Response to the Proposals Paper Product Rationalisation of Managed Investment Schemes and Life Insurance Products

Introduction

AXA is a leading provider of life insurance, managed investment schemes and superannuation. AXA welcomes the opportunity to provide a response to the Proposals Paper *Product Rationalisation of Managed Investment Schemes and Life Insurance Products*.

AXA strongly supports the introduction of a legislated product rationalisation mechanism. Under the current financial services regulatory framework there is limited scope for business to rationalise products, as this is difficult and expensive to achieve. This restricts the ability of the industry to upgrade products, implement technological advancements, deliver efficiencies to members, and respond to legislative change. It also means that businesses need to maintain numerous legacy product administration systems, which increases the overall risk of the industry as products may be maintained on outdated IT infrastructure.

For customers, the current framework can lock them into outdated products, which can be costly for businesses to administer. Ultimately this limits a business's ability to pass efficiencies back to customers through lower prices. AXA considers that retail customers across the whole industry would benefit from a legislative mechanism to rationalise legacy products through:

- reduced costs
- greater access to modern products; and
- greater access to more innovative investment products; and
- a reduction in operational risk as a result of replacing legacy systems with better technology systems.

In making its submission AXA has been mindful of the stated purpose of the Rationalisation Proposals. AXA recognises that there is a tension between protecting consumers and providing mechanisms that are efficient, practical and sufficiently flexible to be useful in practice.

AXA believes the proposed approach is unlikely to facilitate the level of product rationalisation that is required to deliver real efficiency benefits for the industry and its customers due to the limited scope of the proposal and the prescriptive nature of the tests that have been presented.

In particular, AXA is disappointed by the exclusion of superannuation products from the scope of the proposals paper. AXA is strongly of the view that there are useful changes that could be made to the successor fund regime which would facilitate further rationalisation of superannuation products. The opportunities for further consolidation have recently been highlighted by Mr Jeremy Cooper, Chairperson of the Super System Review.[1]

In addition, and as an example, AXA has approximately 20,000 customers invested in deferred and allocated annuity products. These products were available only from life insurers and were popular from the mid-1980s until the mid-1990s for the purpose of holding superannuation rollovers or facilitating retirement incomes through a direct life insurance policy. Many life insurers have a similar book of this business and

[1] *Clearer Super Choices: Matching Governance Solutions* Phase One Preliminary Report, 14 December 2009 www.SuperSystemReview.gov.au

similar issues in addressing them. These are classic examples of products that have become outdated due to changes in the regulatory environment and the market.

Whilst these are effectively superannuation products, the successor fund transfer mechanism provided within the SIS Act does not apply as deferred and allocated annuity customers are not members of a superannuation fund. It is often clear these customers would be better served by superannuation membership however the proposed rationalisation mechanism does not cater for a transfer from an individual life insurance contract to a superannuation fund.

As a result, AXA would welcome an expansion of the scope of the proposed product rationalisation mechanism to address this anomaly. Specifically, this would involve explicitly recognising that rationalisation could involve a change in product type from a life insurance policy to an interest in a superannuation fund.

AXA notes that the proposed approach appears to define “outdated” as off-sale for more than 2 years, and “inefficient” as expensive for providers or customers, through the examples provided for the Legacy Product Test.

Often, however, product rationalisation may be in the interests of customers where the product is currently on-sale and is not expensive. This may occur in circumstances where duplicate products emerge, resulting from market evolution or where merger or acquisition of product providers occurs, or as an immediate effect of market or legislative change.

Additionally, AXA notes that through the use of a set period between the closure of a product to new business and its rationalisation, the product provider and/or product holder may be forced to incur a loss in the intervening period which could otherwise be avoided.

Accordingly, AXA recommends a principles based approach to the definitions of “outdated” and “inefficient” to avoid arbitrary constraints on what can and cannot be rationalised.

Nature and scope of a product rationalisation mechanism

AXA does not consider that a detailed and prescriptive test is necessary or that it is necessary for the product rationalisation mechanism to be subject to any threshold requirements, as outlined in the legacy product test.

AXA supports the introduction of a principles-based product rationalisation mechanism under which a product provider could, subject to meeting the legislative requirements of the mechanism:

- vary or amend the terms of issue of a financial product
- terminate the issue of a financial product
- transfer the rights and interests of beneficiaries in a financial product to another financial product or products.

In undertaking any product rationalisation, product providers will continue to be subject to the existing legal duties provide holders with protection. For example:

- responsible entities continue to be subject to the duties in s601FC(1) of the

Corporations Act, including the duty to act in the best interests of members and to give priority to member interests over their own (s601FC(1)(c))

- trustees of superannuation funds continue to be subject to fiduciary principles and the specific covenants imposed by s52(1) of the SIS Act, including the duty to act in the best interests of beneficiaries (s52(1)(c)), and
- life insurers continue to be subject to the duties in the Life Act, including the duty to give priority to the interests of policy owners when there is a conflict with the interests of shareholders (s32 and s48).

Legacy Product Test

The stated reason for the need for a Legacy Product Test is to ensure that the proposed Product Rationalisation Framework is used (only) to remove outdated and inefficient products.

As stated above, AXA does not agree that a Legacy Product Test is necessary to achieve this outcome. The requirement to give priority to the rights and interests of product holders, together with satisfaction of a ‘no disadvantage’ test is sufficient to ensure that product rationalisations will not occur where the circumstances do not justify it.

The circumstances in which a product rationalisation is warranted can vary enormously. A product can become out dated and/or inefficient very quickly through innovation in the industry, or legislative change. The adoption of a Legacy Product Test, and in particular the requirement for the product to be closed for two years, will undoubtedly result in some products which warrant rationalisation failing the test.

For example, the Investment and Financial Services Association (IFSA) and the Financial Planners Association (FPA) have taken action in the last 12 months which is leading to the removal of in built commissions from an array of financial products.

In managed investment schemes, it is common to have retail and wholesale unit trusts which are identical except that the retail unit trust has a fee structure which facilitates payments to advisers. It is AXA’s expectation that over the next couple of years the fee structure of these retail trusts will change to remove the adviser payments, at which point the retail and wholesale trusts will become identical. When this occurs, there will be clear advantages in merging the two unit trusts into one. The merger will result in increased scale and reduced costs. These mergers will not, however, occur if the product is required to be closed for two years to take advantage of the rationalisation mechanism, and for five years to secure capital gains tax relief.

If AXA’s arguments are not accepted and a Legacy Product Test is to be imposed, we make the following comments on the proposal.

In relation to the first proposed criterion that the product has become uneconomic for policy holders/members (product holders), AXA submits that this criterion is useful. However, the two specific tests that are proposed do not demonstrate that the product has become uneconomic for product holders.

The first test is an indication of the decline of the popularity of the product (which may or may not be linked to being uneconomic for product holders) and the second test indicates that the product has become uneconomic for the product provider rather than the product holders.

AXA submits that the criterion should be broadened from 'has become uneconomic' to 'has or will become uneconomic'. There are a number of circumstances in which it is clearly evident to a product provider that the product will become uneconomic in the (near) future. Where the product will become uneconomic for the product holder, it is incumbent upon the product provider (particularly where it has a fiduciary relationship with the product holder) to be proactive.

AXA submits that a test that could be applied under this criterion, for the rationalisation of a managed investment scheme, is that it is not able to meet its investment objectives. There can be several reasons why this may be the case. For example, it may be that a decline in the size and membership of the scheme will increase its expenses to the point where the earnings after expenses cannot achieve the objective. Or it may be because an asset class upon which the scheme's investment strategy was based, has ceased to exist.

For life insurance products, an appropriate test could be whether the benefits being offered to a client under their existing policy are inferior to those of the current, on sale product.

Reference has already been made to the test that refers to a net operating loss. AXA believes that if a Legacy Product Test is considered necessary, the net operating loss test provides reasonable grounds for rationalisation. However, an additional criterion to which this test relates should be included as 'The product has become uneconomic for the product provider.' This criterion should replace the existing criterion that the 'costs of operating the product have become excessive for the product provider because of an outdated technology platform……'

AXA supports the final criterion that product rationalisation, or a program of rationalisations, will result in the decommissioning of an underling administration system or linked (interrelated) system.

No disadvantage test

AXA supports the principle of a 'no disadvantage' test. Our understanding is that the test is to be applied to the total value of the rights and entitlements in the existing product and the rationalised product, rather than a matching of individual rights and entitlements. This approach would allow a person to be moved from one product to another where a particular entitlement was lost but the overall value of the rights and entitlements in the rationalised product would be at least as great.

AXA believes that this is a reasonable approach. While there may be concerns that such an approach could be open to manipulation, AXA believes that the difficulty in assessing the relative value of two very different entitlements means that in practice one entitlement will only be substituted for another where the entitlements are similar.

AXA submits that the no disadvantage test should make it explicit that the no disadvantage assessment is done at the 'total value' of the rights and benefits of the existing and rationalised products.

AXA is also supportive of the proposal that individuals may be able to be compensated for the loss of a particular benefit or entitlement as an alternative to replicating a benefit or entitlement. Again, AXA expects that this capacity would be utilised in only a relatively small number of cases, but that its inclusion would be valuable. Obviously such a provision could only be used where a specific dollar value

could be assigned to the benefit.

As an example, AXA had one old insurance product with a small number of policyholders where one of the benefits was a specific dollar amount payable in respect of a particular event, and which was only payable once. Payment of the benefit to every policy holder to discharge the entitlement under the policy was cheaper than the cost of building the functionality required to administer this benefit on a new administration system.

AXA submits that the ability to compensate a person for the failure to replicate a right or entitlement should be made explicit, and that the dollar value of any such compensation should be included in the 'total value' assessment.

The Proposals paper proposes that the product provider 'rationally and objectively demonstrate that with a high level of certainty that there will be no detriment to any [product holder]'.

AXA submits that this test sets too high a benchmark to be practicable. Satisfaction of this test would require an investigation of the financial and personal circumstances of each and every product holder and how these might play out over time. Consideration will need to be given to the interaction of the current product and the rationalised product with other financial products each person holds, and potentially also their level of income and marginal tax rate.

For example, a product rationalisation might result in a transfer from a managed investment scheme with a single investment manager to a managed investment scheme with several managers. For the typical product holder, having multiple investment managers is a benefit through the diversity this introduces. However, if an individual already has a significant exposure to one of these managers in other assets they hold, the change could result in an increase in the exposure that person has to a particular investment manager, and a reduction in investment manager diversification for the individual concerned. This would be considered detrimental to the individual, but the detriment would not be evident without knowledge of the client's financial or personal circumstances. Gathering this information would be impractical and unreasonably intrusive.

Similarly, while a change in a definition in a life policy might typically make it easier to claim a benefit, understanding whether a particular insured person would be more likely to claim under one definition than another may require details of the client's current health.

'High level of certainty' is not adequately defined or explained in the paper, and is so general a term that it is likely to present significant difficulties for product providers. The difficulty in explaining or defining the term is highlighted by the fact that the paper describes it as 'where the likelihood of any detriment arising to a policyholder or member is very low'. This is effectively a tautology, and more detailed guidance in the legislation would be helpful.

AXA proposes a principles-based test that would require the following elements to be satisfied:

- The product provider has reasonable grounds for believing that the total rights and interests of product holders in a financial product would not be materially adversely affected. (In the case of a transfer to another superannuation fund or managed investment scheme, AXA considers that this would apply to both the transferor product provider and transferee product provider.)

- In the case of a transfer of the type described above, the current and future rights and interests of existing product holders in the receiving entity would not be materially adversely affected by any transfer of other product holders to the product.

- The product provider is not obliged to consider the individual circumstances of product holders.

Independent expert reports and external approval

AXA considers that approval of a product rationalisation by a regulator or other external body, and the requirement for an independent expert's report, are unnecessary. AXA believes that reliance on a principles-based test coupled with the existing duties imposed on product providers is sufficient to ensure that product holders in rationalised products are not disadvantaged or put in a worse position by product rationalisation.

These requirements will significantly increase the cost of a product rationalisation exercise. In doing so it will reduce the number of product rationalisations that occur. This will have the effect of increasing costs to all participants, through lost opportunities to improve efficiency.

It also has the capacity to 'excuse' the product provider from responsibility for the assessment, effectively allowing them to outsource the risk associated with the decision. The ability to do this could ultimately lead to poor decision making, which is not in the interest of product holders.

AXA submits that there is also a distinction between allowing a regulator to intervene in a rationalisation proposal which it believes is not in the interests of product holders (which AXA supports) and requiring a regulator or court to approve all product rationalisations.

AXA notes that the existing successor fund transfer process for superannuation funds does not require an independent expert's report or external approval, and yet successor fund transfers have been excluded from the product rationalisation proposal.

The following reasons for this exclusion are provided in the Proposals Paper:

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

- The 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 trustees of the original fund and the trustee of the new fund to work closely together to ensure that the original member receives rights equivalent to those rights the member enjoyed under the original fund in respect of the benefits.

AXA submits that these arguments in support of the successor fund transfer mechanism would apply equally to similar mechanisms for managed investment schemes, where a fiduciary relationship exists between the Responsible Entity and

the unit holder.

These also apply to a life insurer, where the directors have an obligation to give priority to the interests of policyholders where a conflict arises. This means that if a product rationalisation would benefit the life company but would not be in the interests of policyholders, the rationalisation could not occur.

Tax relief

Where tax will be incurred in the course of rationalising a product it acts as a significant deterrent, and it is highly unlikely that the product rationalisation will be undertaken. For this reason, tax relief is an essential element of any product rationalisation mechanism.

AXA notes the five year period attached to tax relief, relative to the two years period in the proposed Legacy Product Test. AXA believes that the proposed test unnecessarily defers the benefit of product rationalisation for customers and/or product providers. The five year period appears to be based on the premise that the tax relief associated with a product rationalisation represents lost or deferred tax revenue, and there should therefore be significant hurdles to protect Commonwealth revenue by ensuring that the relief only applies to 'genuine' cases.

AXA submits that this premise is false. Rather than deferring or surrendering tax revenue, the tax relief measure ensures that tax collection is not artificially brought forward by the product rationalisation. If the product rationalisation did not occur, the tax would be collected at some date in the future, typically when the product holder left the product and/or an underlying asset was sold.

The effect of product rationalisation can be to artificially trigger the early collection of tax; the proposed 'tax relief' essentially ensures that the tax is incurred at a later date, as it would be had the rationalisation not occurred. The tax relief is actually a measure to ensure tax neutrality, rather than to provide a concession or benefit to investors. On this basis, AXA submits that the requirement that the product has been closed for five years is unnecessary and inequitable.

Conclusion

The creation of an effective rationalisation mechanism for financial products has significant advantages for product holders, product providers and the broader economy. It will allow the efficient transfer of consumers to more up to date products and provide greater efficiencies for the industry through increased scale, cost savings from the closure of outdated administration systems and reduced fees for clients. Giving product providers confidence that they can close outdated and/or ineffective products will encourage product innovation and support Australia's ambition to become a regional financial services hub.

While the current proposal is an important step forward, AXA does not believe it will facilitate the level of product rationalisation required to achieve these goals. AXA submits that the changes proposed by AXA will make the mechanism more effective, while still providing effective consumer protection and requiring minimal change to the existing regulatory environment.

Summary of Recommendations

- Superannuation products should be included in the proposed rationalisation mechanism.
- The creation of a product rationalisation mechanism under which a product provider can, subject to meeting the legislative requirements of the mechanism:
    - vary or amend the terms of issue of a financial product
    - terminate the issue of a financial product
    - transfer the rights and interests of beneficiaries in a financial product to another financial product or products.
- The product rationalisation mechanism should be expanded to allow a change of product type; in particular the rationalisation of life insurance policies that are held for superannuation purposes into superannuation funds.
- A principles based approach to the definitions of "outdated" and "inefficient" should be adopted to avoid arbitrary constraints on what can and cannot be rationalised.
- A principles-based test that would require the following elements to be satisfied:
    - The product provider has reasonable grounds for believing that the total rights and interests of product holders in a financial product would not be materially adversely affected. (In the case of a transfer to another superannuation fund or managed investment scheme, AXA considers that this would apply to both the transferor product provider and transferee product provider.)
    - In the case of a transfer of the type described above, the current and future rights and interests of existing product holders in the receiving entity would not be materially adversely affected by any transfer of other product holders to the product.
    - The product provider is not obliged to consider the individual circumstances of product holders.
- If a prescriptive Legacy Product Test is to be retained, AXA submits that the first criterion should be broadened from 'has become uneconomic' to ' has or will become uneconomic'.
    - For managed investment schemes the test under this criterion should be that it is not able to meet its investment objectives.
    - For insurance products an appropriate test would be the benefits under the policy are inferior to those of the product provider's current on-sale product.

- An additional criterion of ‘The product has become uneconomic for the product holder’. This criterion should replace the existing criterion of the ‘costs of operating the product have become excessive for the product provider because of an outdated technology platform……’ The existing ‘net operating loss’ test should be applied to this criterion.

- The no disadvantage test should make it explicit that the no disadvantage assessment is done at the ‘total value’ of the rights and benefits of the existing and rationalised products.

- The ability to compensate a person for the failure to replicate a right or entitlement should be made explicit, and the dollar value of any such compensation should be included in the ‘total value’ assessment.

- Approval of a product rationalisation by a regulator or other external body, and the requirement for an independent expert’s report, should not be required.

- The requirement that the product has been closed for five years to obtain tax relief is unnecessary and inequitable.