

### This Week's Top Articles

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### Royal Commission's Table of (Dis)Contents

Graham Hand

After weeks of reading the Financial Services Royal Commission Final Report on a screen, my hard copies arrived recently. Anyone can order them for free [here](#). There's something different about sitting down with a book, like in the good old days, and it's surprisingly easy to read. Kenneth Hayne does not write in a legalistic way, but he is chatty in places, as if writing as his thoughts form. Someone should have given it a good edit but my guess is nobody was willing to suggest this to Mr Hayne. He's even elegant in places:

*"It is time to ignore the ghostly apparition of constitutional challenge conjured forth"*

*"Saying only that there may be a 'disruption' or 'unintended consequences' is nothing but a naked appeal to fear of the future."*

#### Revelations in the Table of Contents

But something jumped out even before I left the Table of Contents section. There's not much in the 'Banking' section. It's often called the Banking Royal Commission (and in fact, Cuffelinks bought the url [www.bankingroyalcommission.com](http://www.bankingroyalcommission.com) although we never activated it). The Banking section starts on page 51 and finishes on page 118, only 67 pages. Even in there, 28 pages are devoted to mortgage brokers and intermediation. Surely a wider range of banking services should have been the Commission's primary target, not a mere 40 pages.

Look at the topics in the Table of Contents:

- Intermediated home lending
- Intermediated vehicle and consumer good lending
- Access to banking services
- Farm debt mediation
- Valuation of land
- Charging default interest
- Distressed agricultural loans
- Enforceability of industry codes
- Processing and administrative errors



Among the vast array of products and services banks offer, are these the most important? Farm debt mediation! Valuation of land! Distressed agricultural loans! It's a rural banking review. Nothing much on how banks price products, credit card lending and rates, transaction services, foreign exchange, fees on loans and deposits, closure of bank branches ... on it goes. Why is a cheque dishonour fee \$30 for an automated process? Why are some credit card rates over 20%? Why are term deposit rollover rates worse than new offers? The Commission scratched the surface.

It matters because bankers are now focussing on the issues raised by Kenneth Hayne, leaving some major issues untouched.

Then 'Financial advice' starts on page 119 and goes for 100 pages, after which 'Superannuation', which also deals with financial advice, kicks in and covers another 47 pages.

There's twice as much on financial advice as banking (acknowledging there are later general sections on culture and remuneration). It's more like the Financial Advice Royal Commission.

And another financial service which carries many similarities to financial advice, stockbroking, does not rate a mention.

### **What about stockbrokers and FoFA?**

The instructions given to the Royal Commission are in the [Letters Patent](#). It refers to 'financial services', and it invites the Commissioner to inquire into almost anything that he considers relevant to "peace, order and good governance". The massive industry of listed securities, stockbroking and the ways companies raise money on exchanges barely rates a mention. Meanwhile, financial planning was pilloried in the witness box month after month, as if the remuneration and market practices of one industry were any less questionable than the other. Who can forget the well-justified trials on the Future of Financial Advice (FoFA) misdeeds, grandfathered commissions and the evidence of financial adviser, Sam Henderson and others.

The Terms of Reference make no more direction towards financial advice than stockbroking, and the official name of the inquiry is the Royal Commission into Banking, Superannuation and Financial Services Industry, with no direct reference to financial advice.

Since FoFA and financial advice were front and centre for months, why wasn't an activity examined which has close operational parallels (such as distribution of products for commissions, raising of capital for companies, provision of advice to consumers)? Stockbrokers and financial planners carry far more similarities than differences.

In a previous article, [8 problems the Royal Commission missed](#), I wrote about the ability of fund managers and other market participants to avoid the FoFA rules by using the Listed Investment Company (LIC) structure. It was good to see Christopher Joye write a quality analysis in *The Australian Financial Review* on 8 March 2019 entitled, ['Boiler rooms are back as listed investment companies'](#). He notes:

*"Fund managers have figured out how to circumvent the vital Future of Financial Advice (FOFA) consumer protection laws to pay gigantic sales commissions worth more than \$150 million to brokers and advisers despite FOFA being implemented to prevent precisely this practice ...*

*When these laws were introduced in 2012, they applied to all investment entities, including listed and unlisted funds and investment companies. In 2014, however, sustained industry lobbying convinced politicians to exempt listed investment companies and trusts from FOFA's all-important reach ...*

*In dollar terms, fund managers have paid more than \$150 million in conflicted commissions to get brokers/advisers to push their products to retail investors, often in incredibly short time frames ...*

*For the vast majority of fund managers rushing to exploit this huge loophole, there is zero chance they could secure this volume of capital as quickly as they can on the ASX through normal FOFA-compliant channels."*

The legislation Joye is referring to includes [7.7A.12.B of Consolidated Regulations](#). It says:

*"A monetary benefit is not conflicted remuneration if it is a stamping fee given to facilitate an approved capital raising."*

So call commission a 'stamping fee' for 'an approved capital raising' and we're off to the races. Call a commission a conflicted remuneration from a product provider to a financial adviser, and we're off to the slammer.

### **Redefining financial advice**

Given both political parties have indicated that Hayne's report will be adopted in full with only one or two exceptions, what does it say about the future role of financial advice? Here is a sting in the tale that financial advisers should worry about.

For a start, there is plenty of evidence that Hayne is unconvinced about the merits of advice. For example:

*"... poor advice which, too often, is the result of the conflicts of interest that continue to characterise the financial advice industry. Other professions are not so pervaded by conflicts of interest and do not have such a high tolerance for the continued existence of conflicts of interest. Until something is done to address these conflicts, the financial advice industry will not be a profession."*

*"the existing disciplinary arrangements for financial advisers are fragmented, and hampered by inadequate sharing of information."*

*"Not all advisers (financial or other) are equally skilled or diligent. In some cases, reasonable advisers may form radically different views about what should be done."*

*"In 10% of all the files ASIC reviewed, ASIC 'had significant concerns about the potential impact of the advice on the customer's financial situation'."*

### **Has Hayne misunderstood where financial advice was heading?**

Powerful implications for financial advice start on page 238 of the Final Report. I will quote extensively because these findings are a redefinition of the future of financial advice, and the industry is not reacting enough. Advisers are shell shocked and keeping their heads down. Kenneth Hayne writes:

*"It is not consistent with the sole purpose test for a trustee to apply funds held by the trustee in paying fees charged by an adviser to consider, or re-consider, how best the member may order his or her financial affairs generally or may best make provision for post-retirement income."*

*It follows that the nature of the advice that may properly be paid for from a superannuation account is limited to advice about particular actual or intended superannuation investments. This may include such matters as consolidation of superannuation accounts, selection of superannuation funds or products, or asset allocations within a fund. **It would not include broad advice on how the member might best provide for their retirement or maximise their wealth generally.** Any practice by trustees of allowing fees for these latter kinds of financial advice to be deducted from superannuation accounts must end. (my bolding).*

*I would modify the general rule in respect of MySuper accounts, and permit no deduction for advice fees of any kind ... It is difficult to imagine circumstances in which a member would require financial advice about their MySuper account. If a member wants financial advice, the cost of that advice should be charged to and paid by the member directly.*

*Perhaps a superannuation member invested through a platform would benefit – or believe they would benefit – from ongoing financial advice in respect of their superannuation investments. But such benefits would be relatively modest, and would accrue to relatively few members ... the advice in respect of which fees may be charged is limited to advice about particular superannuation investments."*

This recommendation flies in the face of current practice and will result in fewer people obtaining financial advice. Many superannuation funds allow the cost of financial advice fees to be charged to the super account. For example, an adviser telling a MySuper client about co-contributions, or dividing up an estate between dependants, or transferring from accumulation to pension, or aged care. Advice fees on such issues will no longer be chargeable to the super account.

Financial advice should not be predominantly about investments, but it is a holistic solution to satisfy future goals, especially retirement. It is no more relevant to advise about investing for retirement than it is for estate planning, aged care, lifestyle coaching, budgeting, property and tax advice. Kenneth Hayne is pushing the industry back to an old model where advisers were stock pickers and fund managers, and this should not be the primary skill.

The advice industry is fruitlessly fighting against the banning of grandfathered commissions, but Hayne's proposed change in their fundamental model is far more important. In fact, one of the reasons managed accounts have become so successful is that advisers put their clients into model portfolios designed by investment experts, allowing advisers to concentrate more on the non-investment side of their client's future goals and retirement plans. Most members will not pay for advice from their own pocket, and denying payment by their super fund will result in less people obtaining the advice they need.

*Graham Hand is Managing Editor of Cuffelinks.*

## Sole purpose test needs level playing field

Adrian Urquhart

Imagine this scenario: *SuperConcepts would like to announce a great deal with one of Australia's leading online retailers. Available for a short time only, individuals who join an SMSF administered by SuperConcepts will receive 20,000 Shopper Points worth \$550 for only \$100. And the cost can be deducted from your SMSF.*

It wouldn't take long for the regulators to remind us about Section 62 of the Superannuation Industry (Supervision) Act (SIS Act) that details the sole purpose test. The ATO [defines this test](#) as:

*"Your SMSF needs to meet the sole purpose test to be eligible for the tax concessions normally available to super funds. This means your fund needs to be maintained for the sole purpose of providing retirement benefits to your members, or to their dependants if a member dies before retirement."*

Super is only for "providing retirement benefits". Yet there is an offer in the market right now that has created such dizzying confusion that the entire SMSF sector has vertigo.

### Inducements are not for retirement

Clarity is needed around the sole purpose test for super funds as these types of marketing inducements seem to be gaining mass publicity and momentum. Our clients are asking for further guidance on what is now considered to be appropriate and enforceable in order to avoid breaches and ensure a level playing field.

We are not saying a breach of the sole purpose has occurred or is occurring, but we do believe clarification is needed for where the line can be drawn.

Under what circumstances is a fund permitted to offer inducements with a quantifiable financial value to attract new members if the inducement is being funded by existing members?

There is also the issue of members receiving a personal benefit from the assets of a fund before retirement, which arguably is not an incidental benefit because it has influenced the trustee's decision to enter into the arrangement.

Over the years we have seen many examples of SMSFs breaching the sole purpose test because a member or related party has received a personal benefit from the fund assets before retirement.

### Previous regulator clarification

In 2002, APRA and the ATO issued a media release confirming that:

*"The investment of superannuation fund monies in particular schemes was inconsistent with the 'sole purpose test' for regulated funds. The particular schemes that fail the test offer non-superannuation shareholder benefits and the cost of the scheme is borne by the fund."*

*"In the case of trustees that offered [Coles Myer Discount Card shares as an investment option](#) and participated in a scheme whereby members were provided with the relevant discount card, APRA and the ATO will take no action provided trustees agree that they will not participate in any future scheme:*

- *by which an advantage or benefit (not being a superannuation benefit within the meaning of the SIS legislation) is conferred on a beneficiary of the fund of which they are trustee or on any other party; and*

- *where there is an identifiable cost to the fund arising from the conferring of the advantage or benefit, whether a direct charge or an indirect cost such as the foregoing of income which would otherwise be derived by the fund.”*

Given the emergence of new similar arrangements, the SMSF sector needs to know whether this position has changed and, if not, under what circumstances can a fund offer a financial inducement to attract new members.

The issue goes beyond the sole purpose test. The SMSF sector also needs to understand how this kind of inducement-marketing works in relation to the Royal Commission’s anti-hawking recommendation.

Our clients see a danger that some in the superannuation sector get caught up in breaches by seeing these new inducement offers that appear acceptable.

We’re hearing real concerns that if everyone in the industry is not on a level playing field, then the superannuation sector could become unbalanced with unforeseen consequences. And that’s not good in a superannuation sector set up for fairness and equity to all Australian retirees.

*Adrian Urquhart is CEO of [SuperConcepts](#), a sponsor of Cuffelinks. This article is for general information purposes only and does not consider any individual’s investment objectives.*

*For more articles and papers from SuperConcepts, please click [here](#).*

## Investor questions for marketplace lenders

John O'Brien

One of the conceits of Gary Shteyngart’s *Super Sad Love Story* is a future in which everybody’s ability to continue accessing consumer credit is determined, in real time, by credit poles that announce to the world the credit ratings of those who pass by. The book, which was written back in 2010, seemed to anticipate a world in which, companies know more about you than you do about yourself.

### Anticipating borrower credentials

Consumer lending seems ripe for these forms of corporate intelligence to anticipate the behaviour of potential or current borrowers. Advances in artificial intelligence have been used by banks on credit card lending for decades and seem to be paying off. The average annual U.S. net credit card loss rate for prime borrowers has been at its lowest recorded (below 3%) for the past five years, significantly below the 30-year 5% average. As the average interest rate on US credit cards has remained at over 13%, the average bank seems to be making a lot of money on this type of lending, as long as they can control its risk.

The original promise of peer-to-peer lending was precisely this: why should the banks benefit from this enormous spread between lending rates and funding rates? A potential investor in marketplace lending (i.e. a lender) should benefit instead. And the rates paid to marketplace lenders are higher than they would otherwise receive if lending to a bank itself. However, just as with securitisation lending, investors in marketplace lending own the risk, and need to ensure that it is carefully managed. The consumer credit arena was littered over the decades with those who flew too close to the sun, particularly in new forms of consumer credit [1].

### Comparisons with other types of lending

On its surface, marketplace lending seems promising for a potential investor. A pool of consumer or commercial loans sourced through an intermediary provides the benefit of borrower diversification, just as a securitisation loan pool does, and at a higher net estimated spread than other types of lending.

Another perceived advantage is that pools of loans have the benefit of apparent familiarity. Unlike high yield bonds or loans or even asset-backed securities (ABS), these auto, commercial and consumer loans are easily understandable, not highly structured as ABS are, and locally (according to their originators) have experienced only nominal losses of less than 0.25% as a percentage of the pool.

The table below shows an estimate of the credit spread available from marketplace lending compared with other types of lending. Note that while most data is based on historical performance of debt type, the

marketplace lending estimates are projected based on the experience of comparable types of consumer lending.

**Estimated loss-adjusted credit spread by type of asset**

Asset Type	Current Spread	Avg Long-term Spread	Annual Default Rate	Avg Recovery Rate	Net Default Loss	Loss-Adjusted Spread Return
High Yield Bond	3.75%	5.25%	3.50%	37.00%	2.21%	2.63%
High Yield Loan	4.50%	4.50%	2.50%	53.00%	1.18%	3.18%
<b>Marketplace Lending</b>	<b>6.00%</b>	<b>6.50%</b>	<b>3.50%</b>	<b>10.00%</b>	<b>3.15%</b>	<b>2.75%</b>
Commercial Property (Mezzanine)	5.00%	5.25%	3.50%	37.00%	2.21%	2.63%
Middle Market Loan	5.75%	4.50%	3.50%	53.00%	1.65%	2.59%
Asset Backed Securities (Subordinate)	3.75%	4.50%	3.00%	12.00%	2.64%	1.39%

*Source: Moody's, Credit Suisse. Loss-adjusted spread is estimated based on a four-year average loan life. Recoveries are assumed to occur simultaneously with defaults for simplicity (in reality there would be a lag). Long term spread for marketplace loans is interpolated to be historical average spread for BB unsecured consumer securitised debt, with lower assumed default rate (actual historical is 5-10%) and similar recovery rate.*

**Difficulties knowing default rates in advance**

But there are also reasons for caution with respect to marketplace lending. In general, debt investing and equity investing are different. With less upside available in debt than equity, it ordinarily pays more to be an early investor in equity than in a new type of debt. The reason we have done so well (in some respects) as a species is because of our enthusiasm for what is new. But successful debt investors can perhaps be considered a particularly dour sub-species. Australia has gone through a period of around 30 years of economic expansion, has never had a full subprime lending cycle, and so new investors in consumer debt should be careful. Most marketplace loan packages also do not have the same level of equity protection as their predecessor securitisations, although this is beginning to change.

Potential investors should therefore be conservative with respect to the eventual losses expected on this type of lending. An annual loss rate of 3.5% when realised losses are less than 0.50% seems high, but subprime consumer lending annual losses have historically been in the high single digits virtually universally, and higher if a pool performs poorly. If this 3.5% loss rate doubles to 7%, for example, the annualised total return over a four-year period becomes -1.75%. In prior economic cycles, securitisation loan originators tried to limit investor losses by freezing credit, and in revolving pools by allowing payments to go to debt investors first. Still, some of the lowest-ranked ABS debt had net credit losses, which is why subordinate ABS have some of the worst loss-adjusted spreads over the past two decades.

The other way that loan originators have tried to limit losses is by setting interest rates high enough to compensate for the risk. Commercial marketplace lending rates are 15% and more. Some consumer rates may be lower than this, but higher than traditional credit card rates. A high annual interest rate should be enough to compensate a loan originator for residual credit risk. Part of this charge is also to cover loan servicing costs, which for subprime lending have traditionally been 4-6% annually. But without additional credit protection, potential investors might also ask is why the rates they receive are significantly lower than this, since the disintermediation of banks and their fees was meant to be a main advantage of this type of lending.

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## The making and pricing of loans

A key question for marketplace lenders should be how they use their intelligence on potential borrowers to make and price loans. If marketplace lenders truly have developed valuable ways of assessing customer behavioural risk through intelligence, they should be able to describe it in detail to potential investors without giving away their business advantage.

The world of credit poles for consumer credit assessment, just as with other forms of machine-learned intelligence, is probably not as far away as we think. But along the way, there will almost certainly be some accidents, just as there have been over the past two decades. An investor evaluating marketplace lending should take care that he or she is aware of the risks for the potential return they can receive.

*[1] NextCard, an internet-based credit card company that issued securitisation debt and failed in the early 2000s, is probably the easiest example to pick out. The technology was far ahead of the credit intelligence actually needed to make the business work. As investors, we try to learn from our mistakes.*

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## How marketplace lending meets investor needs

Daniel Foggo

The author of the article in Cuffelinks, [Investor questions for marketplace lenders](#), draws attention to the perpetual need for responsible investors to be shrewd and judicious when deciding where to place their hard-earned money. This, of course, is sensible advice.

However, it's also true that today's investors face a risk environment of unprecedented complexity. In 2018, the S&P/ASX200 declined by 6.8%. Residential property values are falling and bank deposit rates fail to match inflation. In the last year, the Australian media landscape was dominated by the findings of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, with its revelations of duplicitous lending practices, improper fees, and general misconduct that, by the banks' own admission, fell far short of community expectations.

### The ground between equities and low deposit yields

Needless to say, today's investors are eager for services that allow them to navigate a relatively safe path between the high-risk allure of equity investments and the lower yields offered by traditional financial institutions, which, for all their perceived stability, too often function as a costly and unduly complex intermediary between lenders and borrowers.

This then is the intersection at which peer-to-peer lending, or marketplace lending, has been able to thrive. At its best, marketplace lending appeals to investors who seek transparency and stability, but still wish for higher returns than would be available to them if they invested in traditional products like bank deposits.

Indeed, the author of *Investor Questions for Marketplace Lenders* concedes that, on this score, marketplace lending has succeeded. Marketplace lending demonstrates that, when the middleman is willing (or able) to tighten his belt — that is, when he narrows the spread between the lending and funding rates offered by traditional financial institutions — borrowers and lenders both benefit from competitive rates. For example, RateSetter lenders have averaged a return of over 7.5% since launch in Australia in 2014.

But what about risk? Readers of *Investor Questions for Marketplace Lenders* may conclude that marketplace lending involves an unacceptable degree of exposure. Let's examine this in more detail.

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### Three ways the lending exposure is addressed

**First**, many P2P platforms are structured such that investors *don't* need take 'all of the risk' upon themselves. For example, several platforms require borrowers to contribute to a provision fund, which exists to protect lenders against the consequences of defaults and missed payments. For this reason, the P2P company RateSetter was able to pay its investors \$11 million in interest in 2018 without one of them losing a single cent of capital or interest. Moreover, its Provision Fund has grown to represent over 6.1% of its loan book, which is substantially more than the losses it has experienced to date (approximately 1.4%), and its expected future losses. It gives investors a higher degree of confidence in their future returns.

**Second**, the risk involved in marketplace lending is further mitigated by the historical resilience of consumer credit itself as an asset class. Interestingly, even during a severe economic depression, the annualised loss experienced in consumer credit rates has tended to be less pronounced than with other forms of credit, such as commercial loans and investment property loans.

Automotive finance, for example, performs particularly well. Borrowers tend to prioritise paying off a secured car loan over other debts, which is unsurprising given that they need their car to get to work, attend interviews, and maybe even take the kids to soccer practice.

**Finally**, it's misleading to imply that loans financed by marketplace lending bear any inherent resemblance to the type of subprime loans that gained widespread notoriety following the financial collapse of 2008. This false equivalence overlooks the crucial role played by marketplace lending platform operators when it comes to assessing the creditworthiness of prospective borrowers. Responsible operators subject loan applicants to a screening process that takes into account the very same factors any traditional financial institution would scrutinise, from credit histories to monthly income versus expenses.

### Growing role in intermediation

In short, marketplace lending offers a simple way for investors to access consumer credit. As they continue to offer strong returns, Australian marketplace lenders are growing rapidly into the ~\$140 billion consumer credit market. Ultimately, we expect that marketplace lending models will come to represent a significant and structurally important part of our financial system. This will likely involve marketplace lenders acting as a conduit between superannuation funds (both SMSFs and larger industry funds) and consumers seeking credit.

The evidence for this imminent transformation can be seen in specific examples of institutional participation. For example, RateSetter attracted \$100 million in support from the Government's Clean Energy Finance Corporation, which sought assistance with its expansion into consumer finance. As a result, RateSetter is now the largest funder of consumer loans for the purchase of renewable energy equipment, such as solar panels and home batteries.

We expect to see similar developments over the coming decades as marketplace lending moves into the mainstream. Its growth will now depend on the rate at which new investors and borrowers learn of the benefits that marketplace lending can offer them.

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### Retirement planning is not just about income

Aidan Geysen

The proposed changes to dividend imputation rules highlight one of the potential risks of a concentrated, home-biased, income-oriented portfolio.

It's clear that investors who rely on dividend imputation credits for income will have an important decision ahead as to how to restructure their portfolio should this proposal come into effect.

Because we believe that an income-only strategy can create heightened risk in a portfolio and limit its potential for capital growth, we are strong proponents of the concept of total return investing – or investing for cash flow *and* capital appreciation.

Our research shows this to be a lower risk approach, in particular for those in the drawdown phase of their investment lifecycle.

**Better not to focus only on income**

Instead of constructing the portfolio to align income yield with spending requirements, a total return approach intends to align the portfolio’s asset allocation with the investors spending goals and risk tolerance.

This approach advocates keeping your portfolio broadly diversified at a low cost and focused on the overall, or total, return. Where the need for additional income occurs over and above the yield generated by this broadly diversified portfolio, the investor spends the amount made from the overall portfolio – or the total return – rather than switching around holdings to generate additional yield.

Changes to tax rules naturally provoke public debate because of the impact on the way investors have structured their portfolios but there are a couple of reasons why the total approach may be beneficial to the long-term health of your investment portfolio.

**First**, an income approach often spends the natural yield of the portfolio which may either exceed the spending requirements or it may fall short. This approach pays too little attention to the capital base, which can result in the portfolio being eroded by inflation and failing to last the duration, or retirees underspending from their portfolio and living an unnecessarily frugal retirement.

**Second**, an income-orientated portfolio may not align with the investors actual risk tolerance, which is particularly relevant in Australia, where portfolios are often concentrated in a small number of shares to generate the desired income yield. In particular, financial sector shares in Australia are commonly overweighted. Financial sector shares comprise around one-third of the Australian market, and around 36% of dividends paid.

In this way, being too focused on the income yield of the portfolio can mean you miss out on the importance of portfolio diversification across sectors and asset classes, replaced by a need to achieve a higher income yield.

Equally, overweighting higher yield bonds in the same pursuit of higher income can expose the investor to moderate or even significant credit risk, heightening volatility in the portfolio. Higher yield bonds display different characteristics to investment grade government and corporate bonds, which are a better diversifier in your portfolio to equity risk than high yield bonds.

**Summary of negative portfolio impacts resulting from common investor practices**

Common investor practice	Portfolio impact (vs a market-cap-weighted portfolio at sub-asset-class level)
1. Increasing the portfolio’s exposure to dividend-centric equity.	Decreases diversification of an equity portfolio by overweighting certain sectors, and increases the portfolio’s overall volatility and risk of loss if the strategy is used as a bond substitute.
2. Overweighting of high-yield bonds and underweighting investment grade bonds	Increases the portfolio’s exposure to credit risk, raises the portfolio’s overall volatility and increases correlations with the equity portion of the portfolio.
3. Shortening duration - overweighting cash and term deposits in preference to bonds	Shortening duration through an allocation to cash or term deposits may dilute the long term defensive characteristics and diversification of a market-cap exposure to bonds. In addition, shortening duration may forego the additional income received from holding bonds with longer duration.

Source: [Vanguard. From Assets to Income: A goals-based approach to retirement spending](#)

**Controlling withdrawals of capital**

In contrast, by focusing on the entire return earned by the portfolio, rather than its individual components, a total-return approach maintains a portfolio’s diversification and allows for better alignment with investment goals. Investors also have more control over the size and frequency of withdrawals. This is particularly useful when considering how to incorporate other financial resources, such as the age pension, into a retirement plan.

Some industry commentators have voiced concerns that investors may be prey to faddish income strategies should Labor's proposal for franking credits come into play. But by taking a sensible, diversified approach and investing for both income and growth, investors can sidestep some of the pitfalls associated with the hunt for yield.

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## The new and improved Pension Loans Scheme

Brendan Ryan

In the 2018-19 Federal Budget, the Government announced an [expansion of the Pension Loans Scheme \(PLS\)](#). Legislation has now passed through Parliament for the changes to come into effect on 1 July 2019.

The PLS, in its new format, allows qualifying Age Pension-age Australians who own property to take out a loan, irrespective of whether they qualify for an Age Pension payment.

The loan is in the form of a fortnightly payment from Centrelink up to 150% of the maximum Age Pension rate. For a single person, this loan potential is about \$36,000 per year, and for a couple, about \$54,000. Full or part pensioners will be able to borrow the difference between their current Age Pension and the maximum 150% rate.

For example, a single age pensioner eligible for the maximum rate of pension of around \$24,000 will now be able to draw up to \$12,000 more each year as a loan, bringing total cashflow (as a combination of Age Pension and Pension Loans Scheme) to \$36,000 per year.

The loan takes the form of a reverse mortgage in that the interest and the loan do not have to be repaid until the house is sold, although it can be repaid earlier. The loan is at a compelling rate of 5.25%, which is less than commercial reverse mortgage interest rates (although the number of providers has fallen rapidly in recent years), and there are limits on how much can be borrowed based on age and the amount of home equity to be applied as security to the loan.

### Key features of the PLS

Due to the way the PLS works, normal ways of thinking about a reverse mortgage do not apply. For example, eligible participants cannot withdraw a lump sum amount for an unexpected cost (as they can in a traditional reverse mortgage) because the amount is capped and trickles in through fortnightly payments.

Also, the Age Pension eligibility needs to be considered as it makes sense to run down savings to qualify for the maximum Age Pension before topping up with the PLS payments. For a single eligible Australian, the maximum asset level for a full pension is about \$260,000, and for a couple it is about \$390,000.

### It's all in the planning

The PLS will become an important component in the planning of lifetime spending. Whether it is used or not, the fact that there is a potential source of cashflow that is supervised and administered by the government should provide some comfort to Australians in later life.

To understand how the PLS may fit in, it's worth looking at the tools the government already provides for Australians in later life trying to work out how to manage their savings over time. The process needs to take into account investment earnings, Age Pension eligibility and the expected cost of living over a lifetime. The PLS should become a standard consideration in this process.

The [Moneysmart Retirement Planner](#) (MRP) is a government-sponsored tool that takes retirement savings and works out how much spending can be supported based on lifespan.

The [ASFA Retirement Standard](#) is the benchmark for the likely spending of Australians in later life. The result of a detailed study of the spending of older Australians, the ASFA Retirement Standard delivers an annual spending rate to deliver a 'modest' and 'comfortable' standard of living.

Put the two together and you get a starting number for how much is required for a comfortable retirement. The ASFA [SuperGuru](#) website suggests a couple will need \$640,000 at retirement to spend at the 'comfortable' rate of \$61,000 per year over a lifetime. Assets are run to zero by age 90.

The PLS adds a government-administered reverse mortgage component to this story. The couple who retire with \$640,000 who were expected to limit spending to \$61,000 per year, now have a little more flexibility with their cashflow over time.

For example, if they plan to spend \$70,000 per year, would need to use the PLS at about age 78. Over the next 12 years, they would drawdown a total of \$217,000, and the loan would be at \$294,000 by the time they were 90 (taking into account interest and assuming they live that long).

They could also choose to use the PLS to supplement cashflow and maintain cash in the bank ready to address requirements as they arise. In the late years, the cost of aged care can be substantial and having funds at hand can offer comfort.

### **The Pension Loans Scheme and the ASFA Retirement Standard**

The maximum rate of the PLS results in a cashflow almost exactly halfway between the ASFA 'modest' and 'comfortable' levels, as shown below. This provides a base case where homeowners with limited assets besides the home (subject to lending criteria) can secure a higher income.

	<b>SINGLE</b>	<b>COUPLE</b>
<b>Max Age Pension</b>	\$23,597	\$36,015
<b>ASFA Modest</b>	\$27,648	\$39,775
<b>150% Max Age Pension</b>	\$35,396	\$54,022
<b>ASFA Comfortable</b>	\$43,317	\$60,977

### **What is the right mix?**

The perfect mix will vary based on the requirements of older Australians. A couple may like a larger reserve pool to provide for future care. With the average aged care Refundable Accommodation Deposit of [\\$424,000](#) in metro Sydney, there is good reason to do this. Similarly, a single age pensioner may like a substantial reserve to have comfort that home care costs can be met.

### **Spending planning is complicated but PLS helps**

For Australians in later life, planning spending, and taking into account government support is enormously complicated. While simplified models like the MoneySmart Retirement Planner help guide decisions, allocating spending over a lifetime is complex, and the implications of mismanaging the drawdown of savings can be stressful at a vulnerable stage in life.

The Pension Loans Scheme is a useful lever to help Australians manage their reserves and cash flow in the later stages of retirement. Financial advice that includes a thorough understanding of the Australian entitlement system is vital.

*Brendan Ryan is a financial adviser and Founder of [Later Life Advice](#). This article is for general information purposes only and does not consider the circumstances of any investor.*

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## Stop blaming Costello for tax-free super

Jon Kalkman

We have now established that a franking credit is part of a taxpayer's taxable income, and that any taxable income held by the ATO that is excess to the tax liability should be refunded in cash as it is currently. This whole franking credit debate has highlighted the refunds that flow to super funds because of the tax concessions they enjoy.

Many readers have blamed Costello's changes in 2007 for making super tax-free in 2007. This is incorrect.

### **With super, it is fund that is the taxpayer, not the member**

Super was designed to help accumulate a nest egg for retirement to supplement or replace the age pension. It works with the cumulative effect of contributions added to investment earnings over 40 years less fees and taxes while no withdrawals can be made before retirement. The fund, not the member, pays 15% tax on (concessional) contributions, 15% tax on investment income and 10% tax on capital gains. The fund is a single taxpayer, paying tax on behalf of all its members. Therefore, with shares, the fund is the shareholder and taxpayer, not the member.

In retirement, most people transfer their super balance to a pension account because of its preferential tax treatment. A super fund paying a pension pays zero tax on income and capital gains. That has been the case since Keating introduced universal and compulsory super in 1992. Keating could have left contributions and investment income tax-free if he taxed the benefit stage (pension and lump sums) normally, but he was not prepared to wait 30 to 40 years before collecting any tax.

### **Tax-free status of pensions is a reward for compulsory saving**

Keating recognised long ago that Baby Boomers would be a great strain on the public purse in retirement (from 2011 onwards) unless they saved for their own retirement. The tax-free status of the pension fund has always been seen as compensation for compulsorily forcing people to lock their money away for 40 years. It is an encouragement for people to save for their own retirement and thus becoming less reliant on the age pension. The deal Baby Boomers were sold was that, after paying tax on contributions and investment income for 40 years, they would have tax-free pension funds.

Younger people and politicians who were not party to that social contract are often surprised and somewhat offended that super funds should be tax-free in retirement, and they blame the then Treasurer, Peter Costello, for making super tax-free after 60 in 2007. They are mistaken. The tax on earnings (income and capital gains) inside a pension fund has been zero and unchanged since 1992. This includes the time when Costello made withdrawals from a super fund, tax-free (after age 60) in 2007, when Mr Shorten was Minister for Superannuation in 2010, and when Treasurer Morrison limited the size of a tax-free pension fund to \$1.6 million, in 2017.

Under Keating's original plan, members would still pay tax on benefits taken from a fund in retirement but only on the concessional portion of that benefit and then only after a 15% tax rebate to compensate for taxes already paid. Consequently, very little tax was collected from this source. This is the tax on member withdrawals that Costello eliminated in 2007 and no government since has tried to reverse that decision, simply because the potential tax collected is not worth the political pain.

Costello's changes did not affect the tax on super funds.

### **Part of the deal with a super pension is mandatory withdrawals**

Members in a super pension fund have an obligation to take a mandatory minimum pension withdrawal every year in cash and that mandated minimum increases with age. It means that assets must be progressively sold to satisfy that pension requirement. The effect is to progressively deplete the fund to reduce or eliminate concessional super being passed to beneficiaries on death. In fact, many people exhaust their super balance well before that time.

### **Impact of franking credits in super**

Australian shares are the only class of assets where the income arrives in the hands of the owner with tax already paid (that is why it is called franking), and will generate franking credits for the fund just like it will for

other shareholders. The fund is a single taxpayer, paying tax on behalf of all its members. Under Labor's proposal, if a fund has members predominantly in accumulation phase it will have a tax liability and it will be able to use its franking credits to pay some or all of the fund's tax liability but there will be no cash refund for any excess franking credits. The fund's final tax position depends on income from assets other than shares and the number of members still in accumulation phase with tax obligations on contributions and investment income compared to the number of members in the tax-free pension phase.

Retirees in pension phase in an industry fund may find that the fund has sufficient members in accumulation phase to allow their super pension to continue to receive a refund of their franking credits at least until the fund is overwhelmed by the number of members in pension phase. Such a policy is easily overturned.

SMSFs typically only have a couple of members, both in pension phase and the fund has no other tax liabilities to absorb franking credits. Under Labor's proposal, the fund will lose all its franking credits refunds, or up to 30% of its income depending on the fund's allocation to shares.

It is sometimes suggested that pension funds should be taxed the same as accumulation funds. Such a tax would certainly collect a lot of money because it would apply to income from all assets in the fund, not just shares, and it would apply to all super pension funds, SMSFs and industry funds alike. It would avoid the perceived discrimination of Labor's proposal against SMSFs, but no one would then use a pension fund with its mandated requirement to remove assets from this concessional area, and that has estate planning implications.

If retirees remain in a pension fund, Labor's proposal will seriously impact the fund's capacity to continue to pay the mandated withdrawals because it will have lower after-tax earnings. When the super fund is exhausted, most people become reliant on the age pension, at least in part. Labor appears not to have considered that their proposal has severe long-term implications for the cost of the age pension to the taxpayer.

*Jon Kalkman is a Director of the [Australian Investors Association](#). This article is for general information purposes only and does not consider the circumstances of any investor.*

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