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Product Rationalisation Project
Corporations and Financial services Division
The Treasury
Langton Crescent
PARKES ACT 2600
by e-mail: prodrationalisation@treasury.gov.au

26 February 2010

Dear Sir / Madam

**Re: Product Rationalisation of Managed Investment Schemes and Life Insurance Products – Proposals Paper**

Deloitte welcomes the opportunity to comment on Treasury's Proposal Paper "Product Rationalisation of Managed Investment Schemes and Life Insurance Products" (the Proposal).

We appreciate the Government's decision to share the draft framework with the wider public for comment and also commend Treasury's project team for appropriately identifying the many issues and uncertainties currently faced by the managed investment scheme and the life insurance sectors on this issue and for the way in which the Proposal has been framed for comment.

The review of the product rationalisation mechanisms available for life insurance companies and managed investment schemes provides an importance opportunity to create a mechanism which will facilitate efficiency in the industry without adversely impacting policyholders or investors. This facility will provide product providers with increased flexibility to respond to the changing market place whether driven by regulation, competition or economics.

Ultimately such efficiency will be important in helping to make Australia a true financial services hub of Asia.

In addressing the project's specific questions contained in the Proposal, we have sought to highlight what we believe to be the main issues in those areas and, where appropriate, have suggested potential recommendations for consideration by the Project.

**Specific Questions**

Our responses to the specific questions raised in the Proposal are detailed below.

**1 Legacy Product Test**

1.1 Do you agree with the need for a legacy product test? If not, why not?

In our view the Legacy Product Test is not required. This is on the basis that it restricts the circumstances in which the rationalisation framework can be applied without affording any additional advantage to the policyholder / investor over and above the protection afforded to these stakeholders by way of the No Disadvantage Test.

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Its inclusion precludes the realisation of other benefits associated with rationalisation where the product in question does not meet the Legacy Product Test e.g. removal of systemic risk, technology improvements and product innovation. This appears inconsistent with the Governments broader objective to drive improved efficiency and effectiveness in the wealth management industry.

Removal of the Legacy Product Test should also be considered in order to avoid adversely impacting the realisation of benefits associated with a merger or acquisition by delaying the rationalisation of ‘open’ duplicate products until at least two years after the merger or acquisition.

### 1.2 Do you consider the proposed criteria and specific tests to be appropriate and clear?

If the Legacy Product Test is to be retained, further refinement of the proposed criteria and related tests is necessary to ensure the objective of the framework is met i.e. to ensure the needs of product providers are met whilst ensuring no adverse impact to investors. Specific concerns with respect to the proposed criteria and objective tests are as follows:

i. The product has been closed to new investors / policyholders for a period of two years

This criterion is unnecessarily restrictive serving only to make it more difficult to achieve the proposal objectives of ‘a mechanism which is efficient, practical and sufficiently flexible to accommodate a wide range of scenarios’. The requirement for a rationalisation mechanism is borne out of product providers’ need to manage products which are or have become uneconomic or superseded by improved product offerings. These scenarios are not limited to products which have been closed for a period of two years or indeed any product that is closed.

ii. The product has become uneconomic for policy holders or members.

The example test cited for determining if a product is ‘uneconomic’ pertaining to the incurrence of a ‘net operating loss on the product to be rationalised over the past two preceding years’ is too restrictive and does not cater for all legitimate situations in which rationalisation may be an appropriate solution for product providers and policy holders / investors alike. A product which is not loss-making may still be uneconomic in the context of the providers broader product portfolio, for example:

a) A product which is not achieving target margins upon which the broader organisational cost budget has been set. As such the product may be being cross-subsidised by other products without offsetting benefits such as growth in market share etc to justify its inclusion in the product portfolio; or

b) A product which is incurring addition unnecessary costs e.g. where a product is enabled by technology with end-of-life issues and for which other administration systems within the product provider could be just as effectively used.

iii. The product has become out of date because of changes in the regulatory regime.

This test is also too restrictive. It does not recognise other legitimate circumstances which may cause a product to become dated. For example the development of new technologies which the product does not / cannot leverage such as online internet access which provides 24 hours / day, 7 days/ week access to transact in respect of the product. Similarly the product may not offer all of the features a more modern version of the product may offer e.g. investment options. If a provider offers these more modern options via another similar product it makes little sense in terms of efficiency and effectiveness to replicate them in the older product.

Finally, the criteria do not accommodate a situation where a product does not have critical mass, for whatever reason i.e. it never attracted investors in the first place or they have invested and subsequently exited the product, to ensure it can be operated in a fair and equitable manner for all investors.

1.3 If not how could they be improved? Are there other criteria or specific tests that you consider better?

Suggested improvements aimed at improving the flexibility to utilise the mechanism in order to drive increased efficiency and effectiveness for providers without adversely impacting members are as follows:

i. Extend the test to include ‘open’ products which will cater for a merger / acquisition scenario where typically product rationalisation would improve synergy benefits to be extracted thereby improving the efficiency and effectiveness of the provider and drive benefits for investors in the form of reduced fees, fewer administration errors and improved service; or

ii. If (i) is not possible, as a minimum remove the requirement for the product to have been closed to new investors / policyholders for a specific time period (two years or otherwise); and

iii. Modify the criteria under which a product can qualify as ‘legacy’ as follows:

   a) Extend the criteria pertaining to a situation where ‘a product has become out of date’ beyond regulatory changes to include products whose service levels (in respect of investment advice, knowledge of call centre and administration staff, administration errors due to increased manual processing arising from use of legacy systems, and / or legacy system support), features (e.g. exit fees, higher fees) and functionality (e.g. online account access) are also dated by comparison to more modern versions of similar products;

   b) Extend the objective tests for determining if a product is uneconomic to include products which are not achieving target margins or which are incurring additional unnecessary costs;

   c) Include a test to cover the situation where product providers simply wish to rationalise the number of duplicate or similar products on offer in order to enable the provision of a more efficient and cost effective product for the member, mitigate risk, consolidate product knowledge and enable improved customer service; and

   d) Include a test to cover the situation where a product does not have critical mass in terms of the number of product holders required to ensure it can operate in a fair and equitable manner for all investors.

## 2 Taxation Relief Test

2.1 Do you consider the test to be appropriate and clear?

Assuming the Legacy Product Test is retained we have two concerns with the Taxation Relief Test:

i. It duplicates a number of the requirements covered in the Legacy Product Test, specifically:

   a. The requirement for the product to be closed; and

   b. The requirement that 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 of Product Disclosure Statement as the amount that was sought to be raised.

ii. The only additional requirement it creates is for the product to have been closed to new members or policyholders for a period of 5 years, as opposed to the 2 years required in the Legacy Product Test. This inconsistency serves to unnecessarily complicate the application of the framework.

2.2 If not how do you think it could be improved?

i. Our recommendation would be to remove the Taxation Relief Test from the framework.

ii. If this is unacceptable, then as a minimum the time period for which the product must have been closed should be consistent across the Legacy Product Test and the Taxation Relief Test and in our view the shorter period of 2 years is preferable. This is on the basis that it is less restrictive in terms of the circumstances in which the framework can be applied and provided the No Disadvantage Test exists, it ensures no adverse impact to policyholders / investors whilst creating significant potential opportunity for improved efficiency and effectiveness in the product providers environment.

## 3 No Disadvantage Test

3.1 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?

There is much that we support in the No Disadvantage Test, as described. These aspects include:

i. That the test applies to the proposed rationalisation together with any compensation – as it means that the test covers the final outcome for the customer;

ii. That it covers all rights – so the protection is complete;

iii. That it must be applied to each customer – so all individuals will be protected;

iv. That it is applied with a high degree of certainty – so the bar is not set too high;

v. That it covers future scenarios – so it is not just the current position that is protected; and

vi. That risk profile is maintained – so customers will keep the risk profile they selected, any change in risk profile not necessarily being in customers' interests.

3.2 If you do not consider the current test to be appropriate, how do you think it could be improved?

We believe the No Disadvantage Test could be improved as follows:

i. Clarify that the loss of 'insurance benefits 'e.g. death benefits, does not satisfy the No Disadvantage Test just because there is a 99.95% degree of certainty that an individual will not die in a year, since the loss of such a benefit could have a very significant impact for the dependants of anyone who does die; and

ii. To permit a greater degree of judgement in applying the test in cases where it is 'not possible to determine the loss of a right in all circumstances'. An example illustrates this point. We believe that it could be seen to be in customers' interests to be upgraded from a product with a fixed annual fee of 2% of account balance to one with a fee of 1.5%, but with the product provider having the right to vary fees up to 2.5%. The most likely outcome would be that the customers would enjoy a 0.5% pa fee reduction. We believe that it should be open to the independent expert and to APRA, ASIC or the Court to make the judgement that the rationalisation was, on balance, in the interests of the customers. In this example, we can see that the risk of a fee increase of 0.5% pa would be particularly acceptable if the customer could exit the product in future with no penalty and the product was one for which market forces would effectively prevent unreasonable fee increases.

3.3 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?

Refer Section 3.2. above.

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## 4 Managed Investment Schemes

**4.1 Do you consider the proposed mechanism for managed investment schemes to be appropriate? In particular, do you think it provides and appropriate level of protection to members, without imposing excessive burden on responsible entities?**

Whilst the proposed mechanism provides improved options to REs for rationalising managed investment schemes in terms of driving efficiency whilst continuing to offer an appropriate level of protection to members and without imposing excessive burdens on responsible entities it also raises some concerns as follows:

i. Under Options A and B, where a scheme has more than one class of unit each class is entitled to vote separately which is onerous for the product provider;

ii. Option A which requires a 5% level for member objections is inconsistent with the 10% by value test in Option B;

iii. Residual liability for the RE under Options A and B in the event that a member chooses to make a compensation claim after the rationalisation has completed; and

iv. We note the proposal to afford ASIC the ability to seek an additional Independent Expert Report (IER) and would hope that the instances in which this is required are the exception, rather than the rule.

**4.2 If not, how could the mechanism be improved?**

i. Under Option A and B, if a scheme has more than one class of unit then each class should not be entitled to vote separately unless the class rights are legally entrenched .

ii. Increase the level for member objections in Option A from ‘5% to 10% by value’ to make it consistent with the ‘10% by value’ test in Option B.

iii. If approval under Option A is not achieved and the RE elects to pursue Option B, then if the ‘10% by value’ quorum requirement is not met under Option B then the members of the scheme should be considered to have consented to the rationalisation proposal;

iv. Allow a specified period after which the scheme has been deemed to be agreed, within which compensation claims must be made e.g. 90 days from the rationalisation date, for Options A and B; and

## 5 Life Insurance Products

**5.1 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?**

We believe that the proposed mechanism would be effective. We think that the independent expert together with APRA provide adequate protection for policyholders, however we would hope that the instances in which a second IER is required by APRA are the exception, rather than the rule.

**5.2 If not, how could the proposed mechanism be improved?**

We think that the process could be simplified by removing the simple/complex assessment. There are four possible situations:

- A simple rationalisation that APRA approves;

- A simple rationalisation that APRA refers to the Court;
- A complex rationalisation that APRA could approve (not allowed under the proposal); or
- A complex rationalisation that is decided by the Court.

We think that it would be more effective to have:

- A rationalisation approved by APRA; or
- A rationalisation decided by the Court, either referred by the product provider or by APRA

This provides for a complex rationalisation to be approved by APRA if both APRA and the product provider want that. Alternatively the Court process provides greater certainty to the product provider, albeit at greater cost and a longer timeframe.

We also think that the proposed process could be improved for Deferred Annuities. These were the original products issued by life insurers for the rollover of superannuation benefits when customers changed employers. They are owned by the customer. These products have been superseded and now people rollover within a superannuation fund. Life insurers offer such funds. We would like to see a process for rationalising a Deferred Annuity into a Superannuation fund. The contractual owner would have to change from the customer to the trustee of the Superannuation Fund while the beneficiary would remain the same. We suggest that this would be acceptable provided the assets backing the policyholder's benefits remained in the same Virtual PST. This condition means that the policyholder does not lose the protection of having benefits provided by an entity subject to capital adequacy requirements, i.e. a life insurer.

## 6 Taxation

### 6.1 Life Insurance Products

#### *6.1.1 Have the key taxation issues been identified? How should they be addressed?*

No. Refer Section 6.1.2

#### *6.1.2 If not, what other issues need to be considered and how should they be addressed?*

The key issues in respect of life insurance policies are:

- 10-year eligible period rule – there should be a deeming provision in the tax legislation that ensures that where the product rationalisation tests are satisfied that the start of the beneficiary's eligible period for the replacement product is the same as it was for the legacy product.
- CGT taxing point on transfer – a mechanism similar to that used in respect of Part 9 transfers should be adopted where the transfer involves a transfer outside the same tax consolidated group.
- Revenue investments transferred - a mechanism similar to that used in respect of Part 9 transfers should be adopted where the transfer involves a transfer outside the same tax consolidated group to ensure there is no tax liability arising on transfer.
- Stamp duty – transfer of underlying assets from one service provider to another may result in stamp duty being payable on the transfer (depending on the nature of the assets). We would recommend an exemption from stamp duty be available where the transfer is due to product rationalisation.
- 45 day rule – the transfer of underlying share investments from one product provider to another product provider could result in the 45 day franking credit rule been unintentionally being failed. A provision is required to ensure that this unintended consequence does not arise.

- Carry forward tax losses – where an investment policy is replaced with a policy issued by a life insurance company outside the original tax consolidated group any carry forward capital or revenue losses should be transferred to the new policy issuer. This is required as a the original consolidated group may not be able to utilise the carry forward tax losses but will be required to compensate the policyholders to the extent that the losses have been reflected in the unit price for that policy.

### 6.2 Managed Investment Schemes

#### *6.2.1 Have the key taxation issues been identified? How should they be addressed?*

No. Refer Section 6.2.2.

#### *6.2.2 If not, what other issues need to be considered and how should they be addressed?*

The key issues in respect of managed investment schemes are:

- CGT taxing points – roll-over relief is required to ensure that no CGT tax consequences arise at the member or managed investment scheme level as a result of the transfer of the interest from one scheme for another.
- Revenue investments transferred (including sections 26BB and 70B and Division 230) - a mechanism is required to ensure that the transfer of investments taxed on revenue account are not taxed at the time of transfer but any gain or loss is deferred until it is sold by the replacement interest
- Stamp duty – transfer of underlying assets from one service provider to another may result in stamp duty being payable on the transfer (depending on the nature of the assets). We would recommend an exemption from stamp duty be available where the transfer is due to product rationalisation.
- 45 day rule – the transfer of underlying share investments from one product provider to another product provider could result in the 45 day franking credit rule been unintentionally being failed. A provision is required to ensure that this unintended consequence does not arise.
- Carry forward tax losses – a similar mechanism to that available on the merger of superannuation funds, any carry forward capital or revenue losses should be transferred to the replacement managed investment scheme interest. These losses would have continued to be available to the members of the original interest if the rationalisation had not occurred.

In conclusion, we trust that Treasury’s recommendations will go a long way towards providing an appropriate framework within which product rationalisation can occur which satisfies the needs of the various stakeholder groups. Importantly, in our view, the Government should ensure that any resulting framework serves to facilitate efficient and effective delivery of high quality cost effective wealth management products and services to the Australian public and support Australia’s standing as the fourth largest onshore managed funds market in the world.

If you have any queries or would like to discuss any aspect of our submission further, please contact Susan Woods on (02) 9322 5813.

Yours sincerely

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