

Product Rationalisation Project
Corporations and Financial Services Division
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26 February 2010

Dear Sir or Madam:

PwC submission to Treasury on Product Rationalisation Proposal paper

We are very pleased to provide input into the product rationalisation proposal. We welcome the recommended reforms and believe that it will allow the industry to provide better products and service to customers at the same time as improving efficiency and reducing costs.

We attended the product rationalisation session at IFSA on 24 February 2010 and appreciated the opportunity to understand the background thinking of Treasury. We believe that in some respects the proposal falls short of Treasury's objective to "accommodate a wide range of rationalisation scenarios".

To support the proposal development process, we have divided our submission into two parts:

- Section 1 Recommendations that operate within the current scope of your proposal
- Section 2 Recommendations that are further reaching to enable more rationalisation.

We would be pleased to meet with Treasury to talk through any of the ideas presented in our submission.

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Partners

Section 1: Operating within the scope of the proposal

In this section we consider the proposal paper put forward by Treasury and make recommendations within that scope. We consider these to be the minimum changes required and believe that the overall affect would be to create a useful set of situations where rationalisation could proceed.

3.2.1 Common Elements: Legacy product test

Key questions

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

- Yes, in the context of Section 1 only – See Section 2 for further discussion of this test.

(b) Do you consider the proposed criteria and specific tests to be appropriate and clear?

- Within the proposed scope the test seems clear.

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

- n/a

3.2.2 Common Elements: Taxation relief test

Key questions

(a) Do you consider the test to be appropriate and clear?

- No. Rationalisation would usually crystallise tax and, as a consequence, members would be disadvantaged and rationalisation would not proceed. The key objective of the rationalisation proposal is to enable rationalisation and, thus, tax relief is a critical component of the regime. We recognise the need to balance promotion of rationalisation with protection of taxation revenues. We believe that the current tax relief test fails to achieve these dual objectives because it would prevent a significant proportion of rationalisations from proceeding. We suggest:

- i) The taxation relief test is removed and the legacy product test is used to determine whether rationalisation can occur. And if the legacy product test is met then tax relief is automatically granted. This promotes the objective of enabling rationalisation.
- ii) Taxation revenue would be preserved because:
 - without tax relief rationalisation is unlikely to occur and, as a result, that tax revenue remains deferred anyway; and
 - with tax relief the rationalisation can occur and taxation revenue remains deferred.

(b) If not, how do you think it could be improved?

- See above.

3.2.3 Common Elements: No disadvantage test

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?

- In most respects we believe the test to be clear and appropriate.

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

- We believe that an industry wide guide should be developed so that all parties (the product provider, members, independent expert, regulators and court) have a clear understanding of what the requirements entail. This is important to ensure that rationalisation proposals don't fail as a result of different interpretations of the operation of the test. The guide should cover the topics such as:

- Materiality
- Future scenarios to consider
- Grouping of benefits
- Comparing risk profiles
- Reasonable exercise of existing discretions
- Valuation of rights and options

(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?

- Our discussion in the industry highlighted that the first factor "Product providers may use a variety of means to ensure ..." requires elaboration. In order to help we believe that some examples could be given. Some examples could be:
 - It would be acceptable for the unit pricing and redemption processes to be changed provided that the process is no less equitable to members in general. For example, a provider could change from processing redemptions weekly using historic unit pricing to industry best practice of transacting daily using forward pricing.
 - The provider could change how an investment guarantee is achieved provided that the guarantees are expected to deliver similar levels of protection and the value for money is comparable. For example, a participating policy in a life insurance company may have similar outcomes to an investment ratchet in a modern investment product.

- Compensation may be offered for a loss of a right. For example, a participating contract has a right to future profit shares which may be valued and a cash value paid out as would be seen in a demutualisation.
- A key objective of rationalisation is often to standardise the product features available to members. This standardisation is usually accompanied by service improvements for members. However, in practice some little used legacy product features may not be available or replicable in the replacement product. For little used product features, we believe that it would not disadvantage members if, in the assessment of the no disadvantage test, the product provider were able to consider alternative products that members could readily opt to take as a replacement.

Consumers in our modern economy regularly change product to continue to meet their changing needs and get the “best deal”. We believe that in applying the no disadvantage test, the product provider and independent expert should be able to consider alternative product opportunities provided that:

- The number of members needing to take up that option is a small proportion – perhaps less than 10%;
- There are no barriers to exit the existing product and entry to the new product;
- The alternative product is readily accessible to members; and
- The alternative product is a viable alternative that is likely to meet all of the needs covered by the existing product and at a comparable cost.

This approach would further promote rationalisation and continue to protect the interests of members.

3.3 MANAGED INVESTMENT SCHEMES

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?

- Yes, however we recommend minor changes to the threshold, compensation process and to the required capabilities of the independent expert.

(b) If not, how could the mechanism be improved?

- Based on our experience we believe the 5% threshold under approval method (1) will turn out in practice to be too low. Rationalisation typically occurs only when an entire portfolio of products can be rationalised (for example, all products on an administration system must be rationalised to enable that system to be decommissioned) and a “no” vote on one managed investment scheme would likely derail the entire process.

The threshold should be set to balance the desire to promote rationalisation and protect the interests of members. We note that:

- A portfolio of managed investment schemes will contain some small schemes and, as such, a small voting block can derail an entire rationalisation proposal.
- Human nature is such that most members that object will vote. Thus, the level of no vote is likely to be the full extent of the objections.
- The independent expert will have reported on whether the rationalisation proposal disadvantages any member. Thus, objections are likely to be as a result of subjective matters or misunderstandings that are of no financial consequence to the member.
- Members' interests are further protected by virtue of ASIC's right to intervene if "response highlights that the no-disadvantage test has not actually been satisfied".

We believe that the threshold should be increased to 10% without reducing the protection afforded members and that this will significantly reduce the risk of a minority interest derailing the entire rationalisation process.

- For a product provider to go ahead with rationalisation finality in outcome must be achieved and, appropriately, finality is one of Treasury's stated objectives. If members were able to revisit the no disadvantage test with the benefit of hindsight then the product has not actually been rationalised and the member has effectively got the better of two products. To achieve finality, any compensation should be based on objective factors and relate to monetary detriment that was reasonably foreseeable at the time of transfer. This would balance the need to protect the interests of members and promote rationalisation.
- With respect to complaints from members, we believe that the existing internal dispute resolution process is an effective mechanism and should be used prior to the external process.
- The independent expert should be appropriately skilled so as to be able to quantify the value of benefits and rights as well as the financial impacts on members under a variety of scenarios. The independent expert should be able to clearly demonstrate independence from the product provider. We also note that the advice of different specialist disciplines may be required.

3.4. LIFE INSURANCE PRODUCTS

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?

- We are concerned that the proposed mechanism for life insurance products may not achieve the objective of promoting rationalisation because it appears to essentially be a court approval process. We also recommend minor changes to the compensation

process and to the required capabilities of the independent expert in line with our recommendations for managed investment schemes.

(b) If not, how could the proposed mechanism be improved?

- Our concern is that the definition of “straightforward” cases that APRA can approve will be applied narrowly and the vast majority of product rationalisation cases will be considered by the court. Our experience of Part 9 activity is that, although product rationalisation could be completed at time of transfer of business, life insurance companies do not take up that option. We put forward that there is a perception that courts are:
 - effective at addressing points of contract and law; and
 - less effective at dealing with equivalence of value of benefits.

We suspect that if product rationalisation proposals were in the main to be handled by the court then rationalisation activity will be limited – contrary to Treasury’s objective.

We believe that APRA could consider and approve rationalisation proposals that involve “straightforward points of contract and law”. APRA would be able to consider cases that in the main involve the equivalence of value of benefits. We believe that the majority of rationalisation proposals are mostly about the equivalence of benefits and, thus, this approach would encourage take up of rationalisation (to everyone’s benefit).

This regime would continue to provide a very high level of protection to the interest of members. APRA would consider the report of an independent expert. APRA also has a team of experts capable of considering the range of technical issues involved in evaluating the no disadvantage test and protecting the interests of members. We note that under the Financial Sector (Transfers of Business) Act 1999 APRA already completes the approval role for transfers and product rationalisation between friendly societies. In most respects, the cases that we propose APRA can approve would be very similar. Additionally, the complaints and compensation regime would be available to members.

- Any new rationalisation regime should be optional or additional to existing approaches. For example, the industry has successfully upgraded life insurance products from one year to the next by providing enhancements that are clearly superior for customers. It would be detrimental to customers and the industry if the new rationalisation approach were to prevent this.
- The following comments are repeated from above in the managed investment scheme section as they are also applicable to the life insurance regime.
 - For a product provider to go ahead with rationalisation finality in outcome must be achieved and, appropriately, finality is one of Treasury’s stated objectives. If members were able revisit the no disadvantage test with the benefit of hindsight then the product has not actually been rationalised and the member has effectively got the better of two products. To achieve finality, any compensation should be based objective factors and relate to monetary detriment that was reasonably foreseeable and not unlikely at the

time of transfer. This would balance the need to protect the interests of members and promote rationalisation.

- With respect to complaints from members, we believe that the existing internal dispute resolution process is an effective mechanism and should be used prior to the external process.
- The independent expert should be appropriately skilled so as to be able to quantify the value of benefits and rights as well as the financial impacts on members under a variety of scenarios. The independent expert should be able to clearly demonstrate independence from the product provider. We also note that the advice of different specialist disciplines may be required.

4.2 TAXATION - LIFE INSURANCE PRODUCTS

Key questions

(a) Have the key taxation issues been identified? How should they be addressed?

- We agree that the key tax attributes such as capital gains, revenue gains and life insurance bonuses should be considered in any proposed relief for life companies and policy holders.

(b) If not, what other issues need to be considered and how should they be addressed?

- n/a

4.3 TAXATION - MANAGED INVESTMENT SCHEMES

Key questions

(a) Have the key taxation issues been identified? How should they be addressed?

- We emphasise the importance of tax relief to enable successful rationalisation. Without tax relief, the value of members' benefits would likely reduce and it is extremely unlikely that the no disadvantage test could be met and, thus, we will fail Treasury's objective to enable rationalisation. Accordingly we would like to expand on the detail of the nature of the tax relief required as follows:
 - The capital gains tax (CGT) discount concession available to the transferor fund is able to be preserved in the transferee fund. This could be achieved by deeming the acquisition date of the investment by the transferee fund as being the date the investment was originally acquired by the transferor fund for the purposes of the CGT discount concession rules. Similar rules are already available under the superannuation merger provisions.
 - Realised capital and revenue losses can be transferred to the transferee fund.

(b) If not, what other issues need to be considered and how should they be addressed?

- An amendment to the deed in these circumstances could technically trigger a resettlement of the transferee managed investment scheme and, consequently, it would have tax consequences and result in failure of the no disadvantage test. Provided that the proposed rationalisation meets the required tests then resettlement should not result in adverse tax consequences.
- In addition, a resettlement could also give rise to state stamp duty consequences. Assistance from the Commonwealth in encouraging States to provide exemptions would be welcome.

Section 2: Recommendations for broader application of the regime

We appreciated the briefing session with Treasury at IFSA on 24 February 2010. At that session, a number of suggestions were discussed that were considered unlikely to be taken up at this stage but you asked that we cover them in our submission.

Accordingly, in this section we make recommendations that are further reaching and we believe will result in a framework that provides greater benefit to the industry and its customers by enabling more rationalisation without detriment to government revenue or member interests. Our comments relate to Treasury's objective number 5:

Objective 5: '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.'

We believe that the principles underlying the product rationalisation regime should encourage simplicity and efficiency provided that:

- the interests of customers are maintained or enhanced – the “no disadvantage” test; and
- the regime is not misused to reduce government revenue.

Accordingly, we discuss removal of the legacy product test.

Ideally the product rationalisation regime should also allow transfers between different types of legal entities. There is a range of legacy products that exist in a number of the different historic tax and regulatory regimes. The only solution to this issue is to allow rationalisation of these products into the equivalent contemporary regime. However, we acknowledge that transfers between different types of legal entities will create additional and complex challenges (too many to detail in this submission). For this reason, our remarks below continue to focus on rationalisation within a single type of legal entity.

The legacy product test

We believe that legacy product test dramatically reduces the opportunities to rationalise products. For example:

- **Mergers and Acquisitions:** An acquirer of a book of business will end up with a number of very similar products that it will want to rationalise early in order to improve efficiency and service. Many of these products will not be closed and the acquirer will have to wait at least 2 years before rationalisation can begin. This appears at odds with the goals of the proposal.

- **Decommissioning legacy administration system:** In many cases a small percentage of products on a legacy administration system may have remained open. As such, in order to proceed with the rationalisation the provider would need to close the remaining products and wait two years or more.

In a modern and competitive market place with corporate restructures these situations are not uncommon. Product providers will take a portfolio approach to rationalisation because benefits are usually achieved when an entire portfolio is rationalised.

We note that, other than to reduce the number of rationalisations that can occur, the legacy product test:

- Plays no role in the protection of members interests. The approval process and no disadvantage test are very effective at protecting the interests of members.
- Does not protect government revenue. Tax relief is a key component of the no disadvantage test by ensuring that members are not disadvantaged by having to pay tax earlier than would otherwise have been the case. In fact, arguably “tax relief” is the wrong description because rationalisation is not designed to change the amount of tax payable.