

Product Rationalisation

of

**Managed Investment Schemes and Life
Insurance Products**

Proposals Paper

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Consultation process

This Proposals Paper follows on from an Issues Paper on product rationalisation published in June 2007. It contains a proposed product rationalisation framework including specific mechanisms for rationalising legacy products in managed investments and life insurance, and seeks relevant comments from the public on the framework and the proposed mechanisms. Interested parties are invited to make written submissions that address, but need not be limited by, the issues and questions raised in this paper.

Submissions may be lodged electronically, by post or facsimile. Please direct submissions to:

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Telephone inquiries may be made by calling (02) 6263 3971.

The closing date for submissions is 26 February 2010. Submissions may appear on the Treasury website, www.treasury.gov.au (subject to any claims for confidentiality).

It will be assumed that submissions are not confidential and may be made publicly available. If you would like your submission, or any part of it, to be treated as 'confidential', please indicate this clearly. A request made under the *Freedom of Information Act 1982* (Cwlth) for a submission marked confidential to be made available will be determined in accordance with that Act.

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LIST OF ABBREVIATIONS

APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
Beneficiary	A member of a relevant scheme or fund or a life policy owner
Corporations Act	<i>Corporations Act 2001</i>
CGT	Capital gains tax
EDR scheme	External dispute resolution scheme
IFSA	Investments and Financial Services Association
ITAA 1936	<i>Income Tax Assessment Act 1936</i>

EXECUTIVE SUMMARY

The purpose of this Proposals Paper is to serve as the basis for publicly consulting stakeholders about a proposed product rationalisation framework for superannuation products, managed investment schemes and life insurance products.

The framework set out in this paper was developed in consultation with a group of expert advisers. In order to ensure that all stakeholders have the opportunity to make their views known, the Government has decided to expose the draft framework to the wider public for comment.

The key issue in developing a product rationalisation framework is to ensure an appropriate balance between the interests of various groups of stakeholders, in particular investors and product providers. Adequate powers need to be provided for regulators to exercise their supervisory and enforcement functions.

Sections 1 and 2 provide background information as well as a summary of the Government's objectives.

Section 3 of this paper discusses a number of tests and mechanisms that are designed to achieve these objectives, and covers separately each of superannuation funds, managed investment schemes and life insurance products. It also asks for comments on a range of key questions.

Taxation issues are also an important issue in product rationalisation, and Section 4 is devoted to a discussion of these matters. Comments are again invited on a range of key questions.

Section 5 provides a conclusion and indication of next steps.

1. INTRODUCTION

Product rationalisation is a process of converting or consolidating products of a similar nature into a single product with equivalent features and benefits. The objective of the process is to remove economically inefficient products ('legacy products') by transferring beneficiaries into new, more efficient products.

For the purposes of this paper, the term 'beneficiary' refers to a member of a managed investment scheme or superannuation fund, or a life policy owner.

The need for product rationalisation frequently arises out of changes in commercial practices as well as legislative and regulatory developments (non-tax changes) which result in financial products becoming outdated and closed to new investors.

The Investment and Financial Services Association (IFSA) has estimated that the total amount of funds under management in legacy products may amount to \$221 billion, or approximately 25 per cent of all funds under management at the time of the estimate.

In June 2007 a Product Rationalisation Issues Paper (the Issues Paper) was released for public consultation, seeking submissions on a number of key issues and options.

The Issues Paper provides comprehensive background information on product rationalisation including the nature of the problem, the Government's objectives in considering possible regulatory reform, key issues which need to be addressed and a range of high-level options for addressing the problem. The Issues Paper is available on the Treasury website at <http://www.treasury.gov.au>.

In late 2007 approximately 20 submissions were received in response to the Issues Paper. The submissions came from a range of stakeholders and have been made available on the Treasury website at the address provided above. Analysis of the submissions to the Issues Paper showed a considerable level of disagreement between stakeholders on a number of key issues. Further consultation was therefore deemed necessary before the Government could develop a product rationalisation framework for further consultation with stakeholders.

In February 2008 the Government agreed to the formation of a panel of experts (the Panel) to advise on the development of a product rationalisation framework. The Panel was formed by inviting all organisations who provided substantive submissions in response to the Issues Paper, or who specifically requested to be involved, including industry participants and industry representative bodies. The Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulation Authority (APRA) and the Australian Taxation Office (ATO) attended meetings of the Panel as observers.

The Panel met several times during 2008 to discuss a possible high-level product rationalisation framework and develop the key elements of such a framework in further detail, including whether taxation changes may be required to facilitate product rationalisation transfers. Following conclusion of the discussions, briefing was provided to the Government outlining the proposed product rationalisation framework and requesting approval for the preparation of a Proposals Paper for public consultation.

On 5 August 2009 the Minister for Financial Services, Superannuation and Corporate Law announced the Government's intention to release a Product Rationalisation Proposals Paper (the Proposals Paper) for public consultation.

This Proposals Paper sets out the proposed framework and its key elements for consideration and comment by the public. A number of key questions are provided indicating which areas and issues the Government is particularly concerned about. It is noted that the proposals set out in this Paper were those developed in consultation with the Panel and do not represent government policy at this stage.

Stakeholders are free to select which questions and issues they wish to comment on. You are encouraged to comment on the key questions provided in the Proposals Paper, but comments may be submitted on whichever areas and issues stakeholders may feel concerned about.

Please provide your submissions in writing and preferably in electronic format. Information on how to make a submission, including the deadline for submissions, is provided on the page of this Proposals Paper immediately following the title page.

2. PURPOSE

The objective of this Proposals Paper is to set out the product rationalisation framework developed with the Panel for public comment. The Government is particularly interested to obtain comments as to whether the proposed framework achieves its main objectives, which may be summarised as follows:

- Beneficiaries receive an appropriate level of protection of their interests, in particular as in some cases they may be transferred to a new product without providing their explicit consent. In this situation, it is imperative to ensure that only beneficiaries in genuine legacy products may become subject to such transfers and that appropriate mechanisms are provided to ensure that their interests are given full consideration in deciding on whether a product rationalisation proposal should proceed.
- Beneficiaries receive financial products with at least equivalent rights and benefits, taking into account all relevant aspects of the beneficiaries' rights and benefits in the legacy product as compared to the new product.
- If there are cases where individual beneficiaries suffer losses, adequate compensation is provided.
- Neither beneficiaries nor providers suffer adverse tax consequences.
- Product rationalisation transfer mechanisms and requirements are efficient with respect to time taken and costs incurred, as well as practical and sufficiently flexible to accommodate a wide range of rationalisation scenarios. The desired outcome is that the mechanism is useful in practice and results in an appropriate reduction in the numbers of legacy products outstanding.
- Industry is provided with an appropriate level of certainty that product rationalisation transfers are not open to subsequent challenge after completion.

- Regulators are provided with appropriate powers to supervise rationalisation proposals and processes, as well as to intervene in cases where misconduct is apparent.

The proposed product rationalisation framework consists of a number of tests and processes designed to ensure that the objectives stated above are achieved. Further information on the framework is provided in the following sections.

3. PROPOSED PRODUCT RATIONALISATION MECHANISM: FURTHER DETAILS AND ISSUES FOR DISCUSSION

3.1 INTRODUCTION

A framework providing a common product rationalisation mechanism for all types of life insurance policies, interests in managed investment schemes and superannuation products has in the past been proposed. However, following detailed consideration and discussion of the issues, it has been found that the structural, legal and institutional environment in which the legacy product problem is embedded varies considerably between the managed investment, superannuation and life insurance sectors. For instance, in the case of life insurance each policy constitutes a separate contract between the consumer and the product provider.

It is therefore likely that pursuing a single approach will require a complex and time consuming development process due to the different circumstances surrounding each product area. The compromises that may be involved could result in a process that is less effective in addressing the issues in each industry. It is therefore suggested that working within the current structural, legal and institutional environments in developing separate rationalisation mechanisms may produce a better outcome than pursuing a single approach. In view of this situation it is proposed that tailored solutions be considered separately for each of the products.

Splitting the product rationalisation process into three also allows the most pressing areas of concern to be addressed first. It is arguable that life insurance and managed investment schemes require more urgent attention than the superannuation sector. Currently, superannuation fund level transfers or transfers of a class of beneficiaries, for example all members of a defined benefits scheme, can be effected under current law using the successor fund provisions. This process appears to be functioning reasonably smoothly at the moment and barring refinements at the margin it is difficult to argue that this sector urgently requires a new rationalisation process.

The Issues Paper provides more detail on the current rationalisation process for superannuation products (see section 3.4).

It is noted that there is also an existing method to rationalise friendly society managed fund products.

In view of this situation, the work done by the Panel is focused on developing a product rationalisation framework for managed investment schemes and life insurance policies. Rationalisation issues for superannuation funds and friendly society funds could be considered in a second stage. Further comments explaining why superannuation funds have been excluded at this stage are provided in the next section.

3.1.1 Superannuation products

It is proposed that superannuation be excluded from initial consideration of a product rationalisation mechanism.

The superannuation industry has undergone a period of substantial consolidation as a result of the introduction of the Registrable Superannuation Entity (RSE) licensing regime in 2004. During this period, a large number of members were moved into new superannuation funds as funds merged and the equivalent rights test was used for the transfer of member benefits from regulated superannuation funds. It is noted that the successor fund regime is presently not subject to any regulatory scrutiny prior to implementation.

The successor fund transfer process is generally appropriate for the superannuation industry due to the fiduciary duty imposed upon superannuation trustees.

This fiduciary relationship between trustee and member creates an alignment between the two parties which is an element not present in some other industries. The fiduciary duty also requires the trustee of the original fund and the trustee of the new fund to work closely together to ensure that the member receives rights equivalent to those rights the member enjoyed under the original fund in respect of the benefits.

In addition, legacy products are not as significant an issue in superannuation compared to other industries due to the nature of the industry and the existing transfer provisions. However, this may change with the passage of time.

The overwhelming majority of members are in accumulation schemes which offer substantially the same features across the board (with there being some small differences in areas such as the level of insurance provided or differences introduced by the governing rules). This situation has meant that a legacy product problem is not present on any large scale given the existing transfer provisions centred on an equivalent rights test.

In relation to defined benefit schemes, the successor fund arrangements have worked to enable rationalisation to be effected and in cases where difficulties have arisen, Part 18 of the *Superannuation Industry Supervision Act 1993* provides a mechanism for the amalgamation of superannuation funds with the approval of APRA.

Additionally, many employer sponsors have moved their defined benefit schemes to a retail master trust as a separate sub-fund as they wish to maintain its separate and distinct nature.

As outlined above, the issues in superannuation are related more to the transfer of members due to funds consolidating rather than any specific legacy product problem. APRA's guidance in this area is well established and will be updated to cater for emerging issues if any.

3.2 COMMON ELEMENTS: NO DISADVANTAGE, LEGACY PRODUCT AND TAXATION RELIEF TESTS

The product rationalisation mechanisms for managed investment schemes and life insurance products outlined below differ significantly. However, there are a number of key elements that are common to both. These are:

- The legacy product test, which is designed to ensure that only genuine legacy products are allowed to benefit from the product rationalisation mechanism;
- The taxation relief test, which provides a further condition that must be met before a product rationalisation proposal can benefit from the proposed taxation relief; and
- The no disadvantage test, which is designed to ensure that no scheme member or policyholder will be worse off as a result of a product rationalisation transfer.

These three tests are discussed in further detail below.

3.2.1 Legacy product test

Introduction of a product rationalisation framework is built on the assumption that it will be used to remove outdated and inefficient products. In order to ensure that this is the case, the proposed framework includes a legacy product test defining which products are eligible to benefit from the processes contained in the framework.

A legacy product test is intended to provide an objective test which sets out the criteria to be met for a product to be considered a legacy product.

The disclosure material provided to beneficiaries as part of the product rationalisation process would include information demonstrating that the product is outdated and inefficient and explaining why the rationalisation is being undertaken (see sections 3.4 and 3.5 below).

The product rationalisation process could only be initiated if the product meets the legacy product test. This is a threshold requirement that must be satisfied by all product rationalisation proposals.

The proposed legacy product test would require firstly that the product has been closed to new investors/policyholders for a period of two years and satisfies at least one of a number of prescribed criteria. For each of these criteria an objective test would be prescribed for demonstrating compliance.

The product must also not be an interest in a managed investment scheme that was closed to new members after it had raised an amount that was disclosed in any prospectus or Product Disclosure Statement as the amount that was sought to be raised.

The criteria and objective tests are as follows:

- the product has become uneconomic for policy holders or members. The specific test demonstrating this could for example be expressed as follows:
 - the total number of the product holders at the date the application for a rationalisation occurs is 50 per cent less than the largest total number of product holders over the course of the life of the product; and
 - the product provider has incurred a net operating loss on the product to be rationalised over the past two preceding financial years; or
- the product has become out of date because of changes in the regulatory regime. The specific test demonstrating this could for example be expressed as follows:

- any holder of the product receives a lower after tax return or a lower social security benefit as a result of a regulatory change that affects the product; or
- the costs of operating the product have become excessive for the product provider because of an outdated technology platform or other reasons. The specific test demonstrating this could be expressed as follows:
 - : the indirect cost ratio of the product (as set out in item 104 of Schedule 10 of the Corporations Regulations) for the most recent periodic reporting period is more than 25 per cent higher than the indirect cost ratio for the financial year the product was last offered to new policy owners or members; or
 - : where the fees able to be charged are fixed, the ratio of fees to expenses has fallen by more than 25 per cent after the closure of the product to new investors; or
- the product rationalisation, or program of product rationalisations, will result in the decommissioning of an underlying administration system or linked (interrelated) system.

No product rationalisation proposal could proceed unless the legacy product test was satisfied. Sections 3.4 and 3.5 contain further information on how this could be demonstrated.

Key questions

- (a) Do you agree with the need for a legacy product test? If not, why not?
- (b) Do you consider the proposed criteria and specific tests to be appropriate and clear?
- (c) If not how could they be improved? Are there other criteria or specific tests that you consider better?

3.2.2 Taxation relief test

To ensure that the tax relief is available only for genuine legacy products, the product must satisfy the taxation relief test for the taxation relief to be available.

A legacy product could only receive taxation relief if:

- the product has been closed to new members or policyholders for a period of 5 years and the product is not an interest in a managed investment scheme that was closed to new members after it had raised an amount that was disclosed in any prospectus or Product Disclosure Statement as the amount that was sought to be raised; and
- the product meets at least one of the criteria provided under the legacy product test.

Key questions

- (a) Do you consider the test to be appropriate and clear?
- (b) If not, how do you think it could be improved?

3.2.3 No disadvantage test

Principle

The no disadvantage test is based on the principle that a product provider must be able to rationally and objectively demonstrate with a high level of certainty as defined below that there will be no detriment to any policyholder or member as a result of a product rationalisation transfer.

The no disadvantage test ascertains the total value of the rights and entitlements (including contingent rights and entitlements) of each policyholder or member in the old product, and tests whether any policyholder or member suffers a diminution in value of those rights and entitlements (including contingent rights and entitlements) in the new product.

The no disadvantage test must be satisfied with a high level of certainty. The outcome of the test will be sufficiently certain where the likelihood of any detriment arising to a policyholder or member is very low, based on what can reasonably be known to the product provider at the time. An acceptable likelihood will be consistent with the underlying nature of the product being rationalised.

The term 'rights' is defined broadly and includes contractual rights, monetary rights and rights provided under the law in relation to a particular product (for example, the benefits provided under prudential regulation).

Factors to consider

In applying the no disadvantage test, product providers must consider all relevant factors, including (but not limited to) the following:

- Product providers may use a variety of means to ensure that the test is satisfied, including (but not limited to) offering compensating or similar rights and entitlements, monetary redress and replication of rights and entitlements.
- Product providers must address all features, rights and benefits of the old product, including (but not limited to) fees, charges, premiums, taxes, industry sector characteristics, withdrawal rights, insurance benefits (including both the sum insured and any relevant definitions) and the riskiness of benefits. Product providers must also consider the transaction costs involved in moving policyholders and members from the old to the new product.
- Product providers must take into account the impact on rights and entitlements enjoyed by each policyholder or member of future scenarios. If there are any such scenarios, other than those that are highly unlikely to eventuate, that result in detriment to a member or policyholder, the no disadvantage test has not been satisfied.
- If it is not possible to determine the impact of the loss of a right in all circumstances (other than those that are highly unlikely to eventuate), the only way to meet the no disadvantage test will be to replicate that right in the new product.
- If policyholders or members have been made promises which imply a certain risk profile in the old product, then those promises must also be maintained with respect to the new product.

Guidance

Details of the application of the no disadvantage test to various product areas may vary. The regulators may issue guidance on how the no disadvantage test should be applied in specified circumstances.

Key questions

- (a) Do you consider the proposed no disadvantage test to be appropriately framed? Does it contain all the necessary key elements? Are the terms used in the test clear and practical?
- (b) If you do not consider the current test to be appropriate, how do you think it could be improved?
- (c) Are the 'factors to consider' listed above appropriate, clear and complete? If not, what changes should be made, or what additional factors should be included?

3.3 MANAGED INVESTMENT SCHEMES

The proposed product rationalisation mechanism for registered managed investment schemes that satisfy the legacy product test would incorporate the following elements:

- The responsible entity (RE) would develop the product rationalisation proposal, including the application of the prescribed no-disadvantage, legacy product and (where required) taxation relief tests. This could include seeking any necessary tax rulings from the ATO.
- The RE would be required to commission an independent expert's report. The independent expert would be required to report that s/he is satisfied that the no-disadvantage, legacy product and (where required) taxation relief tests have been satisfied.
- The independent expert would be selected by a method to be determined which could be:
 - by satisfying a set of criteria; or
 - from a list of ASIC approved experts.

The rationalisation proposal would be provided (through postal mail or via email, where the member has agreed to accept notification by email) to all members within the scheme. The proposal would include a summary of the rationalisation scheme, the independent expert's report and a statement from the RE confirming that the no disadvantage, legacy product and (where required) taxation relief tests had been satisfied, including whether any ATO rulings had been obtained.

The proposal would be required to be lodged with ASIC with sufficient time for ASIC to consider and comment prior to being sent to members.

Information that a member would reasonably require to make a decision whether to vote on, or object to, the proposal, would have to be made available to members. Some of this information could be incorporated by reference and provided on request or on a website (see

regulation 7.9.15DA of the *Corporations Regulations 2001* for an example of how incorporation by reference could operate).

ASIC would review the material. Its role would be analogous to its current role in reviewing disclosures for meetings falling under item 7 of section 611 of the Corporations Act where a takeover bid is approved by a resolution passed at a general meeting of the target company. ASIC will have the ability to request additional disclosure to be provided to members. This may include an additional independent expert report.

The disclosure would state by which of the following options the RE has chosen and, if option A or C is to apply, invite any representations as to any concerns about the proposals to be given to the RE or the Court (depending on which approval process is followed).

The RE could proceed with the proposal if any one of the following is satisfied:

- Option A – no more than 5 per cent of members in any class notify the RE within 30 days that they do not agree to the proposal being implemented without approval of a Court or meeting of members (having been provided a separate tick box form with the disclosure enabling this).
- Option B – a majority by value of members in each class who voted on the proposal approve it, and at least 10 per cent by value vote in each class.
- Option C – the Court approves.

3.3.1 Option A — Member objection model

Members would be given a 30 day period in which to lodge a formal vote/ objection against the proposal.

Members in each class of members where they exist would be entitled to vote separately.

Where the number of returned member objections meets the 5 per cent level, the RE may opt to withdraw the proposal or apply to the Court for approval. This approval will be required before the proposal can be implemented.

Where the number of returned member objections does not meet the designated level discussed above, it will be considered that the members of the scheme have consented to the proposal through acquiescence and the proposal may be implemented.

The RE will be responsible for lodgement of a notice stating that the requirements for approval have been met. The RE will also be responsible for keeping a register of the objections. The register will be accessible to ASIC as well as individual members.

ASIC would possess the right to intervene in the proposal where a response highlights that the no-disadvantage test has not actually been satisfied.

The RE and the RE of any scheme into which the members are transferred would be liable to compensation claims made by any member after the product rationalisation is completed. Claims could be brought forward through the current external dispute resolution (EDR) schemes such as the Financial Ombudsman Service.

3.3.2 Option B — Ordinary Resolution of Meeting of Members

The rationalisation proposal would need to be approved by an ordinary resolution of the members, meaning a majority (50 per cent plus one) of the votes of the members who have attended the meeting (in person or by proxy). The members would need to be provided with disclosure documents before the meeting as set out above.

Members in each class of members would be entitled to vote separately.

A quorum requirement will apply to the meeting of members requiring a certain number, or percentage, of members in each class to attend in order for the resolution to be passed. A level of 10 per cent by value in each class is considered an appropriate level recognising practical difficulties in achieving a high level of attendance.

If the quorum is not achieved, the proposal could be implemented if approved by the court as set out below.

If the proposal is approved by the meeting of members, the RE and the RE of any scheme into which the members are transferred would be liable to compensation claims made by any member after the product rationalisation via current EDR schemes such as the Financial Ombudsman Scheme if the member is disadvantaged.

3.3.3 Option C — Direct application or referral to Court

A RE may apply directly to the Court for approval of a product rationalisation proposal or may elect to continue to the Court where the proposal is rejected by the members through the above mechanisms. The product provider would be required to satisfy the Court that the proposal, as put to the members, satisfied the no disadvantage test and that there was no material failure to meet requirements for disclosure.

ASIC could act as a friend of the Court and may give an opinion to the Court, but would not be obliged to so act. The separate decision to allow ASIC to act as a friend of the Court would be at the Court's discretion. In addition ASIC could exercise its power to intervene in proceedings.

Where a Court makes the decision, that decision would be determinative of the interests of the parties. Therefore there would be no possibility of compensation claims being brought forward by individual members through existing EDR schemes after the Court decision. Failure to comply with the Court decision would be subject to normal adjudication processes.

Key questions

- (a) Do you consider the proposed mechanism for managed investment schemes to be appropriate? In particular, do you think it provides an appropriate level of protection to members, without imposing an excessive burden on responsible entities?
- (b) If not, how could the mechanism be improved?

3.4. LIFE INSURANCE PRODUCTS

The Government proposes a court-based process for the rationalisation of life insurance products that satisfy the legacy product test, with broad discretion for APRA to approve certain rationalisation proposals (essentially those where the application of the no disadvantage test is relatively simple) or otherwise refer them to the Court.

The proposed mechanism is modelled on the current Part 9 transfer provisions in the *Life Insurance Act 1995* which only apply to transfers of business between life insurers. This new mechanism will represent a significant change as, for the first time, the Part 9 process will be clearly applicable to product rationalisations within a life insurer rather than only when business is transferred from one life insurer to another. However, this new mechanism will require some significant modifications and extensions.

The product provider would develop the rationalisation proposal, which would include the need to satisfy itself that the prescribed no-disadvantage, legacy product and (where required) taxation relief tests have been met. This could include seeking any necessary tax rulings from the ATO.

The product provider would be required to commission an independent expert(s)'s report. The independent expert would be required to report that s/he is satisfied that the no-disadvantage, legacy product and (where required) taxation relief tests have been satisfied.

An independent expert would be selected by a method to be determined which could be:

- by satisfying a set of criteria; or
- from a list of APRA approved experts.

The rationalisation proposal would be provided (through postal mail or via email, where the policy holder has agreed to accept notification by email) to all policy holders. The proposal would include a summary of the rationalisation scheme, the independent expert's report and a statement from the RE confirming that the no disadvantage, legacy product and (where required) taxation relief tests had been satisfied, including whether any ATO rulings had been obtained.

The proposal would be required to be lodged with APRA with sufficient time for APRA to consider and comment prior to being sent to policy owners.

Information that a policyholder would reasonably require to understand the proposal and assess whether it is detrimental to their interests must be made available to policyholders. Some of this information may be incorporated by reference and provided on request or via a website link.

APRA will have the ability to request an additional independent expert report.

APRA would review the material prior to its circulation to policy owners.

Each policy owner would also be entitled to a copy of the full rationalisation scheme on request.

The disclosure would include by which option the product provider proposes to proceed and invite any representations as to any concerns about the proposals to be given to the

product provider. Details of any such concerns would then be provided to APRA or the Court (depending on which approval process is followed).

Disclosure of the terms of the new product would be subject to the ordinary disclosure regime administered by ASIC.

3.4.1 Application to APRA

The product provider could then apply to APRA if it believed that it satisfied the simple case criteria. Alternatively, product providers who have self-assessed as complex may apply directly to the Court (for further details on this scenario please see below).

The criteria for determining what constitutes a simple case would be developed with further input from the Expert Panel.

APRA could choose to conduct informal conversations with product providers about ways to enhance the product rationalisation proposal. This would not be obligatory.

APRA would have the ability to approve the proposal where it agrees that the no-disadvantage test is straightforward. Prior to approving any proposal APRA would assess it against the no disadvantage test. If APRA did not consider the proposal straightforward, the product provider may withdraw the application or utilise the court process.

APRA's role would not be based on a simple 'yes/no' power but would include:

- powers for APRA to return a proposal to the providers asking for more information or amendments (the Court will also possess this power), including the ability to request an additional independent expert report (the Court will also possess this power); and
- the ability to refer decisions to the court at APRA's discretion. An APRA referral of a proposal to the court would not constitute a rejection of the proposal.

Where APRA approves the proposal, policy holders would have access to the current EDR schemes for individual compensation claims.

3.4.2 Direct application or referral to Court

Where a product provider applies directly to the Court or where APRA refers a product rationalisation proposal to the Court, the product provider would be required to satisfy the Court that the proposal, as put to the members, satisfied the no disadvantage test.

APRA must be provided with a copy of the scheme proposal as well as a copy of the independent expert's report. APRA would, in all instances and as is currently the case under Part 9, have the ability to seek additional independent expert reports at the expense of the product provider.

APRA will be entitled to be heard on the application. The separate decision to allow APRA to be heard will be at the Court's discretion.

Where a Court makes the decision, that decision would be determinative of the interests of the parties. Therefore there would be no possibility of compensation claims being brought forward by individual members through existing EDR schemes after the Court decision. The

Court decision could be appealed and failure to comply with the Court decision correctly would be subject to normal adjudication processes.

Key questions

- (a) Do you consider the proposed mechanism for life insurance products to be appropriate? In particular, does it provide a sufficient level of protection for policyholders, without imposing an excessive burden on product providers?
- (b) If not, how could the proposed mechanism be improved?

4. TAXATION

4.1 GENERAL

To ensure that the taxation relief is only available for genuine legacy products, any product which is proposed to be rationalised must satisfy the taxation relief test for the taxation relief to be available. The test is discussed above in section 3.3.2.

An important principle in considering taxation relief is that relief would be limited to circumstances where the legacy product and the replacement product have the same tax characteristics. That is, broadly:

- if a legacy product is a life insurance policy, the replacement product would need to be a life insurance policy; and
- if a legacy product is an interest in a managed investment scheme, the replacement product would need to be an interest in a managed investment scheme.

Taxation relief could therefore not be obtained if a life insurance product is rationalised and changed into a managed investment scheme.

The taxation issues arising for life insurance products are to some extent different from those affecting rationalisations of managed investment schemes. These two scenarios are therefore discussed separately below.

4.2 LIFE INSURANCE PRODUCTS

Capital gains tax (CGT) is unlikely to be an issue for a life product rationalisation where assets are held and remain in the same life company. In relation to the entity, no taxation issues should arise as there is no disposal of assets – that is, no CGT events should happen. Nor would a disposal event arise on revenue account (which is more common within a life insurer's ordinary business).

A special tax regime applies to standard life insurance policyholders. Policyholders are not assessable on tax on life insurance policy proceeds provided they held the policy for more than the section 26AH eligible period (which is 10 years from commencement date, or deemed commencement date, for policies issued after 7 December 1983). Therefore, the only

issue with these policies is to ensure that product rationalisation transfers do not cause the eligible period to restart.

However, a CGT taxing point may arise if the life company assets are transferred to another life company or custodial arrangement as part of the rationalisation. A CGT roll-over may therefore be necessary to facilitate such transfers.

- Issues would potentially arise for assets held by the entity on revenue account (such as traditional securities which are specifically taxed on revenue account under section 26BB of the *Income Tax Assessment Act 1936* (ITAA 1936)). It may therefore be necessary to find some appropriate method of providing relief. For instance, the issue may be able to be handled administratively by characterising the disposal of assets as part of a rationalisation as being a capital transaction (and therefore subject to CGT roll-over). This approach has worked for Part 9 transfers.

In relation to policyholders, the issues are the same as for intra entity rationalisation. That is, it will be necessary to ensure that rationalisation does not cause the eligible period to restart.

Key questions

- (a) Have the key taxation issues been identified? How should they be addressed?
- (b) If not, what other issues need to be considered and how should they be addressed?

4.3 MANAGED INVESTMENT SCHEMES

In relation to both entities and members, the rationalisation of managed investment scheme products may require a CGT roll-over as the transfer of investments may trigger CGT taxing points.

Issues would potentially arise for assets held on revenue account (such as traditional securities which are specifically taxed on revenue account under section 26BB of the ITAA 1936). It may therefore be necessary to find some appropriate method of providing relief. For instance, the issue may be able to be handled administratively by characterising the disposal of assets as part of a rationalisation as being a capital transaction (and therefore may be subject to CGT roll-over).

Key questions

- (a) Have the key taxation issues been identified? How should they be addressed?
- (b) If not, what other issues need to be considered and how should they be addressed?

5. CONCLUSION

The Government understands the problem of legacy products and the benefits that could be derived from introducing a product rationalisation framework to remove such products.

The Government's main concern in developing the proposal presented in this paper has been to ensure that there is a balance between the interests of key stakeholders, in particular beneficiaries and product providers. It is further noted that there are substantial taxation issues that need to be considered and addressed.

The purpose of this paper is to invite comments from the wider public on the proposed product rationalisation framework, to ensure that views of all stakeholders have been taken into account in developing a detailed product rationalisation framework including appropriate taxation arrangements.