed to the intermediaries as upfront commission. Since July 2013, these commissions have been banned.

The intermediaries were also paid ongoing (trailing) commission, usually 0.3% or 0.4% per annum on the value of an investor's account balance. **It is these commissions which all the fuss is about.** These payments were intended to subsidise the cost of providing ongoing service to people who bought the managed funds.

Who pays it and who gets it?

Two important factors to note.

First, the trail commissions were paid by the investment manager out of their management fee. It was not an added fee that was deducted from the investor's account. Consequently, it did not (and still doesn't) show up specifically as a debit on investor statements. If an investor didn't invest via a financial adviser, the fund manager kept the money and didn't rebate it to the investor. These managers didn't really want a direct relationship with investors, and they certainly didn't want to jeopardise their adviser distribution arrangements. Any fund manager who 'went direct' or discounted fees risked being blacklisted by angry advisers.

Second, these commissions were not paid directly to financial advisers (and still aren't). The vast majority of financial advisers are authorised representative of a 'licensee' (sometimes referred to as a 'dealer group') rather than take on the responsibilities and risks involved with having their own licence. This spawned the creation of a group of independent licensees, some of which attracted large numbers of financial advisers. Investment managers paid commissions to the licensees who passed them on to financial advisers after deducting a percentage to cover the costs and profit margins of the licensee.

Along came vertical integration

In the late 1990s, banks recognised the profit opportunities that vertical integration could deliver, and retail banks bought fund managers, administration platforms and licensees. They derived profits from the management fees created by fund managers, admin fees from the platform and a share of the commissions created by financial advisers. Furthermore, their profits were bolstered by the mushrooming size of the superannuation market which grew from virtually nothing in 1992 to more than $2.7 trillion today.

Over time, the legal and compliance demands on financial planners grew to such an extent that trail commission was nowhere near enough money to cover the costs of financial advice. Consequently, many advisers tacked on an adviser service fee to the client's account. This fee had to be agreed with the client in writing, via a signed copy of the application form, and was directly deducted from the client's account and was specifically itemised on the client statement.

Some adviser groups rebated the entire trail commission and covered their costs by charging adviser service fees. Others used a combination of trail and adviser service fee.

The ban on commission

Rumblings about commissions had been growing for a while but really blew up when the industry funds started spending big money on advertising. These 'compare the pair' advertisements graphically revealed how much money could be 'lost' by ordinary Australians over the course of a lifetime. The Labor Government introduced a package of measures designed to eliminate commissions and increase transparency, including:

- A ban on upfront and trail commissions on all new investments.
- Super funds had to invest all new super contributions into new low-cost investment options which didn't pay commissions.
- All existing super accounts would have to be transferred to the new low-cost investment option unless the member had actively selected a non-default option, or the fund received notification from the member saying they wanted to remain where they were.
- Advisers had to provide Fee Disclosure Statements every year.
- Clients had to sign an Ongoing Service Agreement every two years which clearly stated the services that were to be provided and what they were being charged.

The key date was 1 July 2013 but many of the measures had grace periods and different implementation dates. This confusion was amplified when the Coalition won power and announced they would roll back some of the changes, but the cross benchers objected.

Grandfathering of commissions

The measures that were eventually introduced contained some sweeteners, omissions or mistakes, depending on your view. The major concession was that **trail commissions on existing investments were grandfathered**. In other words, if an investor remained in an investment, trail would continue to be paid until the investment was redeemed, in theory forever.

Due to the forcible transfer of commission-based superannuation accounts to commission-free accounts, grandfathered commission was expected to die out relatively quickly. However, they are an important part of the revenue structure of many advice groups, although certainly not all. Many people are arguing for a blanket ban on commissions in the wake of the Royal Commission.

What isn't generally recognised is that many superannuation members are actually better off in commission-paying investment options.

First, low cost super funds often underperform other investment options, even after fees. **Second**, when MySuper and FoFA were introduced, many retail super funds found other ways to earn revenue, ostensibly because of the additional legal and risk costs. While they deducted the trail from the management fee, some increased their administration fees, inserted an adviser service fee or added a regulatory reform fee to cover the costs of compliance. Overall, management fees went down but perhaps not as much as expected.

Some workplace super funds also changed their fee structure so that management fee discounts were lower on the new MySuper products. These discounts often started when the workplace super fund reached $1 million but following the introduction of MySuper, the starting point for the discounts on some new low-cost options moved $5 million. This sometimes wiped out any cost savings accruing from MySuper. Also, many financial advisers were rebating some or all of their trail commission, and this benefit was lost to MySuper members under the new fee regime.

Grandfathering rights were also extended to allow advisers job flexibility and retirement options:

- If a financial adviser leaves his current licensee and joins another licensee, the trail continues to be grandfathered and the new licensee receives the commissions instead.
- If the adviser retires and sells his business to another financial adviser, the new financial adviser can inherit the commissions.
- If the adviser's licensee buys his business the licensee inherits the trail commission.

In my opinion, these allowances are reasonable otherwise it creates a restriction on advisers to practice, dramatically limits their employment options, decreases the value of their business and reduces their retirement choices. Grandfathering is an expected concession when changes are made to legislation (and listen to the howls of complaint when it is denied!) so why should financial advisers be treated any different?

Bigger FoFA mistakes

I believe the biggest mistake the government made when introducing FoFA was that Fee Disclosure Statements and Ongoing Service Agreements did not have to disclose trail commissions. This gave advisers the opportunity to be economical with the truth, and it is probable that many investors remain completely unaware of exactly how much money advisers are making on their investment. Many advisers did not disclose trail commissions. In their view, commissions are payments made by the super fund from their management fees and not a direct cost to the client.

While history is on their side, the future is not.

Before retiring in June 2018, I spent 26 years in the investment and financial planning industry including with two fund managers, two banks and three financial planning organisations. Even with this background, I may have overlooked an important aspect of commissions so please feel free to chime in!

Prior to retirement, Rick Cosier was a financial adviser for 26 years and Principal of Healthy Finances Ltd. This article is for general information only and does not consider the circumstances of any individual.

How will Labor's negative gearing rules apply?

Bob Deutsch

(This is a modified version of an article published in *TaxVine*®, The Tax Institute's flagship, member-only weekly news service).

If elected in 2019, Federal Labor plans to introduce restrictions on negative gearing for investors. Two weeks ago, I confirmed with the Labor Party that their proposed changes to negative gearing would apply across the board to all investments.

Previously, it was thought that Labor's negative gearing restrictions might only apply to property investment, as they announced :

> *Labor will limit negative gearing to new housing from a yet-to-be-determined date after the next election. All investments made before this date will not be affected by this change and will be fully grandfathered.*
>
> *This will mean that taxpayers will continue to be able to deduct net rental losses against their wage income, providing the losses come from newly constructed housing.*
>
> *From a yet-to-be-determined date after the next election losses from new investments in shares and existing properties can still be used to offset investment income tax liabilities. These losses can also continue to be carried forward to offset the final capital gain on the investment.*

This article examines some practical examples of how Labor's restrictions might operate. I make no political statement, either on my own behalf, or on behalf of The Tax Institute.

In summary, under the proposals, the excess of interest expense over income (such as rent or dividends) cannot be utilised against salary and wage income. It must be carried forward for offset in future years against future investment income or capital gains from the disposal of the investment assets.

Negative gearing: how big is the problem?

Although interest rates have been at record lows for many years, negative gearing remains pronounced as rental returns have also fallen. Interest rates of 4 to 5 % and rental returns of 2 to 3% are common profiles giving rise to negative gearing, albeit far more modest than when interest rates were at 15%-plus levels back in the 1980s. (That may provide some explanation for the failure of negative gearing reforms in the mid-1980s – but that is another story!)

Further, in the context of margin lending to fund share acquisitions, interest rates are usually into double digit levels. While some shares pay dividends much higher than the often-paltry returns achieved on property investments (think RIO 7.19% BHP 7.02% CBA 8.94%), that is not always the case (think CSL 1.24% QBE 2.57% Aristocrat 2.12%).

Labor's figures suggest an improvement to the Federal Budget bottom line of $32 billion over 10 years. That figure, I believe, relates to both negative gearing and the proposed halving of the capital gains tax (CGT) discount from 50% to 25% so the exact tax contribution from negative gearing restrictions is unclear. Nonetheless, it does seem that Labor expects a substantial return from the change.

The scope of Labor's proposed measures

After some interrogation, I have confirmed that Labor's restrictions on negative gearing will apply (after a yet-to-be announced commencement date) to all investments on a global basis to every taxpayer. In other words, it will apply to property and shares and any other relevant asset class. It will look at a taxpayer and assess their overall investment income measured against their overall investment interest expenses.

Both these points are critical to an understanding of what is proposed.

What does this mean for investors in a practical sense?

Let me illustrate what this means for investors with three examples.

Example 1 – Harry

After the proposed commencement date, Harry, an Australian resident, borrows $500,000 from a bank and uses the borrowed funds to buy an investment property in suburban Melbourne. The interest rate is 5% per

year and the net return (after all deductions other than interest) is 3.5% net per year. Harry is employed deriving PAYG income of $200,000 per year but has no other investments, geared or otherwise.

Example 2 – Raylene

After the proposed commencement date, Raylene, an Australian resident, borrows $500,000 under a margin loan arrangement and uses the borrowed funds to buy shares in an Australian company. The interest rate on the loan is 8% per year and the net return on the shares (after all deductions other than interest) is 2% per year (being the grossed-up dividend yield on CSL, QBE and Aristocrat combined, for example). Raylene is employed deriving PAYG income of $300,000 per year but has no other investments, geared or otherwise.

Example 3 – Suellen

After the proposed commencement date, Suellen, an Australian resident, borrows $1,000,000 from a bank at a 5% per year interest rate and uses the borrowed funds to:

- buy a property for $500,000 which has a net rent (before interest) of 3%; and
- buy shares in an Australian listed public company which will pay a grossed-up dividend yield of 5%.

In addition, Suellen uses $500,000 of her own funds to purchase 5-year treasury bonds, paying her an interest rate of 2% per year (I assume treasury bonds will be covered by the restrictions).

The restrictions on negative gearing will need to be carefully monitored by all three people.

Harry and Raylene will both fall foul of the proposed negative gearing restrictions as their interest expense exceeds the income – in Harry's case by $7,500 and Raylene's case by $30,000 (that is, interest expense of $40,000 or 8% of $500,000 minus $10,000 dividend or 2% of $500,000).

Under current rules, that excess could have been used to offset other income earned by Harry and Raylene giving rise to tax savings of $3,375 for Harry and $13,500 for Raylene. Under Labor's proposals, the excess cannot be so utilised but must be carried forward for offset in future years against future investment income or capital gains from the disposal of the investment assets.

Their position will need to be looked at afresh every year as their circumstances may change. If, for example, the interest rate falls and the rent rises, the property may become positively geared (or just less negatively geared). In addition, they may buy new assets with better gearing ratios, in which case the problem may again be reduced or even completely eliminated.

Suellen, on the other hand, owns property bought with borrowed funds, shares bought with borrowed funds and bonds bought with her own funds. She will not have a negative gearing problem. Her total interest expense is $50,000 but her total investment income from the three sources is $50,000. She will be able to fully utilise the losses which she makes through the negative gearing of her property and share portfolio essentially through the positive gearing of the bond portfolio.

It's bad news for Harry and Raylene but okay for Suellen. No doubt she might also prefer a life without the added drama of watching the negative gearing ceiling but with careful planning she can manage the process.

This is the key to dealing with the fallout from Labor's restrictions. Management of portfolios should have regard to the restrictions on negative gearing.

In addition, purchasing properties in the name of the family member best able to manage any negative gearing restrictions will also be vital.

Finally, while I believe this interpretation is conceptually consistent with what Labor has announced, much will depend on the detail of the legislation. Sometimes the detail can surprise and can be inconsistent with the conceptual foundations.

Professor Robert Deutsch is Senior Tax Counsel at The Tax Institute. This article is for general information only and does not consider the circumstances of any investor.

Schemes designed to deal with longevity risk

Jeremy Cooper

Australia's large super funds are building better products to provide income in retirement for their members. In part, this reflects policy initiatives such as innovative income streams, but some funds are actively considering their retirement offer ahead of the potential requirement to offer each member a CIPR (Comprehensive Income Product for Retirement).

The key element of a CIPR is to manage longevity risk. This can't be done if the only option is an account-based pension (ABP), which the majority of superannuation pensions are currently based on. While a partial investment in an annuity can provide the longevity risk management, there are other options for funds to use a collective income stream alongside the ABP.

What exactly is a collective income stream?

In short, a collective income scheme is one in which:

- members have no individual account (i.e. ownership of capital) in the scheme.
- the liability of the employer sponsor(s) to contribute is both certain and limited.
- there is a retirement income target, but no concrete promise (this of course could be made more secure (e.g. by derivatives) or guaranteed by a third party, but without recourse to the sponsors).
- longevity risk is spread across the pool.
- investment risk is spread across the pool.

These schemes are sometimes called 'group self-annuitisation schemes' (or GSAs) but the definitions have blurred since GSAs were first described by some Australian academics. There are key differences between the various collective schemes in their degree of flexibility and the approach to managing retiree risks. These factors include:

Flexibility	Risk Management
– Entry point (pre/post retirement) – Choice and ability to change – Access to capital – Payment of residual capital (estate) – Timing of contributions – Timing of payments	– Mortality pooling – Market risk protections – Diversification (asset allocation) – Guarantees and capital protection – Inflation protection

There are three key benefits from using a GSA (or other collective income schemes):

1. Pooling idiosyncratic longevity risk

There are two forms of longevity risk. One risk is related to how long everyone will live, and will change with medical improvements and lifestyle changes etc. (systematic longevity risk). The other risk is that some people will live considerably longer than the average (idiosyncratic longevity risk).

GSAs pool idiosyncratic longevity risk. Pools of retirees (in the same age cohort) tend to have a more reliable distribution of ages at death, particularly as the pool becomes larger. When planning for 10,000 retirees, the law of large numbers will start to see quite a predictable distribution of lifespans around the mean and hence the risk is effectively diversified away.

Because it has no resources beyond what is in the pool, a GSA arrangement is still exposed to systematic longevity risk. This form of risk, if it unfolds, will be borne directly by the GSA-funded retiree in the form of a reduced income.

2. Mortality credits

A mortality credit is the higher payment that is available to someone who contributes their capital to a longevity pool, where participants are only entitled to payments while they are alive. Those who live beyond the actuarial life expectancy of the pool benefit from the contributions of those who die earlier.

Leading annuity expert, Moshe A. Milevsky (2006), describes it as a process where the capital and interest of the deceased member is 'lost' to that person and their beneficiaries. It is then 'gained' by the surviving members of the pool. The remaining value of the notional capital of the deceased is spread across all members to help support their lifetime income payments.

As the life expectancy is an average, approximately half of the members of the pool will die before reaching the expected average and will not benefit further. The remaining value of their notional capital is then available to support the remaining liabilities in the pool. These mortality credits are distributed ex-ante by the scheme in setting its targeted payment rates. In other words, mortality credits enable the income paid to the member to be higher than the combined total of the partial return of capital and projected asset returns of the scheme comprised in each payment.

Mortality credits provide a form of return not directly linked to the capital markets.

3. Reduced (or no) capital costs

Pooling of longevity risk (both idiosyncratic and systematic) is available through a lifetime annuity offered by a life insurance company. These products also remove the market risks from the retiree and pay a guaranteed income. In order to secure these payments, the shareholders of the life insurance company provide capital as a buffer to protect the retiree. This capital is at risk to the shareholders and needs a sufficient return. The guaranteed payments to the annuitant are set so that what remains from the returns on the total asset pool provides the expected return to shareholders. If these expectations turn out to be wrong, the losses are borne by the shareholders, who, in the worst case, would be called on to provide even more capital under powers given to APRA in 2012.

The logic for GSAs is that by not using capital buffers or guarantees, they will be able to avoid the cost of the capital or the insurance afforded by the guarantee and thereby increase the retirement income able to be distributed to members. The flip side of this argument is that a guarantee has a value in the defensive or 'safety-first' part of the portfolio and not having a guarantee is a weakness, rather than a strength.

The development of better retirement outcomes for Australians is likely to see growing use of GSAs and other collective income streams. This will require solutions to some of the more technical aspects, such as operating a GSA over risky assets with a need for surplus/deficit management or highly volatile income streams.

There is also a regulatory concern over the disclosure of the GSA target. Without a guarantee, there can be no real promise of income in retirement. How will retirees be able to distinguish between alternative structures that might target different incomes from the same asset mix? At least with a guaranteed product, the income can be relied on. The additional capital backing the promise provides this security for the retiree.

There is no magic pudding in retirement. A GSA scheme can share investment risk between one member or generation of retirees and another, but it can't reduce it overall. If one GSA member takes less investment risk, another member is taking more. Pooling does reduce the idiosyncratic mortality risk, but as with idiosyncratic market risk under the capital asset pricing model, this is an unrewarded risk. Removing it alone does not increase total returns to the pool.

Jeremy Cooper is Chairman, Retirement Income, at Challenger, a sponsor of Cuffelinks. For more articles and papers from Challenger, please click here.

More detail on the $1.6m Transfer Balance Cap

Monica Rule

We asked Monica to respond to this comment in response to Noel Whittaker's article last week:

Monica's comments on the $1.6 million TBC no longer being relevant (provided documentation was done properly as at 30 June 2017) seem incredible. Can this be explained in a bit more detail?

Most SMSF members who are receiving a retirement pension from their SMSF are aware of the transfer balance cap (TBC) of $1.6 million. It limits the amount an SMSF member or member of an institutional super fund can hold in their retirement pension account from 1 July 2017.

The starting point for the $1.6 million

If an SMSF member was already accessing a retirement pension and their pension account balance was in excess of $1.6 million, they needed to reduce the balance to $1.6 million by 30 June 2017. Any new retirement pension that commences on or from 1 July 2017 cannot have its net assets value in excess of $1.6 million.

Once a retirement pension commences, new contributions cannot be added to the pension account. Any new contributions made into the SMSF must go into the accumulation account. If at a later date, the member wants to combine money in the accumulation account with money in the pension account, they will need to cease the pension and transfer the balance of the pension account into the accumulation account. They can then commence a new pension with the funds in the accumulation account, as long as it does not exceed the TBC.

How does the Tax Office know the balance of retirement pension accounts?

SMSF trustees are required to report each member's retirement pension account balance to the Tax Office using the Tax Office's form NAT 74923 "Super transfer balance account report". The reporting timing depends on their members' total superannuation balance. A member's total superannuation balance is the sum of all their accumulation accounts and retirement accounts across all of their superannuation funds subtracting any personal injury (structured settlement) contributions that have been made into any of these funds.

Where an SMSF member is receiving a retirement pension that commenced prior to 1 July 2017, their pension account balance as at 30 June 2017 must be reported to the Tax Office on or before 1 July 2018. For all other situations, the reporting requirement is based on the member's total superannuation balance.

If **all members** of an SMSF have a total superannuation balance of **less than $1 million**, then their SMSF can report on an annual basis when it lodges its income tax return.

For example, an SMSF has one member who is receiving a retirement pension on or after 1 July 2017 and all members of the SMSF have a total superannuation balance of less than $1 million as at 30 June 2017.

If **any members** of an SMSF have a total superannuation balance of **$1 million or more**, then the SMSF must report within 28 days after the end of the quarter in which the TBC event occurs.

For example, an SMSF has only one member with a total superannuation balance of $1 million or more, then it must report all events affecting members' TBC within 28 days after the end of the relevant quarter, even if the balance of the first member to start a retirement pension is below $1 million.

Once the reporting framework is set, SMSF trustees will not be expected to move between annual and quarterly reporting due dates, regardless of fluctuations in any of their members' total superannuation balances.

Exceeding the TBC

Where an SMSF member has exceeded their TBC, the reporting must be done sooner:

- A voluntary member commutation of their pension in response to an excess transfer balance determination must be reported within 10 business days after the end of the month in which the commutation occurs.
- Responses to commutation authorities must be reported within 60 days of the date the commutation authority was issued.

The reporting requirements for APRA-regulated funds is 10 business days after the end of the month in which the event occurred. For example, if an APRA pension commenced on 2 January 2018, it must be reported by 14 February 2018.

In a situation where an SMSF member rolls their superannuation into an APRA-regulated superannuation fund and commences a retirement pension from the APRA fund, they may want to report the commutation of their pension earlier. This is because there will be a mismatch in timing of the reporting done by the APRA fund (i.e. a new pension being commenced) and the SMSF (commutation of the pension). This may amount to the member exceeding their TBC due to double counting of the member's pension.

Where an SMSF has exceeded the TBC by no more than $100,000 and had rectified the excess no later than 31 December 2017, they should report this earlier. Otherwise the Tax Office will not know that the member has rectified the excess.

No problem if pension balance grows

SMSF members that are in receipt of a retirement pension where their pension account balance does not exceed $1.6 million either on 30 June 2017 or upon the commencement of their pension, do not need to be concerned if their balance grows beyond the TBC at a later date. Also, once the reporting requirements are satisfied, their SMSF does not need to report anything further unless a TBC event occurs, such as a commutation of their pension.

Remember that pension withdrawals and investment earnings do not reduce or increase a member's TBC and therefore do not need to be reported.

Monica Rule is an SMSF Specialist and author of The Self Managed Super Handbook – Superannuation Law for SMSFs in plain English www.monicarule.com.au.

To purchase the latest copy of The Self Managed Super Handbook (7th Edition), now in reprint, please click here. Stocks are limited.

Royal Commission report nails adviser conflicts of interest

Vinay Kolhatkar

The Financial Services Royal Commission asked Professor Sunita Sah for a report on how to mitigate the negative effects of conflicts of interests that influence financial advisers. Professor Sah focusses her research on how professionals who give advice alter their behaviour due to conflicts of interest. Cornell University, where she is a professor of management, describes her interests as including institutional corruption, ethical decision-making, bias, and transparency.

The outcomes of conflicts of interest on advisers

Academic literature on the effects of conflicts of interest on advisers suggests:

1. Conflicts of interest lead to biased advice. Often, advisers are unaware of the bias, and the effects are consistently large.

2. Self-regulatory mechanisms that govern moral standards do not operate unless they are activated. The advisers may not view the conflict of interest as a moral dilemma: "many psychological processes can be used to selectively disengage from moral self-sanctions. Collectively, these processes are known as moral disengagement."

3. Moral disengagement is not sudden. It creeps up on the person and gradually erodes self-imposed sanctions.

4. When the biased advice causes harm, advisers absolve themselves by attributing the activities as 'ordered by others'. This is more prominent if the practice is widespread, and advisers thereby observe other advisers doing the same thing.

5. Moral disengagement can also happen at an institutional level.

6. If the most corrupted are rewarded, moral disengagement accelerates.

7. Over time, private opinion alters as well. Advisers giving biased advice begin to believe their own advice (as being in the best interests of the client).

8. Advisers routinely deny an influence of incentives to a bias even after its demonstration. The bias shifts to the subconscious. Subsequently, ethical issues (in relation to the advice) are pushed aside by the conscious mind.

9. Such psychological processes, including rationalisations at a conscious level, are well established in academia. If there are incentives to not act in the best interests of the client, biased behaviour will not be limited to 'bad apples' but will include many who genuinely consider themselves to be upstanding people and good moral agents. As the report says, humans "are fantastically adept at rationalising and believing what we want to believe."

Thus, "it is relatively easy for advisers to, for example, persuade themselves that the products that they receive commissions for really *are* the best and the clients they recommend investments for really *will* benefit from those investments."

10. A sense of invulnerability to misaligned incentives increases the likelihood of accepting such incentives, and paradoxically, succumbing to them subconsciously.

Is disclosure the remedy?

Reliance on professionalism is grossly insufficient. Sah's report reminds us that CEOs and managing partners of the large accounting firms, including Arthur Anderson and PwC, testified before the US SEC that their 'professionalism' would protect them from being influenced by conflicts of interest.

Sah says that "the most frequently recommended and implemented policy across industries and professions is disclosure," but warns us that disclosure can have unintended consequences. The psychological principle in play here is that people think it is *less* morally reprehensible to give biased advice *intentionally* once a conflict of interest has been disclosed. Advisers may even increase the bias in their advice to counteract anticipated discounting of their advice by their audience.

On the positive side, Sah says that her research indicates that "mandatory and voluntary conflict of interest disclosure can deter advisers from accepting conflicts of interest so that they have nothing to disclose except the absence of conflicts."

In other words, the ability to disclose an absence of conflict is a marketing plus point. We do see that exploited in the marketplace. Corporations become incentivised to remove conflicts of interest. Perhaps regulators could use this source of competitive advantage by making disclosure mandatory.

Secondly, says Sah, if conflicts are unavoidable, as long as industry norms to place the clients first are actually in place (as against just a lip service to such a norm), disclosure will cause more norm-abiding behaviour. Further, real experts with long periods of training in their profession tend to decrease bias with disclosure.

The paradox of disclosure from the client side

As advisers feel more empowered to give biased advice with disclosure, clients may also suffer subconscious biases that unwittingly lead them toward the biased advice. Firstly, clients may feel they are insinuating distrust by not accepting advice where a conflict has been disclosed, and the relationship is good. Indeed, clients may even want to favour their advisers who disclose they receive a higher fee if the client chooses X rather than Y. The client's trust in their adviser increases with disclosure. Advisers will also likely to emphasise situations where they are recommending a product which has a lesser incentive for them.

Such effects are mitigated if clients need not communicate their choices to their advisers. But this is difficult in financial planning as execution of strategy is often part of the service.

Disclosure works better if it's up-front, temporally prior to the advice, or at least at the top of the page (or at the start of the conversation) that sets the advice out.

So disclosure isn't enough. What else works? Or doesn't?

Sah says that educating advisers about self-serving biases does not reduce their bias. It only makes them better at detecting other advisers' biases. Human beings are terrific at pushing ethical concerns into the background when it serves them well. Sah asserts that "Enron's 64-page Code of Ethics booklet did not prevent the ethical failures of many employees within that institution."

Sanctions, Sah recognises, would be hard to implement when outcomes of investment decisions are known much after the fact, and culpability as to a deliberately unsound advice hard to determine.

Fines may encourage institutions to undertake a cost-benefit analysis. Thus, Sah contends that insufficient fines would not provide a significant enough disincentive.

However, I note that the report, despite having a US perspective, does not delve into the class-action litigious culture of the US, where impacts are much bigger and more public than regulatory fines. We may start seeing some of that in Australia with several class actions, using evidence uncovered by the Royal Commission, already announced.

Institutional norms are perceived in a variety of ways, including the actions of leaders, not just the Code of Ethics document. Sah asserts that norms strongly affect individuals. Those in authority should pay attention to the myriad ways in which norms, including of what other advisers actually do, are perceived.

Getting second opinions, cautions Sah, is mostly not feasible due to cost and time. Indeed, we know that a second financial planner may in fact have the same biased incentive.

Realigning incentives is superior to disclosure. Removing incentives that create conflicts is the best way, says Sah – "policies that restricted interactions between the pharmaceutical industry and physicians led physicians to prescribe less (expensive) branded drugs and more (cheaper) generic drugs."

Sah also recommends that "advisees need to be personalised and the harm they have suffered publicised. This decreases the psychological distance between advisers and advisees."

Well, that's certainly happening with the Royal Commission.

Professor Sah's research paper can be found here.

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Floating rate bonds rise in popularity

Elsa Ouattara

Today's market poses a conundrum for bond investors. On the one hand, volatility stemming from rising trade tensions, and China's slowing growth, are driving investors towards bonds as a traditional portfolio shelter. On the other hand, central banks around the world are tightening policy and conventional investment wisdom dictates that bonds do not perform well in a rising rate environment.

What many investors are missing out on is the fact that floating rate bonds allow both portfolio protection and consistent returns. Floating rate bonds minimise the impact of rising rates on a bond portfolio. Interest rate risk is almost non-existent and floating rate bonds are typically more capital stable. Citi has seen a five-fold increase in year-to-date investment in floating rate bonds by investors compared to the same period over 2017.

Investors are attracted to this asset class as floating rate bonds offer investors the inherent advantages of bonds, such as regular income and portfolio shelter in time of market stress, while also benefitting from rising rates. However, many investors have not heard of floating rate bonds and therefore have not included them in their portfolio.

Accessing floating rate bonds

Individual floating rate bonds typically are not accessible to many 'retail' investors due to regulatory restrictions. At Citi, only 'wholesale' investors have access. To be defined as a wholesale investor, a client needs a qualified accountant's certificate stating they have net assets of at least $2.5 million, or a gross income for each of the last two financial years of at least $250,000.

Certified clients can access products that may be country specific or a multinational corporate giving exposure to a thematic like renewables or communications.

There are a few other ways that investors can access these investment benefits, including via ASX-listed floating rate ETFs and bonds, exchange-traded bonds issued by companies like XTB, and unlisted funds. Listed floating rate bonds provide an option for retail investors but they do not cover the wide range of borrowers available in the unlisted market. Wholesale investors can access traditional floating rate bonds by tapping into a global reach and a larger offering with potentially more attractive yields.

How floating rate bonds work

Floating rate bonds pay a coupon that resets periodically and is based on a benchmark short-term interest rate index. For USD bonds, the regular coupon paid to investors is typically the 3-month Libor (London Interbank Offered Rate) plus a spread premium. For example, the coupon can be set at 3-month Libor + 2%. At current levels this would mean the investor earns 4.33% which is as compelling as most fixed rate bonds.

Typically, investors cite three main reasons for choosing floating rate bonds:

- Short-term interest rates are expected to rise
- As alternatives to term deposits for higher levels of income
- To avoid the risk in fixed rate bonds of the bond's price declining when interest rates move up

Rising popularity

Recently, purchases of both USD-denominated and AUD-denominated floating rate bonds have increased significantly. Investors are riding the Fed's rate hiking cycle and are benefiting from expectations of higher short-term rates. The 3-month US Libor is now at its highest since 2008 and some economists expect the US benchmark to near 3.5% by the end of 2019.

Domestically, even though the RBA currently remains on hold, our economists consider the central bank maintains the view that the next move in interest rates is likely to be up.

As demand from investors for floating rate bonds has grown, supply has followed with strong creditworthy issuers offering a smorgasbord of choice. Issuances in USD-denominated and AUD-denominated floating rate bonds have increased significantly in 2018.

These two bonds are examples that illustrate this point:

- Barclays PLC issued a 5-year floating rate bond with a current coupon close to 4% that will increase as the Australian benchmark rate, the 90-day BBSW, increases.
- China's Far East Horizon offers a spread of 2% over the 3-month US Libor for 3 years.

While these two bonds have been the most popular with our clients in 2018 to date, each customer should consider their own needs and circumstances before deciding to invest.

With the market having priced one more Fed hike for 2018 and with the growing likelihood of a second one, investors look likely to continue turning to floating rate notes for both portfolio protection and consistent returns.

Elsa Ouattara is a fixed income strategist at Citi Australia. This article is for general information only and does not consider the specific circumstances of any individual.

7 vital steps to compliance for your SMSF

Graeme Colley

Self-managed superannuation offers greater personal control but also entails a host of responsibilities. With the need to adhere to myriad rules and requirements, and the potential for severe penalties for non-compliance, here's how to achieve the perfect SMSF scorecard.

1. Set up the fund correctly

This is the foundation that the whole SMSF process hangs on. Getting the setup right gives you access to the tax advantages associated with contributions, investment income and benefits.

Here's a list to consider as part of the setup process.

- Determine who the members of the fund will be
- Choose a trustee structure, either individual trustees or a corporate trustee
- Choose and execute a suitable trust deed
- Set up a bank account for the fund
- Register the fund with the ATO
- Obtain an electronic service address so the fund can receive employer contributions

2. Establish the fund's investment strategy

The fund must have an investment strategy stipulating its investment objectives and allowable investment categories. It should be in writing and consider the personal circumstances of fund members, including their age and investment risk tolerance, and it should be reviewed regularly. Here are some points to consider:

- Diversification – to what extent should the fund be diversified with regard to individual investments as well as asset classes such as cash, shares and property?
- Liquidity – can the fund pay benefits to members and other expenses when required?
- Insurance – should policies be held for fund members?
- Ongoing relevance – does your fund continue to reflect its purpose and any changes in its members' circumstances?

3. Manage the actual investments

Depending on its trust deed and investment strategy, your SMSF may have a wide range of permissible investments including public and private company shares, managed funds, private trusts, cash and term deposits, direct property, and even artworks and collectibles.

Where the investments are made at arm's length to third parties on commercial terms there are few issues outside the norm that need to be considered. However, with investments involving related parties such as family companies or family unit trusts, restrictions may apply. As these rules can be complex, guidance from an SMSF expert can be useful.

Points to check when investing:

- Is the investment permissible in the fund's trust deed and investment strategy?
- Is the investment on an arm's length commercial basis?
- If the investment involves related parties, does it meet the relevant regulatory provisions?
- Have you kept copies of documents and other records concerning the investments, especially those involving related parties?

4. Manage your contributions

Contributions that may be accepted by the fund can depend on many factors, including:

- Can the contribution be accepted by the fund because of the type of contribution, member's age and work status?
- Should the contribution be included in your fund's taxable income?
- Have you received an election from a member concerning the tax-deductibility of personal contributions?
- Are the contributions counted against a member's concessional or non-concessional contributions caps?

5. Pay an income stream

The main purpose of any superannuation account is the eventual payment of benefits. Before paying a lump sum or pension you need to ensure the member has met a condition of release such as retirement or reaching age 65.

Before an income stream can commence, some calculations are required which are based on the value of the member's accumulation account and their age. Each year a minimum amount of the income stream is required to be paid. When commencing or paying an income stream from your SMSF, make sure:

- The member's account balance has been valued according to ATO 'market value' guidelines
- The minimum amount of the income stream for the year has been calculated
- A maximum pension amount has been calculated in the case of a transition to retirement income stream
- The income stream is paid in accordance with the member's instructions
- The value of the income stream at the time it commences or is commuted is reported to the ATO for transfer balance cap purposes

6. Meet all reporting requirements

It is the responsibility of trustees to ensure formal reporting requirements are met. This includes the fund's income tax and regulatory returns, PAYG information and transfer balance cap information. An auditor is required, and in some cases an actuary must provide a certificate for tax and solvency purposes.

As fund trustee your responsibility is as follows.

- Arrange for the preparation of annual fund accounts
- Arrange for the preparation of the fund's annual income tax and regulatory returns
- Appoint an auditor to the fund
- Obtain an actuarial certificate from a qualified actuary if the fund is required to use the proportional basis to calculate its taxable and tax-exempt income
- Value the fund's assets at their market value
- Make sure that the minimum pension amounts have been paid to members
- Report debits and credits to the ATO for transfer balance cap purposes
- Notify the ATO of changes to the trustees or directors of the corporate trustee
- Notify ASIC of changes to directors of the corporate trustee
- Retain the fund records

7. Wind up your fund (if or when the time comes)

There may come a time when you have to wind up a fund, whether due to a member's death, loss of a member's legal capacity or because the fund has served its useful life and run out of money.

When winding up your SMSF, consider these questions.

- Have you read the fund's trust deed and other documents to see what's required to wind up the fund?
- Have you accounted for any income the fund expects to receive and paid any expenses that are due for payment?
- Have you paid out benefits to members or rolled them over to a fund nominated by the member?
- Have you arranged for final set formal reporting – fund accounts, income tax and regulatory return, and the associated audit function?
- Have you paid any outstanding expenses such as income tax on the fund's income?
- Have you closed the fund's bank account after all liabilities have been satisfied and income has been accounted for?
- Have you notified ASIC if the fund has a corporate trustee?

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