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24 February 2010

Dear Sir / Madam,

We welcome the release of the Government's Product Rationalisation of Managed Investment Schemes and Life Insurance Products Proposals Paper, and appreciate the opportunity to contribute to the development of the mechanism.

About the Commonwealth Bank of Australia

The Commonwealth Bank of Australia (The Group) is one of Australia's leading and largest providers of integrated financial services including retail, business and institutional banking, funds management, superannuation, insurance, investment and broking services. The Group's Wealth Management division manufactures and distributes through Colonial First State Global Asset Management, Colonial First State and CommInsure.

Established in 1988, **Colonial First State** specifically provides investment, superannuation and retirement products to individuals as well as to corporate and superannuation fund investors. Colonial First State is the second largest administrator of retail funds (A\$57 billion¹) and has the fifth highest number of financial advisers through our Commonwealth Financial Planning and Financial Wisdom businesses.

Colonial First State Global Asset Management is Australia's largest manager of Australian sourced funds, with more than A\$138 billion in funds under management across a diverse range of asset classes including Australian and global shares, short term investments, fixed interest and credit, property securities, direct property, global resources, and infrastructure. Outside of Australia and New Zealand we operate under the brand name 'First State Investments' and have teams based in the UK, Asia and US.

CommInsure is the specialist insurance arm of our Wealth Management business unit and is Australia's second largest life insurance and third largest annuity provider. While the CommInsure name was first introduced in 1999, its origins within the Australian insurance industry date back well over one hundred years.

¹ Plan for Life, Sept 2009

COMMONWEALTH BANK OF AUSTRALIA SUBMISSION

As a result of various mergers and acquisitions over the years, the Group has a large portfolio of legacy products. We would welcome the opportunity to be involved in any further consultation and would urge the Government to maintain momentum in the development of the proposals so as to finalise the mechanism as soon as possible.

Should you have any questions regarding this submission, please contact me or Mark Baxter (Chief Risk Officer – Wealth Management) at mark.baxter@cba.com.au or (02) 9303 7234.

Yours sincerely,

A handwritten signature in black ink that reads "Graeme Petersen". The signature is written in a cursive style with a large initial 'G'.

Graeme Petersen
Group Executive
Wealth Management
Commonwealth Bank of Australia

PRODUCT RATIONALISATION OF MANAGED INVESTMENT SCHEMES AND LIFE INSURANCE PRODUCTS PROPOSAL PAPER

1. EXECUTIVE SUMMARY

We welcome the opportunity to respond to the Government's consultation paper on product rationalisation. The Group's Wealth Management business currently has about 300 superannuation and investment products² that it considers are 'legacy products'. These products are held by around half a million customers and equate to almost \$15 billion in funds under management (FUM). We believe that a flexible and cost effective rationalisation mechanism will provide significant benefits for consumers, the industry and the wider community. We encourage the Government to continue in its development of such a mechanism as a matter of urgency.

In its current form, the Paper will provide a mechanism by which some rationalisation of managed investment schemes and life insurance products can occur. However, this set of proposals contains certain limitations which will mean that a significant number of legacy products remain across the industry.

By making a number of modifications to the proposals, we believe that a more optimal level of rationalisation will occur, resulting in a greater number of consumers benefiting from superior products and services. In the Group's case, these changes are likely to result in around 50,000 more customers benefiting further from product rationalisation.

In summary, our recommendations are:

- The proposals should specifically allow for cross sector product rationalisation to occur with no taxation penalty.
- Two further, standalone, objective tests be added on to the existing legacy product test, specifically:
 - the product has been closed for 5 years; and separately
 - the product is a legacy product listed in the relevant regulations / prudential standard.
- A separate taxation relief test should not be required. Once the legacy product test has been satisfied, taxation relief should be automatic.
- In regard to the no disadvantage test:
 - it apply to a group of policyholders / members in a particular product (rather than individuals); and
 - the requirement to replicate a right be removed.
- For managed investment schemes:
 - it be made clear that where product rationalisation occurs in accordance with the requirements, it will override any voting requirements that would otherwise have arisen under law or any restrictions under a scheme constitution, enabling the Responsible Entity (RE) to take all necessary actions on behalf of members;
 - the Option A threshold for member objections be increased from 5% to 10%, in line with Option B;

² These products cover: rollover bonds; deferred annuities; superannuation; pensions; annuities; unit trusts; insurance / investment bonds; whole of life and endowment products.

- the Australian Securities and Investments Commission (ASIC) not be required to ‘approve’ the proposal and that a timeframe be specified by which they are required to provide their comments on the proposal; and
 - the RE should not be required to obtain an independent expert’s report.
- For life insurance products:
 - industry are consulted on the development of criteria used to determine what constitutes a simple case that can be approved by APRA; and
 - it be made clear that the Court approval option is available even where APRA has previously considered the rationalisation proposal.
 - All complaints relating to product rationalisation should, in the first instance go through the company’s internal dispute resolution process before being heard by a special tribunal.

2. SCOPE OF THE PROPOSALS

2.1 Exclusion of superannuation

We note that the proposals in the paper are limited to the rationalisation of managed investment schemes and life insurance products and that superannuation has been specifically excluded, with the potential for consideration of rationalisation issues pertaining to that sector being considered at a later stage.

We accept the reasons given in the paper for the exclusion of superannuation. However, we bring to your attention that our submission responding to the Cooper Review – Phase 2 Issues Paper, included a number of recommendations for improvements to the Successor Fund Transfer process that currently exists for rationalisation in this sector. We have included the relevant extract from that submission at appendix 1.

2.2 Rationalisation of legacy life insurance products into superannuation

The proposals do not appear to allow for a legacy product from one sector of the financial services industry (for example, a deferred annuity issued by a life insurance company) to be rationalised into a product offered by another sector of the industry (for example, a superannuation product with similar features issued by a Trustee). The paper specifically states that taxation relief could not be obtained where such rationalisation takes place.

Providing a mechanism that allows rationalisation across sectors could substantially improve the proposals. Without such a mechanism, certain legacy products (such as deferred annuities) will continue to exist indefinitely. This will result in consumers not benefiting from the superior features and services that more modern products offer, and the issuer continuing to face the heightened operational risks associated with maintaining such legacy products. Further, excluding rationalisations across sectors may make it difficult for the proposal to achieve one of its stated objectives, that is “The desired outcome is that the mechanism is useful in practice and results in an appropriate reduction in the numbers of legacy products outstanding.”³

By way of example, of the Group’s almost 300 legacy products, 30 are deferred annuities. This represents over \$1.2 billion in FUM and over 48,000 customers. While the proposed mechanism should enable these products to be rationalised down to one or two products, the rationalised product will still be a legacy product in that it would still be a deferred annuity

³ Product Rationalisation of Managed Investment Schemes Life Insurance Products Proposals Paper, page 3.

style product and would not offer the more modern features that a customer would benefit from if they were instead transferred to an open retail superannuation product.

We note that the cross-sector rationalisation contemplated in the example above would move a customer from one prudential regime (life insurance), and the protections associated with it, to a different prudential regime (superannuation). However, given that under the proposed rationalisation mechanism, rationalisation can only occur where the no-disadvantage test is satisfied and that, under this scenario the Australian Prudential Regulation Authority (APRA) or a Court would need to approve the mechanism, we firmly believe that adequate protection is afforded to customers.

In addition, we note that key differences between the life insurance regime and superannuation regimes, such as capital requirements are currently being considered by the Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System (Cooper Review), with the possibility that more stringent capital and reserve requirements will be put in place for the superannuation industry in the future – something the Group strongly supports.

Recommendation: *The proposals should specifically allow for cross sector product rationalisation to occur with no taxation penalty where it can be demonstrated that the product is a legacy product and the no disadvantage test is satisfied.*

3. PRODUCT RATIONALISATION TESTS

We strongly support the Government's objective of developing a product rationalisation mechanism that is efficient with respect to time and cost and is sufficiently flexible to achieve an appropriate reduction in the number of legacy products. The rationalisation tests outlined in the paper could be modified to better achieve these outcomes.

3.1 Legacy Product Test

The existing legacy product tests are weighted heavily towards reliance on historical data (for example, figures based on comparisons over the life of the product). For many companies with a significant number of legacy products, and particularly those (such as in the Group's case) where many of those products have come as a result of past merger and acquisition activity, such data is either non-existent or not readily available due to inflexible, dated technology. In addition, some of the objective tests do not fit with the expense allocation that typically occurs in the life insurance environment.

To this end, we believe it would be appropriate to include an additional objective test where the product has been closed for 5 years, as we believe a product closed for this long is by nature a legacy product. We submit that this should be a standalone test, that is, that if this test is satisfied then the legacy product test will have been met.

We also recommend the inclusion of a further objective test which makes reference to certain products deemed by the relevant regulator (in consultation with the industry) to be a legacy product. That list could be either provided for in the relevant regulations or maintained by the regulator in the form of a guidance note / prudential standard. Again, this would provide additional flexibility to the proposed mechanism, but with the protection of having the regulator involved. Such an approach would, for example, allow for those products which are accepted by the regulator (and industry at large) to be genuine legacy products to more efficiently satisfy the legacy product test.

Recommendation: *Include two additional, standalone, objective tests:*

- *that the product has been closed for 5 years; and separately*
- *that the product is a legacy product listed in the relevant regulations / prudential standard.*

3.2 Taxation Relief Test

We question the rationale for making the timeframe for the taxation relief test (5 years) different to the legacy product test (2 years) and note that a company is unlikely to undertake product rationalisation if tax relief is not available.

We do not believe that a separate taxation relief test is required. Once the legacy product test has been satisfied, taxation relief should be automatic. This will result in a more efficient and cost effective rationalisation process by reducing the complexity involved in satisfying multiple tests.

Recommendation: *A separate taxation relief test should not be required. Once the legacy product test has been satisfied, taxation relief should be automatic.*

3.3 No Disadvantage Test

The Paper proposes that the no disadvantage test apply at individual policyholder or member level. By setting the test at the individual level rather than at a group of policyholder or member level, the rationalisation process is likely to be costly, time consuming and result in sub-optimal consumer outcomes.

Rather than applying the no-disadvantage test at the individual policyholder or member level, the test should be a general best interest test (similar to what operates for Successor Fund Transfers).

In addition, the requirement to replicate a right where it is not possible to determine the impact of the loss of a right is impractical and inefficient. To illustrate the point, there are some 'rights' which relate to historic methods of calculating unit prices (historic rather than future pricing), asset values (gross versus net) and other incidental differences (for example, transaction cut off times), which are unlikely to be easy to quantify but which make little sense to replicate.

Rather than a requirement to replicate a right, we believe that where loss of a right cannot be determined, it should either be assumed to have no impact, or a best estimate of the impact should be made and appropriate compensation determined and provided. We also note that, in most circumstances, the member or policyholder will continue to have a compensation mechanism available to them following the rationalisation process so consumer protection will be preserved.

Recommendation: *In regard to the no disadvantage test, we recommend:*

- *it apply to a group of policyholders / members in a particular product; and*
- *the requirement to replicate a right be removed.*

4. MANAGED INVESTMENT SCHEMES

In addition to our specific comments on the various product rationalisation tests above, we believe that for managed investment schemes in particular, the process should have appropriate regard to, and operate in conjunction with, the RE's duty to act in the best interests of unit holders.

In this regard, we recommend a number of changes to the proposed mechanism for managed investments schemes, on the basis that they will improve the practical application and efficiency of the mechanism.

Critical to the efficient operation of the mechanism and to provide the industry with an appropriate level of certainty in relation to a rationalisation, is that where the product rationalisation occurs in accordance with the requirements, it will override any voting requirements that would otherwise have arisen under law or any restrictions under a scheme constitution, thus, enabling a RE to take all necessary actions on behalf of members.

Under the proposals set out in the Paper, there are three options available for the rationalisation of managed investment schemes. In regard to Option A – Member Objection Model, we believe that the 5% returned member objection threshold is too low and should be increased to 10%, to align with option B. We believe that, when considered together with the requirements of the no disadvantage test, this is a more appropriate figure to ensure efficient levels of rationalisation can occur whilst still maintaining an adequate level of consumer protection. Where the number of returned member objections meets the threshold, the RE should have the capability to apply to Court or exercise Option B and hold a unit holder meeting.

We do not believe that ASIC need to be involved in approving product rationalisation applications for managed investments schemes, particularly noting the nature of the product and the RE's existing obligations to act in the best interests of unit holders. Furthermore, while it may be appropriate for ASIC to have the opportunity to comment on the rationalisation proposal, there should be a set timeframe by which ASIC are required to respond.

The RE should not be required to obtain an independent expert's report. REs already seek relevant expert opinions when carrying out their best interest obligations and it seems unnecessary to require one 'independent expert' to cover off on a number of elements of the proposal. Moreover, it is unlikely that one person will be an expert in all the required areas (for example, taxation, legal and actuarial). We believe it is more appropriate for an RE to determine the type of expert/s that need to be consulted in relation to the proposal by way of exercising their existing duties.

Recommendation: *The following amendments should be made to the proposed mechanism for managed investment schemes:*

- *it be made clear that where product rationalisation occurs in accordance with the requirements, it will override any voting requirements that would otherwise have arisen under law or any restrictions under a scheme constitution, enabling the RE to take all necessary actions on behalf of members;*
- *the Option A threshold for member objections should be increased from 5% to 10%, in line with Option B;*
- *ASIC should not be required to 'approve' the proposal and there should be a specified timeframe by which they are required to provide their comments on the proposal; and*
- *the RE should not be required to obtain an independent expert's report.*

5. LIFE INSURANCE PRODUCTS

We note that under the life insurance proposals, APRA is able to approve the product rationalisation proposal in simple cases where the no disadvantage test is straightforward. The proposals also note that criteria will be developed to define what constitutes a simple case. We welcome further consultation on the development of the criteria to ensure that there is adequate guidance for the industry (and APRA) on what will be considered to be a simple case.

Of relevance to this point, is our recommendation in section 3.1 above, that an additional objective criteria be added to legacy product test to state that the test will be met if the product is a legacy product listed in the relevant regulations / prudential standard. We believe that the addition of such criteria would also assist in demonstrating that a proposal represents a simple case, noting that the no disadvantage test would also remain highly relevant.

While Option A in the managed investment scheme proposals includes a statement that where the number of returned member objections meets the 5% threshold, the RE may opt to withdraw the proposal or apply to the Court for approval, the life insurance proposals are silent on whether electing to approach APRA for approval of a proposal, precludes the company from subsequently seeking approval from the Court. We would welcome clarification of this point.

Recommendation: *In regard to the proposals for life insurance products, we recommend that:*

- *industry are consulted on the development of criteria used to determine what constitutes a simple case that can be approved by APRA; and*
- *it be made clear that the Court approval option is available even where APRA has previously considered the rationalisation proposal.*

6. COMPENSATION CLAIMS

Under the current proposals, if a RE proceeds with rationalisation under Option A or B, they would be liable to compensation claims made by any member after the rationalisation is completed. The proposals suggest that such claims could be brought forward through the current external dispute resolution (EDR) schemes such as the Financial Ombudsman Service (FOS). We note that where APRA approves a life insurance product rationalisation proposal, policyholders have a similar right to EDR. It is unlikely that FOS will have sufficient expertise in dealing with what are likely to be highly technical matters. We would therefore suggest that it may be more appropriate for a specialist tribunal to be established to consider such matters.

Recommendation: *All complaints relating to product rationalisation should, in the first instance go through the company's internal dispute resolution process before being heard by a special tribunal.*

APPENDIX 1

Extract from the Commonwealth Bank of Australia Submission to the Cooper Review – Phase 2 Issues Paper

2.1.6 Product Rationalisation

While a product rationalisation mechanism presently exists for superannuation products, through successor fund transfers, improvements to the mechanism would result in greater effectiveness and efficiency of the mechanism, reducing the overall cost to funds. In addition, a product rationalisation mechanism for life insurance company issued superannuation and investment products and other non-superannuation products would assist in reducing the overall cost to the industry, particularly where non-superannuation products are administered on the same systems as superannuation products, as is the case for most retail providers. We note that product rationalisation is only going to become a bigger issue for the industry in years to come, as more and more products move to 'legacy product' status (for example as a result of the IFSA Superannuation Charter).

Product rationalisation creates a win-win situation for product providers and customers. Product providers benefit by being able to generate increased scale efficiencies within their business by being able to migrate customers out of sub-scale products. Customers directly benefit from this by gaining access to more modern and competitive products. This is because these products are likely to have one or more of the following - greater product features; increased investment choice; enhanced customer service capability; and / or more competitive fee arrangements. Critical to customers benefiting from any product rationalisation is for there to be no adverse tax consequences from them moving from one product to another during this process.

2.1.6.1 Extension of Capital Gains Tax Relief

The successor fund transfer mechanism could be enhanced by making the capital gains tax relief for fund mergers, announced in December 2008, permanent. We welcomed the amendments made to the measure (announced in May this year), including the extension of the relief until 30 June 2011, and the application to pooled superannuation trusts and the complying superannuation business of life companies. However, to provide the industry with a more cost effective and efficient mechanism of rationalising products, the relief should be provided on a permanent basis.

2.1.6.2 Successor Fund Transfer Mechanism

The successor fund transfer mechanism could also be enhanced by providing trustees with greater certainty in applying the 'equivalent rights' standard. The 'equivalent rights' analysis that must be undertaken currently only applies 'in respect of benefits'. However, because the meaning of 'in respect of benefits' is unclear, industry practice is to compare all the risks, costs and characteristics of the fund, when strictly this may not be required. This occurs regularly when considering insured benefits, fees and charges, and other features that are not benefits to which the member is presently entitled, such as defined benefits. This can mean that the full benefits of true rationalisation are not realised. Rather, only product replication is achieved. Greater clarity in this regard is likely to assist trustees in achieving true product rationalisation.

Where there is doubt as to whether 'equivalent rights' exist, in particular in regards to fees and insurance premiums, it has become industry practise to provide compensation to members in the form of a lump sum increase to their account balance – rather than restructuring the fee design in the new fund. This should be contemplated in the legislation as a possibility where there are not 'equivalent rights', by for instance providing that a successor fund must have 'equivalent rights' or members be provided with fair and reasonable compensation. In respect of features that you cannot compensate for (such as investment option mapping), relief should be provided for trustees where the differences between the products have been adequately disclosed providing the member with an opportunity to exercise their own choice and select an option that suits their personal circumstances. For insurance, prescribed takeover terms would be useful to provide more certainty over assessing 'equivalent rights'.

2.1.6.3 Life Insurance Company Issued Superannuation and Investment Products

It is also important that product rationalisation includes the ability to move from life-insurance company issued superannuation and investment products (for example, deferred annuities, allocated annuities and insurance bonds) to Trustee issued superannuation / pension products. In addition to reducing costs to the industry, such a mechanism would enable these customers to be moved to cheaper, more modern products with enhanced features.

By way of example, Commlnsure have 303 different superannuation and investment products⁴ within its product portfolio. The vast majority of these products are closed to new customers. Consequently, declines in both customer numbers and funds under management have, and will continue to occur over time within each product. As the scale within each product declines, the cost per customer increases as most costs are fixed. Additional cost pressures arise as a result of legislative changes because the projects required to implement these changes are large, given the number of products impacted. The combination of these cost dynamics place upward pressure on the fees that need to be charged to customers. While every effort is made to minimise any fee increases passed on to customers, these fee pressures would be reduced if greater product rationalisation could be undertaken in an efficient as well as a tax effective manner. Appendix 3 includes a number of case studies which illustrate the benefit of product rationalisation for customers and the importance of tax neutrality.

As noted above, the lack of an effective mechanism for rationalising products for life company issued superannuation and investment products and non-superannuation products, contributes to the overall cost of the industry. In this regard, we encourage the Government to continue its work on developing an effective product rationalisation mechanism for these products as a matter of urgency.

2.1.7 Recommendation

We believe significant cost reductions can be achieved in the superannuation industry through...

- Streamlining the process of product rationalisation in super and introducing an effective mechanism for rationalising non-superannuation products.

⁴ These products cover: rollover bonds; deferred annuities; superannuation; pensions; annuities; unit trusts; insurance / investment bonds; whole of life and endowment products.