

Product Rationalisation

Issues Paper

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Consultation process

This paper forms the starting point of the discussion on the particular product rationalisation mechanism to be adopted. It aims to raise issues and canvass possible options for reform. Interested parties are invited to make written submissions that address, but need not be limited by, the issues raised in this paper.

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

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The closing date for submissions is 21 September 2007. Submissions may appear on the Treasury website, www.treasury.gov.au (subject to any claims for confidentiality).

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

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LIST OF ABBREVIATIONS

APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ATO	Australian Tax Office
Beneficiary	A member of a relevant scheme or fund or a life policy owner
Corporations Act	<i>Corporations Act 2001</i>
IFSA	Investments and Financial Services Association
Insurance Contracts Act	<i>Insurance Contracts Act 1984</i>
Life Act	<i>Life Insurance Act 1995</i>
SIS Act	<i>Superannuation Industry Supervision Act 1993</i>

EXECUTIVE SUMMARY

The purpose of this Issues Paper is to serve as the basis for consulting stakeholders about a product rationalisation mechanism in the managed funds sector. For the purposes of this paper, the term 'managed funds' is used to include managed investment schemes which are registered under Chapter 5C of the Corporations Act, superannuation funds and life policies.

Product rationalisation refers to a mechanism for removing outdated managed funds products by transferring beneficiaries out of these products into new products with modern features.

The Regulation Taskforce (the Banks Committee), in its report of 31 January 2006 entitled *Rethinking Regulation*, recommended that the Australian Government, State and Territory governments, APRA and ASIC, should, in consultation with industry stakeholders, develop a mechanism for rationalising legacy financial products (Recommendation 5.19). 'This mechanism should balance achieving greater operational efficiency with ensuring that consumers of the products are not disadvantaged', the Committee stated. The Australian Government response of 15 August 2006 indicated that it agreed to this recommendation.

It is noted that the issues involved in designing an appropriate product rationalisation mechanism are wide-ranging and complex. Addressing them in an adequate fashion requires obtaining the views of all affected stakeholders and giving them thorough consideration in assessing the feasibility of developing a balanced and fair product rationalisation mechanism. The purpose of this paper is to explore the main issues involved in developing such a mechanism and to provide guidance to stakeholders interested in submitting their views on this matter.

Extensive background information on the problem and how it impacts on stakeholders is presented (Sections 1 and 2). This is followed by a discussion of the objectives in considering the introduction of a product rationalisation mechanism (Section 3). The current regulatory provisions relevant to this issue are described, including the key taxation provisions.

Section 4 of this paper sets out the main issues that are involved in the development of a product rationalisation mechanism. A description of each issue is provided, together with one or more questions to which responses are being sought. The issues include whether the mechanism should include the compulsory transfer of beneficiaries, protection for beneficiaries' interests and arrangements for the independent assessment of particular product rationalisation proposals.

Section 5 sets out for discussion purposes a number of possible product rationalisation mechanisms. Stakeholders are invited to submit comments on the options presented, or submit their own preferred options.

Sections 6 and 7 include a summary of the paper and possible next steps. In the light of the comments received in response to this paper, a specific product rationalisation mechanism will be developed. It is likely that a Proposals Paper (including a regulation impact statement) will be released, putting this mechanism forward for further, more detailed comment.

1. INTRODUCTION

The managed investments industry in Australia

Over the last fifteen years, the investment management industry has developed into one of the most important and dynamic components of the Australian financial services sector. It is now one of the major managed funds markets in the world and the largest in the Asia-Pacific region. Total funds under management at the end of 2006 stood at A\$1.096 trillion, up from A\$954 billion at the end of 2005.

The emergence of the managed funds sector in Australia has been underpinned by a number of factors – a sophisticated investor base, mature markets, cutting edge investment products and most importantly, Australia's innovative superannuation policy. Superannuation funds now dominate the local industry, with Australia posting the second highest growth rate in such funds of all OECD countries during the 1990s. As at December 2006, superannuation investments represented over 70 per cent of managed funds with A\$806 billion in total assets.

Product rationalisation

Rationalisation of financial products is a process of transferring investments of a similar nature into a newer product with equivalent rights and benefits. The objective of the process is to remove outdated financial products by rolling them over into other, up-to-date products. The outcome benefits investors by transferring them into modern products with 'investor-friendly' features. Product providers may also benefit by achieving lower costs and better risk management following the removal of the legacy product. Product rationalisation is thus also a response to addressing risks, especially operational risks created by the need to maintain and service outdated computer systems.

The need for product rationalisation in the managed funds industry frequently arises out of changes in commercial practices as well as legislative, regulatory, and tax developments which result in financial products becoming outdated (these are then known as 'legacy products'). A further driver of the need for product rationalisation is industry consolidation and merger activity, as the combined entities resulting from these processes are frequently left with multiple products offering substantially the same benefits to customers.

Since the 1980s there has been a significant increase in the number of legacy products that are closed to new clients and that operate on obsolete computer systems (known as 'legacy systems'). The need to maintain an increasing number of products and systems, including an increasing proportion of legacy products and systems, is creating considerable difficulties for industry. The outcome is an increase in both costs and risks to beneficiaries, product providers and the financial system as a whole.

There are currently certain processes available to rationalise financial products, particularly within the superannuation and life insurance sectors. These existing mechanisms vary widely between sectors and do not observe common standards of investor protection and procedural fairness to beneficiaries.

Submissions have consequently been made to the Australian Government expressing support for introducing an improved and consistent product rationalisation regime covering the whole funds management industry.

The mechanism is likely to involve compulsory transfer into a new product. It could therefore involve legislative intrusion in private proprietary and contractual rights. Ensuring fairness to each individual beneficiary of any product rationalisation mechanism including a compulsory transfer element would be a key consideration. There would need to be satisfactory safeguards built into the mechanism to protect the rights and benefits of beneficiaries.

Financial products to which a product rationalisation regime could apply are managed investment schemes, superannuation funds and life insurance products. As indicated above, the current rationalisation processes in these areas differ widely. A further objective could be to harmonise or amalgamate them to the extent appropriate into a single product rationalisation regime covering all the industries mentioned.

Benefits from such a measure would be expected to accrue to both consumers and industry. Further benefits to the wider economy are also expected to result through a reduction in risks associated with legacy products, leading to improved stability and integrity in the financial system.

Purpose of the Issues Paper

Initial consultation on this matter was held through the Taskforce on Reducing the Regulatory Burden on Business.

The Regulation Taskforce (the Banks Committee), in its report entitled *Rethinking Regulation*, recommended that the Australian Government, state and territory governments, APRA and ASIC, should, in consultation with industry stakeholders, develop a mechanism for rationalising legacy financial products (Recommendation 5.19). 'This mechanism should balance achieving greater operational efficiency with ensuring that consumers of the products are not disadvantaged', the Committee stated. The Australian Government response indicated that it agreed to this recommendation.

In addition, the consultation paper issued by the Parliamentary Secretary to the Treasurer in April 2006 under the title *Corporate and Financial Services Regulation Review Consultation Paper* raised this issue. Submissions received in response to these papers have in general supported the development of a product rationalisation mechanism, subject to an appropriate level of protection for the interests of beneficiaries. The need to address a range of complex issues was also noted, including the taxation implications for beneficiaries and the managed funds themselves.

Given the range and complexity of the issues involved in designing a product rationalisation mechanism, a process including wide-ranging consultation and thorough consideration of the views and submissions received is required. This Issues Paper is intended to start this process by providing stakeholders with the opportunity to consider and comment on the main issues involved in designing such a mechanism. It has been developed in consultation with APRA, ASIC and the ATO.

Structure of the Issues Paper

The Problem Identification section (Section 2) outlines in detail the issues associated with legacy products and systems. In particular it attempts to provide some information on the quantitative extent of the problem. It also analyses the impact of the problem on a range of stakeholders.

The Objectives section (Section 3) sets out the main reasons for considering a product rationalisation mechanism. It also offers a detailed description of the current processes available for the rationalisation of legacy products in the managed investments, superannuation and life insurance sectors. An overview of the main taxation issues involved is provided.

The Issues section (Section 4) provides a discussion of the main issues involved in designing a product rationalisation mechanism. Background description is given for each issue, followed by one or more questions to which responses are sought.

In the Options section (Section 5) a number of possible options for addressing the issues in relation to legacy products are discussed. The Australian Government at this stage does not endorse any of the options presented. The intention is to provide stakeholders with a sense of how the problem could be addressed, and to encourage them to put forward their own proposals.

The final sections (Sections 6 and 7) provide a summary and a conclusion to the paper, including an indication of what the next steps in the process could be.

Submissions

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

Stakeholders are free to select which issues and options they wish to comment on. You are encouraged to comment on most of the issues set out in Section 4, as well as providing an outline of your preferred option for a product rationalisation mechanism.

2. PROBLEM IDENTIFICATION

2.1 POTENTIAL NEED FOR GOVERNMENT ACTION

Consumer protection in financial markets: Overall objective

Consumer protection in the context of financial markets refers to the forms of regulation aimed at ensuring that retail consumers of financial services have adequate information, are treated fairly and have adequate avenues for redress.

A key objective in establishing consumer protection arrangements is to ensure that consumers maintain their confidence in the financial system and continue to invest their savings through the channels provided by the system. Loss of confidence in the system may result in a reduction in the overall level of savings, as well as an over-allocation of savings to certain products viewed as being safer and more within the control of the average investor. Against a backdrop of an ageing population and increasing demands on the government's fiscal resources neither of these developments is desirable.

Market failure does not, however, justify government intervention in all areas of the financial system. The degree of regulation appropriate in different areas of the financial system is a matter of judgment. It must generally be at its highest level where systemic risk and information asymmetry are most pronounced, and may be reduced where they are less prominent.

Consumer protection: Product rationalisation

Specific factors justifying government intervention with regard to product rationalisation are:

- There is a high level of information asymmetry between product providers and beneficiaries. Beneficiaries do not have as much insight into the economics of the managed funds they have invested in as the persons handling the day-to-day management of the funds. All information required to make a sound decision may not be publicly accessible. Government intervention may therefore be necessary to ensure disclosure of key information to beneficiaries.
- The issues beneficiaries are confronted with are highly complex and require a high level of financial literacy to understand. There is evidence that beneficiaries are reacting to this situation by being excessively cautious and refusing to accept product rationalisation proposals that are clearly in their favour. Without some protective mechanism to engender trust among beneficiaries product rationalisation transfers may therefore be met by high levels of beneficiary distrust and opposition.
- The continuous accumulation of legacy products and the risks they give rise to may eventually create problems with systemic implications. Increasing occurrences of pricing errors might, for example, undermine consumer confidence in the funds management industry with consequences for the level and allocation of savings by consumers. Accordingly, developing product rationalisation options which balance the rights of individual beneficiaries against systemic safety and integrity needs to be considered.

- Product rationalisation issues include some that are not amenable to a market solution, for example the tax consequences of beneficiaries liquidating existing investments. Government intervention is required to provide a solution to such problems.

2.2 PROBLEM DEFINITION

Definition

Legacy products can be broadly defined as financial products that are closed to new clients but remain in force because there are still investors in the product. For present purposes the product areas being considered are superannuation, life policies and managed investments, for which the collective term 'managed funds' is used in this paper.

Consideration will need to be given to the scope of the product providers that are to be included in the problem definition. It could, for instance, be necessary to clarify whether not-for-profit superannuation funds such as public sector and company funds are included, as well as organisations such as friendly societies. This question could also apply to the type of product to be included, for example whether bundled or risk products should be able to be rationalised.

Origin

New managed funds products are regularly introduced as commercial, technological or legislative changes occur. Products are closed (creating a legacy product) for a number of reasons:

- Changes in government policies and legislation in areas such as superannuation and taxation may radically impact on investment choices and cause investment products to become outdated at a single stroke.
 - A good example can be found in the significant changes to the superannuation regime introduced through the 2006 Budget, removing the taxation of superannuation benefits and abolishing Reasonable Benefit Limits. These reforms removed the rationale for entire classes of investment products such as Term Allocated Pensions.
- Market changes reduce the attractiveness of a particular product or dictate the need for products with new features.
- An innovative product offered does not prove to be a success (that is, an institution unsuccessfully targets a niche market).
- Technological changes make a particular product more expensive to administer than other similar products (for example a new IT system deals better with certain types of business).
- Merger and acquisition activities may create duplicate lines of business and products or result in the inheritance of legacy products.

Life companies and superannuation entities are particularly subject to legacy products partly because of the nature and duration of their products and partly due to the multitude of regulatory and tax differences in these areas. With some products in force for 40 years and more, the number of legacy products in these areas will continue to grow.

Ongoing change in all aspects of the industry means that legacy products are continuously being created. This means that the problems which are caused will continue and grow.

2.3 EXTENT OF THE PROBLEM

It is difficult to define in precise terms the volume of legacy products that exist in the market. Industry, through its peak body IFSA, has supplied the following estimates for 2005. These are based on detailed numbers provided by six product providers, and extrapolated estimates relating to the market as a whole:

Legacy book by type of product		
Item	Six providers	Total market
Funds under management in legacy book		
Managed investments	\$11.7 billion	\$37.7 billion
Superannuation	\$47.3 billion	\$152.6 billion
Life insurance	\$9.6 billion	\$31.1 billion
Total	\$68.6 billion	\$221.4 billion

IFSA also supplied the following statistics which throw light on the proportion of legacy products compared to the market as a whole:

Legacy book as percentage of funds under management		
Item	Six Providers	Total market
Total funds under management in legacy book	\$68.6 billion	\$221.4 billion
Total funds under management	\$252.5 billion	\$814 billion
Legacy products as a % of total funds under management	27%	25% to 30%

IFSA estimates conservatively that the funds under management for the market as a whole are held in a total of approximately 6,000 legacy products for the industry as a whole (1,838 for the six providers furnishing detailed statistics). It is not possible to provide an accurate estimate of the number of investors affected by the problem, since any single investor may hold multiple investments. IFSA numbers indicate that the total number of investments held in legacy products amount to about 10 million.

This overall picture is supported by more precise numbers provided by individual investment managers. One major market participant indicated that 35 per cent of its retail customers were invested in legacy products, with a total of 208,932 accounts worth \$5.8 billion in funds under management.

It is thus evident that legacy products could constitute a significant problem affecting issuers and large numbers of investors in the managed funds markets.

2.4 IMPACT ON STAKEHOLDERS

Legacy products impact on various stakeholders in different ways.

Beneficiaries

Potential issues affecting beneficiaries may include declining service levels, the likelihood of mistakes or fraud, higher expenses and adverse tax consequences.

Legacy products may, however, also provide certain benefits to beneficiaries. Examples are strong and cheaply priced capital guarantees as well as low management fees. The preservation of such benefits in a product rationalisation transfer is a key element of any transfer mechanism.

Service levels

Service levels for legacy products may be expected to suffer some deterioration as a result of a number of factors including the following:

- Investment advice given in relation to legacy products may be limited because financial advisers are unfamiliar with the product and its environment. In addition, research houses do not cover closed products, so that no independent assessment and ratings of these funds are available.
- The understanding of call centre and administrative staff with respect to legacy products may be difficult to maintain and support provided for these products may therefore deteriorate over time.
- Legacy products may lack modern service options because they are run on legacy IT systems. Options such as internet access to account information may therefore not be available.

Proper administration of legacy products

The administration of legacy products may become problematic over time due to factors such as the following:

- The increased complexity of the product range makes it difficult for management to keep the needs of all of an institution's products in mind. Management attention may tend to focus on the non-legacy range of products where business growth is concentrated.
- Support for IT or infrastructure requirements may be reduced for a variety of reasons, including increasing difficulty in sourcing the appropriate expertise either in-house or from external suppliers.
- Legacy systems are more prone to errors and fraud, because they generally require more manual processing of data.

Higher expenses

- Legacy products often have fee structures that are no longer competitive in the current environment. A good example is the high exit fees typical of some older life insurance and superannuation products. These fees generally do not expire until the beneficiary reaches retirement age or some other long-range maturity date. They are usually designed to recoup the costs of selling the product, in particular the up-front commissions paid to agents.
- A large number of small products are more expensive to administer than fewer rationalised products. Where possible, institutions are likely to pass on any extra costs of running legacy products to beneficiaries.
- The operation of legacy systems no longer in general use may give rise to additional costs, due to the need for individual solutions to problems and lack of economies of scale.

Last man standing issues

- There may be potential capital gains tax issues for the last beneficiaries standing in certain types of participating life insurance policies (that is tontine effects). Issues may also arise for managed investment products if unit pricing provisions do not fully address the potential tax implications from unrealised capital gains that affect the valuations of assets. While institutions should be accounting for such issues, there is limited opportunity to correct errors as the number of beneficiaries dwindles.

Industry

Legacy products may create a broad range of risks for product providers. Most of these risks relate to increased administrative complexity leading to higher operational risks. In the absence of a product rationalisation mechanism these issues may multiply over time as the number and types of legacy products increase.

Administrative complexity

Legacy products lead to increased and pervasive administrative complexity. This is particularly due to the following:

- legacy IT systems, platforms and infrastructure;
- fragmented processes and procedures relating to a number of areas including unit pricing, reporting requirements and risk management; and
- staff issues including detailed knowledge of legacy products and their support systems becoming limited to declining numbers of staff. This is frequently coupled with ever more intensive training requirements on multiple products and systems for new staff.

Operational risk

- The corollary of administrative complexity is increased operational risk, through both administrative mistakes and fraud. This may for example occur because of the need to substitute manual processes due to lack of functionality in legacy systems. The increased operational risk associated with legacy products is pervasive, impinging on people, systems, internal controls and corporate governance. This is difficult and expensive to manage, with legacy products often excluded from standardised systems, procedures and risk management processes.
- Legacy products may be one of the causes of unit pricing errors. A number of such cases have occurred in the recent past, requiring product providers to compensate beneficiaries who have suffered losses as a consequence.
- Legacy systems may be unable to cope with new accountability and/or disclosure obligations introduced by law. Failure to comply with the requirements may expose product providers to regulatory action and penalties.

Increased expenses

- Legacy products lead to reduced economies of scale, creating inefficiencies and increasing expenses. Even where a product has been very profitable, it becomes less so as the client base declines.
- Where issues arise with legacy products, resolving these issues, through compensation or system changes, has proved to be expensive and time consuming for product providers.

Reputational and legal risk

- Errors and fraud expose product providers to reputational damage, in addition to direct costs. As the risk of error and fraud increases so does the risk of reputational damage and legal action.

Participating policies (tontines)

- Tontines are an additional complication. For life companies with participating policyholders (and to some extent defined benefit superannuation funds) as policies run off, the question arises as to how to manage and allocate excess provisions and reserves. This is a complex issue which will require further detailed consideration during the consultation and policy development process.

Government

- Legacy products require increased effort and resources for supervision and regulation, both for ongoing work and to deal with one-off breaches such as unit pricing errors. The main reason is that a high level of legacy products multiplies the number and complexity of risks to which product providers are exposed. The oversight of these risks requires more intensive supervisory work on the part of regulators such as ASIC and APRA.
- Major problem areas such as unit pricing demand both special one-off handling of specific incidents as well as ongoing work to manage and contain associated risks within acceptable proportions. In the case of unit pricing practices, for instance, ASIC and APRA consulted intensively with industry on how to achieve this, resulting in the joint issue of a good practice guide. Following publication of the guide, resources are now required to oversee the implementation of the practices recommended in the guide.
- The introduction of new accountability and/or disclosure obligations may need to be adapted because of compliance problems arising in legacy products. Regulators may therefore have to dedicate resources to investigating and considering the special situation of legacy products, as well as for the implementation and supervision of any special arrangements put in place.

Economy-wide costs

Potential consequences for the wider economy include:

- Follow-on effects arising from errors and fraud linked to legacy products. The reduced transparency of the risks to which product providers are exposed may cause an accumulation of problems that is not discovered until a major incident occurs. The implications of such an incident may extend beyond the managed funds sector, which is an integral part of the Australian financial system.
- The impact of a major incident may be particularly significant if it occurs in a superannuation product involving the retirement savings of retail investors. Criticism of product providers, industry associations, regulators and the government is likely to ensue, based on a perceived lack of foresight in addressing the problem.
- The overall level of savings may also suffer due to the impact on consumer attitudes of errors and fraud linked to legacy products on consumer attitudes. Sub-optimal levels or allocation of savings may arise, with consequences for the long-term fiscal health of the community.

2.5 QUANTIFICATION OF COSTS

In this section an attempt is made to provide quantitative estimates of some of the costs on stakeholders. The main estimates were provided by IFSA, which offered to collect data on costs that could be eliminated through the introduction of a product rationalisation mechanism.

Some factors impacting on stakeholders are not quantifiable. Examples are the inferior level of service offered to beneficiaries in legacy products, and the impacts of legacy products on the wider economy.

Industry estimate of cost savings

The estimate provided by industry indicates that annual cost savings resulting from the introduction of a product rationalisation mechanism could amount to \$120 million (conservative estimate) to \$350 million (optimistic estimate).

These numbers are based on a survey of six industry participants which were considered to offer a representative sample of the industry as a whole. The information supplied by these six firms was extrapolated across the industry as a whole, resulting in the estimates supplied above.

The savings included in the estimates relate to internal cost items such as the following:

- reduced compliance, risk management, complaint resolution and legal costs relating to legacy products;
- reduced IT system maintenance costs due to the elimination of legacy systems;
- reduced incidence of unit pricing errors; and
- reduced staff training costs.

Unit pricing

Unit pricing refers to the process of determining the price of each unit in a unitised managed fund based on the net asset value of a fund's investments less certain costs such as exit fees, transaction costs and tax adjustments. The process can be extremely complex and is heavily dependent on IT systems. Because of the reliance by legacy products on outdated IT systems, and the consequent requirement for manual adjustments, legacy products may be particularly prone to unit pricing errors.

Cases of unit pricing errors have occurred repeatedly in recent years, and have resulted in substantial amounts of compensation being paid out to affected fund beneficiaries. Press reports estimate that the total amount of compensation paid for the recent cases of unit pricing errors amounts to approximately \$250 million, and this figure may have increased further in the meantime. This figure does not include the cost of management and staff time spent on dealing with the problem, and of upgrades to IT systems introduced as a result of the errors.

Regulation and surveillance of unit pricing processes also gives rise to substantial costs for the industry regulators, which are additional to the estimate given above.

Exit fees

In 2004 ASIC conducted a survey of superannuation funds with the purpose of deriving an estimate of the number of fund beneficiaries subject to exit fees and of the total volume of such fees outstanding at

the time. The survey was confined to the superannuation sector (that is, it did not include managed investments and life products) and requested information on so-called long-expiry fees, which are fees that typically do not expire until the beneficiary reaches a nominated retirement age.

Based on these assumptions ASIC found:

- There are at least 550,000 beneficiaries with investments in legacy products that are subject to such fees.
- If all these beneficiaries exited their funds at the time of the survey, the total amount of exit fees incurred could amount to over \$950 million.
- On average it will take another 15 years before these exit fees will expire.

Summary

While it is not possible to provide a precise figure for the total costs created by legacy products, the examples given in this section indicate that they are substantial. The burden of these costs must either be borne by beneficiaries through higher fees or else by industry through lower profits. There are unfortunately no data available that would allow an estimate of the proportions in which these costs are distributed between consumers and industry.

2.6 SUMMARY: MAIN REASONS FOR CONSIDERING PRODUCT RATIONALISATION

Beneficiaries in legacy products suffer a series of serious disadvantages. The main ones are deteriorating levels of service, poor product design relative to modern products, higher costs and exposure to the risk of losses due to error or fraud. Providing a method of transferring beneficiaries to modern products while preserving equivalent rights and benefits could be an efficient method of addressing these problems.

The empirical evidence shows that many retail investors find it difficult to assess proposals to transfer them into a newer product. As a rule it is therefore difficult to complete the rationalisation of a product based on the agreement of beneficiaries. Establishment of a balanced and fair product rationalisation procedure could address this problem by allowing the transfer of beneficiaries into modern products with at least equivalent rights and benefits.

For industry, the government and in particular the industry regulators, the accumulation of legacy products is causing an increase in the level and complexity of risks affecting the managed funds industry. The recurrence of unit pricing errors in recent years may be a symptom of this problem. Availability of a mechanism to remove legacy products could facilitate the work of regulators and may benefit the stability and integrity of the financial system as a whole.

3. OBJECTIVES

3.1 OBJECTIVES

The objective of establishing a product rationalisation regime is to create a mechanism that allows for the transfer of beneficiaries out of legacy products under the following conditions:

- Beneficiaries receive financial products with at least equivalent rights and benefits, taking into account all relevant aspects of the beneficiaries' rights and benefits in the legacy product as compared to the new product.
- If there are cases where individual beneficiaries suffer losses, adequate compensation is provided.
- Beneficiaries do not suffer adverse tax consequences.
- Industry is provided with an appropriate level of certainty that product rationalisation transfers are not open to subsequent challenge after completion.
- 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.
- Product rationalisation arrangements are, to the extent appropriate, consistent across the superannuation, life insurance and managed investments sectors, to facilitate transparency for beneficiaries and simplify processes for product providers.

3.2 CURRENT REGULATORY PROVISIONS

The current methods available for product rationalisation are widely held to be cumbersome, slow and expensive. In addition, there is no consistency across the three sectors involved. The following sections provide information on the current regulatory provisions for product rationalisation broken down by sector.

3.3 MANAGED INVESTMENT PRODUCTS

Currently, there are no specific legislative provisions in the Corporations Act for the rationalisation of managed investment scheme products, other than to use the winding up provisions in the legislation to wind up the scheme¹ and, with the agreement of the beneficiary, to transfer the beneficiary to another financial product. The scheme's constitution may also make provision for the winding up of the scheme at a specified time or in specified circumstances (section 601NA of the Corporations Act). Past experience has shown that most members are not willing to attend member meetings and find it difficult to understand the legal wording of the motions they are voting on. In addition, the taxation

1 Sections 601NB and 601NC of the Corporations Act.

consequences flowing from the closure of a scheme and transfer to another scheme are generally unattractive to scheme beneficiaries.

The majority of proposals to terminate a scheme and transfer a beneficiary to another scheme are currently, therefore, unlikely to succeed even though termination may be warranted in economic terms.

Unlike the SIS Act, there is no provision allowing the amalgamation or merger of managed investment schemes. The consequence, particularly in a financial environment where there is rapid technological change and significant changes through product innovation, is that a managed investment product provider must maintain what have become obsolete products that are no longer attractive to new customers.

The main issues encountered in those instances where the rationalisation of a managed investment scheme has been attempted include the following:

- constraints on offering reduced entry fees to transferring unitholders as ASIC has not generally granted relief from the Corporations Act under its differential fees policy for such classes of beneficiaries – reduced fees in practice need to be offered for a period to all applicants, not just the transferring members;
- the need to suspend scheme withdrawals while the scheme is being terminated, which may give rise to conflicts with certain parts of the existing legislation;
- issues in relation to ‘in specie’ transfer of assets of the terminating scheme in consideration of the granting of units to transferring beneficiaries;
- dealing with ‘lost’ beneficiaries – there is no Eligible Rollover Fund mechanism for unit trusts as an example; and
- the considerable costs of giving PDS documents to beneficiaries and dealing with issues in relation to investment choice and personal financial advice to transferring unitholders. Each transferring unitholder must make a separate application in accordance with the PDS to become a beneficiary of the new scheme – often triggering the need for substantial advice in relation to investment choice. Scheme operators will generally not provide such advice (due to the Financial Services Guide and Statement of Advice obligations) and this may lead to problems with beneficiaries who do not wish to engage the services of a financial adviser prior to the change.

(Relevant tax issues are discussed separately below.)

Additionally many operators are concerned that such processes can trigger beneficiary exits – and ultimately loss of funds under management for the operator. Whilst this is not an issue for the beneficiary, it certainly will impact on the management consideration of the viability of proceeding with a product rationalisation proposal.

3.4 SUPERANNUATION PRODUCTS

Superannuation funds operate under a trust structure, with a trustee responsible for managing the trust on behalf of beneficiaries. The trustee has discretion to make decisions on behalf of the

beneficiaries, where these discretions are in accordance with the SIS Act. General law and other legislation will also apply.²

Under the SIS Act a trustee must exercise its duties and powers in the best interests of the beneficiaries as a whole. However, trustees must also consider the interests of beneficiaries impartially and not favour one class of beneficiaries at the expense of another. There are diverse views on how this duty is to be interpreted, particularly in the context of product rationalisation.

Definition of a superannuation ‘product’

The first thing to note in the context of rationalising products in superannuation is that there are many mechanisms available for rationalisation, but the concept of the ‘product’ is blurred.

The SIS Act does not consider superannuation ‘products’. A superannuation product can be thought of partly as a mix of the benefits to which a person is currently entitled and partly as the structure under which future benefits will be calculated. There are analogies that can be drawn to ‘reasonable benefit expectations’ from the life insurance context.

The structure of how benefits are calculated and what options are available are not dealt with in the legislation. Sometimes the trust deed will detail aspects of the benefits and often the disclosure documents will do so as well, but the disclosure documents will often allow room for change at the trustees’ discretion.

SIS Act provisions affecting product rationalisation

The SIS Act protects beneficiaries’ right or claims to accrued benefits (undefined) and the amount of those benefits, by limiting the ways in which these may be adversely altered. There is no legislative mechanism to allow an adverse alteration to minimum benefits (other than certain restrictive exceptions such as paying tax or reversing errors). However, for benefits over and above minimum benefits there is an ability to adversely alter the benefit with the approval of at least two thirds of beneficiaries and APRA prior to the adverse alteration.

Further while a beneficiary may choose a superannuation fund because of some aspect of its ‘product’ (such as its insurance options) as long as the benefits accrued to that beneficiary at a point in time are not reduced, the trustee is not restricted in changing aspects of the ‘product’ (such as removal or alteration of the insurance options) provided that it behaves in a manner consistent with its obligations such as acting in the best interests of beneficiaries and the trust deed or disclosure documents do not limit its actions in this regard.

The SIS Act is silent on alterations to benefits (at any level) insofar as the alterations are favourable to beneficiaries.

There is no regulatory or court involvement in any of the existing product rationalisation options, meaning that the final onus is placed on the trustees alone.

Product rationalisation through transfers based on beneficiary consent, to an Eligible Rollover Fund or a successor fund

There are several legislative mechanisms for transferring benefits to another fund. These generally involve a transfer of minimum or withdrawal benefits and will typically result in a change to the

2 This includes general trust law and the Corporations Act.

benefit structure. Transfers are allowed where the beneficiary gives consent to (or requests) the transfer or the transfer is to an Eligible Rollover Fund (ERF) or a successor fund.

A beneficiary may consent to (or request) a transfer of their benefit to another fund or to another product within a fund. Typically this will involve a transfer of withdrawal benefits and will result in a change to the benefit structure. ASIC has given some class order relief to facilitate product rationalisation within superannuation funds: see ASIC CO 04/1574 *Application form and cooling off relief for certain transfers of members between financial products and interests within a superannuation fund* and IR 05/10 *ASIC and APRA facilitate 'intra-fund' superannuation member benefit transfer*. This class order was developed in conjunction with APRA and contains some specific mechanisms to protect the interests of consumers in the context of product rationalisation.

A trustee may transfer a beneficiary's withdrawal benefit to an ERF. Member consent is not required but there should be disclosure of the circumstances when the trustee will take this action. Where this occurs, the beneficiary ceases to have a claim against the original fund. The withdrawal benefit will be transferred to the ERF which must treat the entire benefit as a minimum benefit. The benefit structure will change.

Accrued benefits can be transferred from one fund to a 'successor fund' if the successor fund confers on the beneficiary equivalent rights to the rights that the beneficiary had under the original fund. APRA guidance states that any judgement of whether rights are equivalent is assessed on the equivalency of the bundle of rights provided to beneficiaries by each fund, not solely on an individual change to a specific right, although special consideration should be given to significant rights. Equivalency is established by the trustees of the funds involved in the transfer – the involvement of APRA, a court or the beneficiary is not required. The benefit structure is likely to change. Successor fund transfers are commonly used when superannuation schemes merge, or one scheme is closed and a new scheme replaces it.

3.5 LIFE INSURANCE

A life insurance policy is a contract between a life company and a policy owner.

In order to rationalise an individual legacy life insurance policy, a life company will ordinarily require amendments to the legacy contract. Examples include changing certain contingent rights or the timing of benefits to align with another policy currently on offer. An individual contract can always be amended by an agreement between the parties. However, without the agreement of the policyholder, a life company cannot amend a contract unless specifically provided for within the terms of the contract and/or allowed under legislation. In order to rationalise a legacy product all the legacy contracts in that product range would need to be changed.

A scheme of arrangement under Part 5.1 of the Corporations Act could be used to change creditor rights. Life policy owners are within the broad concept of creditors. Approval by the Court and particular majorities at a meeting of creditors would be required.

The legislative framework governing a life company's ability to amend life insurance contracts and other life products includes the *Life Insurance Act 1995*, the Australian Constitution, the *Insurance Contracts Act 1984* and the *Financial Sector (Transfers of Business) Act 1999*. In addition, in Australia, most of the rules of contract law derive from the common law. Therefore, it is also important to consider past judgements which indicate how the court has made decisions regarding amendments to life insurance contracts.

Life Insurance Act 1995

The Life Act does not provide any mechanism for product rationalisation *within a statutory fund or within a life company* (that is, between statutory funds).

The transfer and amalgamation of life insurance business *between life companies* is dealt with in Part 9 of the Life Act. The Part 9 provisions explicitly deal with altering the liable party under the insurance contracts but are broadly phrased such that it is not prohibited that contract terms be amended more broadly during the transfer. Contract terms have been amended under Part 9 schemes, though it is noted that to date no scheme has been proposed primarily on the basis of rationalising contract terms. One of the main attractions for a life company of a Part 9 transfer is that it does not require the consent of policyholders.

Part 9 provides that the terms of agreement and particulars of the transfer arrangement be included in a scheme which must be confirmed by the Federal Court.

Part 9 requires that a copy of the scheme and any actuarial report on which the scheme is based be given to APRA. APRA has a role in the Part 9 transfer prior to a notice of intention to apply to the Court for confirmation being published. The applicant must provide APRA with a copy of the scheme and each actuarial report on which the scheme is based. A notice must be published, in a form approved by APRA, in the Gazette and certain newspapers and a copy of the scheme made available for public inspection (as specified) for at least 15 days. A summary of the scheme (approved by APRA) must be given to every affected policy owner (unless the court dispenses with this requirement). Fifteen days after meeting these requirements the company may apply to the Court for confirmation of the scheme.

APRA may also arrange for an independent actuarial report and is entitled to be heard in Court. Although APRA approval is not required before the Court takes action, as a practical matter it is unlikely that a Court would approve a scheme should APRA discover and object to material deficiencies in the scheme.

Part 9 is silent on the criteria to be considered by the Court in making a confirmation and it is therefore sensible to look at what the Court *does* consider when making this decision. In summary these matters include:

- compliance with procedural requirements;
- discretionary considerations including APRA's comments in Court, the actuarial opinions, the applicants involved, any alterations to the policies and concerns raised by policyholders; and
- consideration of whether the policy owners are adequately protected and whether their interests will be adversely affected by a transfer of life insurance business. It should be noted that policy owner protection is not explicitly mentioned in Part 9 and is only linked to the section through reading the initial object of the Act.

It is interesting to note that in all of the judgements examined the court confirmed the proposed scheme – only two with modifications³. APRA objected to none of the schemes. However, in all cases APRA was heavily involved prior to the scheme being submitted to Court and all issues of concern to APRA were dealt with prior to the hearing.

3 (1) Application of Royal & Sun Alliance Life Assurance Ltd [2000] FCA 1259 (31 August 2000) – modified by adding two clauses; (2) Application of Royal & Sun Alliance Life Assurance Australia Ltd [2002] FCA 1392 (1 November 2002) – modifications not stated.

Recent case study

The case study concerns the amalgamation of two life insurance businesses operated within the same group, in this case a major bank. Directors of the entities involved attested to the court that the main reasons for the proposed amalgamation was to achieve cost savings which would assist in maintaining premiums, charges and fees paid by policy holders at competitive levels. It was also suggested that the larger size of the amalgamated entity would provide additional security to policy holders.

The court confirmed the proposed amalgamation and in doing so noted that its primary concern was to ensure that the interests of policy holders were protected in the process. The main factors considered by the court included the following:

- The procedural steps prescribed by the legislation were followed. The main purpose of these steps is to ensure that the affected policy holders and APRA are informed about the proposed amalgamation scheme.
- Confirmation was provided by two actuaries, one of whom was independent, that there would be no adverse effect on policy holders as a result of the amalgamation.
- Confirmation was provided by APRA that it had no objection to the scheme. It was noted that this was a factor of material significance in the court's considerations.
- The costs of the scheme were not to be borne by policy holders.

The concerns of three individual policy holders were also brought to the attention of the court which considered whether they had been properly addressed before confirming the amalgamation proposal.

What does the actuary take into account in a Part 9 transfer?

There is no Australian Actuarial Standard on giving advice for transfers and amalgamations for life insurance business. However, it appears that actuaries refer to a paper entitled 'Actuarial advice on transfers and amalgamations of life insurance business'⁴. A summary of the suggested considerations in this paper are:

- policyholder benefit expectations – a series of considerations depending on whether the business is participating or not. Expected value of discretionary or participating benefits under reasonable circumstances;
- policy owner security – including whether any reduction in absolute security is in practice material; and
- equity considerations – including for both the transferring business and the policy owners already in the destination fund.

Insurance Contracts Act 1984

The Insurance Contracts Act⁵ provides a uniform set of rules to govern the relationship between companies⁶ and contract holders.

4 By James and Turner presented to the 1997 Convention of the Institute of Actuaries of Australia.

5 Administered by ASIC.

The Insurance Contracts Act implies a provision into every contract which requires that each party act towards the other in the *utmost good faith*. This duty requires the parties to act honestly and fairly toward each other and breach of this duty by either party enables the other to claim damages for any loss arising from the breach. Further, the duty ensures that a company cannot rely on a provision in a contract where to do so would be to fail to act with the utmost good faith. In view of this clear statement of the duty of good faith, a general power to review the terms of a contract was considered unnecessary in the Insurance Contracts Act.⁷

Financial Sector (Transfers of Business) Act 1999

The *Financial Sector (Transfers of Business) Act 1999* is an alternative legislative mechanism for transferring life insurance business between life companies in certain situations.

The mechanisms introduced by this Act provide an effective prudential regulation tool to facilitate a quick and efficient transfer of business in the case of financial distress, with the aim of preventing further losses, and maintaining investor confidence in the financial services industry.

3.6 AUSTRALIAN CONSTITUTION

Section 51(xxxi) of the Australian Constitution provides that the Commonwealth Parliament may make laws with respect to ‘the acquisition of property on just terms’. This serves as a guarantee to individuals against the acquisition of property, through law, without just recompense. This protection applies to beneficiaries of managed funds protecting them from amendments to contracts through legislation, where the amendments allow an overall diminution of the beneficiary’s actual or contingent rights if the removal of existing rights is not authorised by the terms of the trust or contractual relationship.

3.7 SUMMARY — SIMILARITIES AND DIFFERENCES BETWEEN INDUSTRIES

The fundamental problem of legacy products is common to all three industry sectors covered in this paper. However, the legal and institutional environment in which the problem is embedded varies considerably between sectors. In particular, the existing arrangements for transferring beneficiaries between products differ considerably.

- In the managed investments schemes sector, the current provisions in the Corporations Act do not contain specific provisions dealing with the rationalisation of legacy products. However, there are provisions for winding up a scheme at the initiative of either the members or the responsible entity, subject to a majority vote as defined in the legislation. There are no provisions envisaging the transfer of the beneficiaries of the previous scheme into a new product.
 - There are however no provisions for specifically addressing the taxation consequences of such a winding up. In many instances, scheme beneficiaries may become subject to significant tax liabilities because of a decision to wind up the scheme. This would constitute a significant obstacle to obtaining member approval for such proposals.

6 The application of the Insurance Contracts Act extends to contracts and proposed contracts of insurance (including life insurance and general insurance) with certain exceptions such as reinsurance (refer section 9 for full list of general exceptions). Certain sections within the Act also provide specific exceptions.

7 Refer Explanatory Memorandum, Insurance Contracts Bill 1984, Paragraph 40.

- In the superannuation sector product rationalisation transfers can be effected under current law using the successor fund provisions and based on the special obligations and functions of fund trustees. Such transfers are consequently being conducted under current law, with relatively limited or even no involvement by APRA.
 - In the superannuation sector introducing a product rationalisation mechanism may have the effect of ‘raising the bar’ in providing for more stringent independent assessment of product rationalisation proposals than occurs under current circumstances.
- The life insurance sector’s main characteristic is that each policy constitutes a separate contract between the beneficiary and the product provider. The current transfer possibilities are limited, and are mainly confined to Part 9 transfers under the Life Act. However, such transfers can only occur between life companies and are subject to Federal Court approval. There is extensive scope for APRA involvement in the court approval process. Outside the Part 9 process there is no possibility for achieving a product rationalisation transfer other than by obtaining the individual agreement of each policy holder.
 - Introducing a compulsory transfer mechanism could in effect allow for individual contracts to be cancelled. It is evident that such a measure could only be contemplated under stringent protection of the rights and benefits enjoyed by beneficiaries under the original policy.

It is thus evident that the differences between the three sectors are significant and need to be considered, particularly in assessing the possibility of establishing a common mechanism covering all three sectors.

3.8 OVERSEAS JURISDICTIONS

A limited amount of research has been conducted to illustrate the treatment of legacy products in the United Kingdom, the European Union and the United States of America (USA).

United Kingdom

- Collective investment schemes are regulated by the Financial Services Authority (FSA). The Handbook issued by the FSA (Handbook) contains a number of provisions relevant to the termination or rationalisation of such schemes.
 - The Handbook makes allowance for rationalisation of collective investment schemes through schemes of arrangement, which involve the issue of units in another fund in exchange for assets of the previous fund. Such exchanges are largely subject to unitholder approval.
 - The Handbook also makes provision for the termination of commercially unviable schemes. Such terminations must be approved by the FSA upon application, and are subject to the provision of specified information, including a confirmation by the depositary (a trustee or other person exercising the function of a trustee) that alternative steps including a scheme of arrangement (as defined in the Handbook) have been considered but have proved not to be feasible.
- With respect to life insurance products, the FSA has introduced special requirements relating to closed funds that are being run off; such closed funds may be regarded as legacy products in the terminology of this paper.

Product Rationalisation

- Life companies that close a fund to new business must submit a run-off plan to the FSA demonstrating how it will effect a full and fair distribution of the assets in the fund. They must also provide a range of information to their policyholders in relation to the decision to close the fund, including what options are open to policyholders affected by the decision.
- However, no mechanism is provided to rationalise closed life products.

European Union

- There is currently no mechanism in force that would allow for the cross-border merger of managed investment schemes in the European Union (EU). The result is an inefficient structure in the funds management industry with a large number of funds affected by high costs due to a lack of scale in their operations.
- One report estimates the number of funds in the EU in 2004 as 31,142 with total funds under management of €5,477 billion. The comparative figures for the USA are cited as 7,992 funds managing €7,734 billion.
- Discussions on creating a cross-border product rationalisation mechanism in the EU are ongoing, but no specific proposals have been put forward to date.
 - Draft proposals made by the European Commission in November 2006 to amend the regulatory framework for investment funds include the facilitation of product rationalisation involving cross-border fund mergers. The Commission intends to finalise its formal proposal by the end of 2007.

USA

- The US market has, as mentioned, a relatively low number of managed investment schemes (mainly mutual funds, as defined in the US). The latest numbers reported by the industry association show that there were 8,117 mutual funds as of December 2006 with total funds under management of US\$10,414 trillion.
- The total number of mutual funds has decreased slightly in recent years, the peak having been attained in 2001 with a total of 8,519 funds. The reason is not that the fund industry in the USA is stagnating, but that it is relatively easy to merge or liquidate funds.
- Figures for 2005 show that about 525 new funds were established, but that about an equal number of funds were merged or liquidated, leaving a net increase of only about 34 funds in comparison to 2004. In contrast, a recent media report stated that in Australia 543 new funds were created in 2006, taking the total number of funds to over 9,500.
- Mutual funds in the USA are in most respects nationally regulated through the *Investment Company Act of 1940*. This act contains a specific rule regulating the mergers of funds. The rule places particular responsibility on the board of directors of the mutual fund company in ensuring that mergers are conducted in the best interests of the shareholders of the merging company (who are in effect the beneficiaries of the fund). Subject to certain conditions being met, mergers may proceed without the approval of shareholders.
- Furthermore, mutual funds are able to liquidate under the provisions of the law under which they are incorporated. Mutual funds incorporate as companies or business trusts under state laws. Liquidation procedures may therefore vary depending on the law of the state in which the fund is incorporated.

3.9 TAXATION — IMPACT OF CURRENT LEGISLATION

The current taxation legislation presents a number of issues in the design of a process for the rationalisation of legacy products. Consideration and resolution of these issues is of crucial importance to the establishment of a product rationalisation process.

There is a wide range of potential product rationalisation scenarios. Each scenario requires consideration of both the operation of current law at member/investor and investment entity level, and the implications of any proposed changes in terms of both the scenario itself and the wider taxation system.

The main income tax issues identified are as follows:

- Product rationalisation scenarios involving a disposal or other realisation of member or investor interests may, depending on their nature and the overall circumstances, be characterised as being on revenue account or on capital account. This requires the consideration of a number of potentially applicable taxation rules, including capital gains tax (CGT).
- Product rationalisation scenarios involving restructures and asset transfers between investment entities may give rise to a range of taxation consequences, including CGT.
- Product rationalisation scenarios involving the transfer of assets and business activities between entities raise other taxation issues including the treatment of tax benefits, such as carried forward losses, in the transfer entity.
- Product rationalisation scenarios involving the movement of superannuation fund members between funds or products have the potential for a range of taxation impacts at the member level.
- Product rationalisation scenarios involving life insurance policies may trigger consequences governing the taxation treatment of life insurance bonuses at the policyholder level.
- Product rationalisation scenarios will also need to be evaluated in terms of non income tax taxation regimes such as the goods and services tax (GST) and state taxes.

4. ISSUES

In this section a number of issues are put forward for discussion and comment. The issues need to be discussed and tentative conclusions reached before a product rationalisation mechanism can be proposed. Examples of possible options are provided in the following section.

4.1 AVAILABILITY

Product rationalisation could be viewed as a one-off opportunity to deal with the accumulation of legacy products at a point in time. Should industry or other stakeholders conclude at some point in the future that there was a renewed need for such a mechanism, then a fresh case would have to be made to the government. Justification of this approach may be sought in the view that product rationalisation constitutes a serious interference with the fundamental rights of beneficiaries and should only be adopted in the most pressing circumstances.

Alternately, the view could be taken that the creation of legacy products is an ongoing process due to factors such as technological developments, market innovation and regulatory change. Product rationalisation should therefore be a permanent mechanism available to deal with legacy products as they arise. While it is true that the fundamental rights of beneficiaries may be infringed in the process, the product rationalisation mechanism itself could contain checks and balances to ensure that this would not result in losses or other disadvantages to those affected.

Discussion point

- 1 Should product rationalisation be limited to a one off opportunity or should it be available on an ongoing basis? What are the reasons for your views?

4.2 THRESHOLD REQUIREMENTS

Should there be any threshold requirements determining which products are to be allowed to be rationalised? The rationale for having such requirements could be to narrow the scope of products which could be rationalised. For example, if the view were taken that rationalisation should be limited to products that are outdated as determined by certain criteria, then this could exclude products that have failed for other unrelated reasons such as misjudgement of the market potential by the product provider.

If threshold requirements are to be imposed, this could require formulating a definition of a legacy product in order to assess whether any given product qualifies under the definition. Alternatively a list of valid reasons could be specified for which product rationalisation transfers should be allowed to proceed. Such reasons could include overall advantages to individual beneficiaries through being moved to modern products, but could also include other reasons such as the removal of systemic or other risks.

In this context consideration needs to be given as to whether it is necessary to define the scope of product providers and product types that are to be included in a product rationalisation mechanism.

As mentioned earlier, necessary clarifications in this respect may affect providers such as friendly societies or not-for-profit funds as well as products such as risk and bundled products.

The definition of a legacy product, or the specification of the criteria for approving product rationalisation proposals, could be difficult to pin down in practice. Room for exercising judgment would need to be provided to the entity assessing the product or proposal.

A different view is that product rationalisations should be allowed to proceed whenever it can be demonstrated through an appropriate test that beneficiaries do not suffer any disadvantages as a result of the transfer, on the basis that beneficiaries are protected while other advantages are achieved such as the removal of systemic risk and the promotion of technological and product innovation. However, in this case there may be situations where rationalisations are proposed not because products have become outdated, but for other reasons such as an inability to achieve economies of scale. This may be seen as a significant shift in the scope of the proposal as a whole.

A related issue concerns the right to bring forward product rationalisation proposals. While the initiative in this regard may be expected to lie mainly with industry, consideration may be given to whether other stakeholders such as beneficiaries or regulators should have the right to do so as well. It may, for instance, be useful for a regulator to have this right as an instrument for managing systemic risk.

A further issue concerns the right of beneficiaries to object to a product rationalisation proposal. Key questions include whether beneficiaries should have this right, and whether there should be a critical level of objections beyond which special measures should apply. An example could be a requirement to call a general meeting of members of a registered managed investment scheme if objections are received from members who in aggregate hold more than 10 per cent by value of interests in the scheme that is to be rationalised.

However, while there is provision for general meetings for holders of interests in registered managed investment schemes, no similar mechanism exists in the case of superannuation funds and life insurance products. Further, the value of life policies and defined benefit superannuation funds will depend on the individual's circumstances and it could be difficult to determine how voting could apply. It may therefore not be appropriate to extend such a requirement to product rationalisation cases in these areas.

Alternatively, objections surpassing a defined critical level may trigger more stringent approval requirements. An example could be a requirement for court approval if objections surpassed the critical level. The issue of establishing flexible procedures and requirements that are adaptable to individual circumstances is discussed in more general terms under Section 4.4 below.

Discussion points

- 2 Should there be threshold requirements limiting which products may be rationalised? If yes, what should these requirements be, and why do you think they are justified? Is it necessary to specify which product providers and product types are to be included? If yes, which ones should be included or excluded, and for what reasons?
- 3 Which parties should have the right to bring forward product rationalisation proposals?
- 4 Should beneficiaries have the right to object to product rationalisation proposals? If so, what special measures should apply if objections exceed a certain critical level, and what should the critical level be?

4.3 COMPULSORY TRANSFER OF BENEFICIARIES

Under the current provisions in the law some legacy products can only be rationalised with the consent of beneficiaries of the scheme. Disregarding Part 9 transfers, for life products all the beneficiaries have to agree before a product rationalisation can proceed. Experience shows that there is frequently a minority of beneficiaries who will not consent.

Reports have noted that beneficiary responses to rationalisation proposals are not always predictable, even if the proposal is clearly in their interests. One explanation may be that some beneficiaries lack the expertise to assess and understand product rationalisation proposals, and will therefore either not respond at all or provide a negative response.

In other cases beneficiaries may have objective reasons for refusing to agree such as the potential loss of benefits. Subjective reasons such as a lack of trust in the motives of the product provider may also play a role.

The advantages of product rationalisation only accrue once all of the beneficiaries in a scheme can be transferred to a new product. Product providers are otherwise forced to maintain the legacy product with all its disadvantages and problems for the sake of a small number of remaining beneficiaries. The latter suffer even more disadvantages as the costs of maintaining the product are distributed over a smaller number of remaining beneficiaries.

Any solution to the problem would therefore appear to require the compulsory transfer of beneficiaries out of legacy products. This means that subject to investor protection measures such as the equivalent rights and benefits test, approval by some independent entity, a compensation mechanism and others, some beneficiaries may be transferred from the legacy to a successor product without giving their explicit consent.

Discussion points

- 5 Should compulsory transfer of beneficiaries be a part of a product rationalisation mechanism?
- 6 If not, how would you address the issue of a small remnant of beneficiaries, for instance in a life insurance product, refusing to consent to a rationalisation proposal and thereby preventing the realisation of the benefits of the proposal?

4.4 EQUIVALENT RIGHTS AND BENEFITS TEST — CONTENTS

Product rationalisation transfers may constitute a unilateral change to the terms and conditions of an agreement with the beneficiary (see discussion under Section 4.3 above). As a matter of principle they should therefore only be allowed to proceed after it has been demonstrated that beneficiaries will not suffer a loss of rights and benefits as a result of the transfer.

The key element in assessing product rationalisation proposals is therefore a test for equivalent rights and benefits enjoyed by beneficiaries before and after the transfer. The nature and contents of this test, and the process by which it is applied, are of crucial importance in creating a fair and balanced product rationalisation mechanism. This test could presumably be applied following an assessment as to whether the product and proposal met any threshold requirements for consideration as a legacy product (see section 4.2).

The Regulation Taskforce Recommendation 5.19, which was accepted by the Government, refers to ensuring that consumers of the products ‘are not disadvantaged’. We take this to mean that each beneficiary should enjoy equivalent rights and benefits in the new product and should not suffer any detriment as a consequence of the rationalisation. Where any detriment arises beneficiaries must have the right to compensation.

In order to achieve flexibility and a wide range of applicability the equivalence test should not require strict one-to-one equivalence of rights and benefits. Guidance may be required on how the equivalence of bundles of benefits for an individual investor should be assessed.

Consideration would need to be given to the level of detail with which the equivalence test should be specified and where any principles or details should sit in the regulatory structure – for example, in the Act, regulations or guidance by the assessor.

Some benefits may not be easily quantified or otherwise valued, in which case it would not be possible to include them in the evaluation. There may therefore be no alternative other than replicating them in the new product or not rationalising the legacy product. The legislation may therefore need to state this as a general requirement, and possibly also include certain specific benefits that would have to be replicated.

The manner in which the no-disadvantage test is applied to beneficiaries should also be specified. To provide certainty that an adequate assessment is conducted, legislation may for example need to provide that rationalisation proposals would at a minimum require that the product provider is satisfied that no beneficiary will be adversely affected. It may also have to be specified how product providers are to demonstrate that no disadvantage will arise.

Discussion points

- 7 Should the legislation itself contain a detailed test? If so, what should the contents of the test be?
- 8 If the legislation does not prescribe the test in detail, what high level principles should it contain? Should guidance be provided for each principle? Who should provide this guidance?
- 9 How should the test be applied to beneficiaries? Do you think it is feasible to require analysis of each beneficiary and their circumstances? How should product providers demonstrate that the no detriment test has been satisfied?

4.5 EQUIVALENT RIGHTS AND BENEFITS TEST — PROCEDURES

This issue concerns which entity should apply the test and what procedures it should follow. As a general principle it appears necessary that an independent entity should be chosen to exercise this function in order to avoid conflicts of interest.

The three sectors

However, it is noted that in all three sectors there are specific entities that are legally obliged to act in the best interests of beneficiaries. This could be viewed as reducing the need for independent assessment of product rationalisation proposals.

- Superannuation funds have a trustee whose function it is to act in and safeguard the best interests of beneficiaries. Superannuation trustees are in a position to approve transfers to successor funds even under current legislation.
- Managed investment schemes do not have a strictly equivalent function to the trustee in superannuation funds though responsible entities do hold scheme property on trust. It is noted, however, that the Corporations Act requires responsible entities to act in the best interests of beneficiaries and to give priority to the interests of beneficiaries if there is a conflict of interest. Broadly similar obligations apply to life companies and their directors in relation to the interests of policyholders. A question in this context would be whether the obligations of these entities are as strong as those applying to superannuation trustees, and whether the same treatment can therefore be applied to all three areas.
- The Insurance Contracts Act requires the parties to an insurance contract to act with the utmost good faith towards each other. This may be seen as further strengthening the obligation of life companies to act honestly and fairly towards policy owners.

The differences between the three sectors are relevant in considering whether the same product rationalisation procedures can be applied to them, or whether it would be necessary to create separate procedures.

Independent assessment

A number of solutions for independent assessment are conceivable, involving for example an independent expert such as an actuary, the regulators, a specially appointed tribunal or the courts. It is also possible that a combination of two or more of these entities could be preferred, or that the approving entity could vary depending on the complexity and degree of contentiousness of the case.

- Evaluations and opinions by independent experts on specific proposals may be prescribed regarding the crucial question whether the equivalence test is satisfied. Actuaries, lawyers and finance practitioners with special expertise in relevant areas such as superannuation and managed investments are examples of such experts.
- Approval by an independent tribunal is another possible solution to the problem of establishing a process that is seen by stakeholders to be independent and fair. This could be based on an approach applied in several areas such as superannuation-related complaints and trade practices. The underlying idea could be to establish an independent body staffed with members who possess the necessary expertise to examine product rationalisation proposals thoroughly and efficiently. Approval by a tribunal could be relatively efficient but may not provide for the same level of certainty as a process based on court approval.
- An alternative solution is to require court approval for all or certain product rationalisation proposals, which would provide all stakeholders with the highest level of certainty achievable. The courts may also have some expertise that is relevant to product rationalisation cases, such as experience in dealing with issues in contract law and equity. However, court processes may be slow and are expensive, which may discourage stakeholders from proposing product rationalisations.

Any provisions requiring court or tribunal approval would need to be framed following consideration as to the appropriate role for the relevant body. It could, for example, follow the provisions in Part 9 of the Life Insurance Act.

Tribunal: Governance and procedures

If an independent tribunal were to have a role in the approval process, its governance and procedures would need to be considered. The following may need to be considered:

- rules concerning the establishment, operation and funding of the entity;
- if it involved a hearing, rules of evidence, nature of representation and other procedural matters;
- rules concerning specific evidence required such as actuarial reports and others; and
- rights of complaint and/or appeal and relevant procedures.

It is also possible that the prescribed procedures could take account of differences between product rationalisation cases, so that a straightforward case could be subject to simpler requirements whereas a more complex case could face more stringent procedures. This could for instance be left to the discretion of the regulator to decide, after an analysis of the detailed circumstances and taking into consideration the submission of the product provider.

The role of the regulators

The role of the regulators (unless they are designated as the final approving entity) should also be examined. A precedent that may be considered in this context is APRA's current role in Part 9 transfers for life products, which extends to vetting of schemes and actuarial reports, the right to require an independent actuarial report, and the right to be heard in court.

The main justification for a special role for regulatory agencies is that they are familiar with the industry and its products, have developed relevant expertise, but at the same time are independent of the industry. They may therefore play an important role in designing and implementing a product rationalisation regime that takes due account of beneficiary concerns and is perceived by beneficiaries to protect their interests.

If a special role is considered desirable for a regulator, the question of which regulator should play this role arises. Several factors will need to be weighed up during the process. Many of the issues arising in this context are more consumer protection orientated and therefore belong more within ASIC's area of responsibility. APRA, on the other hand, may be more familiar with certain industry sectors, notably the superannuation and life insurance sectors, where it may already have an involvement in at least some successor fund and Part 9 transfers.

Approval powers

It will also be necessary to address the question of what powers the approving entity should have. It could, for instance, be restricted to approving or rejecting proposals as made, or be allowed to grant conditional approvals. Responses to this question need to take into account the limitations on powers of various types of entities. A regulator or a tribunal, for instance, cannot exercise judicial powers and would therefore be limited to administering the relevant provisions in the law. Review and appeal mechanisms would also need to be considered.

Differences between products

In the interest of simplicity it could be desirable to have a consistent solution applying to all product rationalisation transfers. There are, however, considerable differences in structure and legal rights and obligations between different products which may create difficulties in achieving this objective:

- The SIS Act contains a number of provisions which may impact on product rationalisation transfers. For example, there are provisions protecting certain types of benefits such as ‘minimum’, ‘withdrawal’ and ‘accrued’ benefits from adverse alteration. These provisions may constitute significant impediments to product rationalisation transfers and may therefore require separate treatment under any legislation.
- In the case of life products all obligations are contractually defined and each policy constitutes a separate contract between the policy holder and the product provider. As set out in section 3.5, there is currently no provision in the legislation that would allow the rationalisation of a legacy life product other than through a Part 9 transfer. The fact that compulsory product rationalisation transfers would require the cancellation of valid contracts may present strong arguments for a separate approval procedure for life policies.
- Differences in the legal obligations imposed on superannuation trustees, responsible entities of managed investment schemes and life companies have been discussed above and may also play a role in considering whether a single process can apply to all three sectors.

In view of the pronounced differences between the individual sectors it may not be possible to have a single product rationalisation approval process. The attempt may still be made in such a case to reduce the differences between the separate processes to a minimum. For instance, a set of comprehensive principles could be developed while making provision for flexibility in their implementation to take account of differences between industry sectors.

Discussion points

- 10 Which entity should be responsible for applying the equivalent rights and benefits test? Should there be more than one entity involved? If so, what would the difference in responsibilities be among the entities involved?
- 11 What rules should apply to the procedures of the approving entity and what should the scope of its powers be?
- 12 Should the regulators have a special role in the approval process? If yes, what should this role be? Is there a case for making a distinction between the regulators, given their different responsibilities?
- 13 Can there be a single process covering all types of products? If yes, how should the differences be addressed? If no, what separate processes should there be and in what respects should they be differentiated?

4.6 TAXATION

An important part of any scheme to facilitate product rationalisation transfers is the taxation consequences of the transfers. If beneficiaries incur tax consequences as a result of the transfers, then it will not be possible to satisfy the no-detriment test.

A number of taxation issues have been identified which need to be addressed as part of a product rationalisation mechanism. Some of these issues, and some indications of how they could be addressed, are set out below. Other issues that may need to be addressed could depend on the exact nature of the product rationalisation mechanism adopted and may therefore need to be considered at a later stage in the process.

The disposal of assets held in legacy products may realise a capital gain for the holders of the assets and therefore a potential CGT liability. Allowing any capital gains realised as part of the rationalisation process to be rolled over into a replacement asset is likely to be an important element of any product rationalisation mechanism.

- Capital gains may arise if assets of an entity providing legacy products are disposed of, or if member/investor interests in legacy products are realised, as part of a product rationalisation transfer.
- The extent to which additional roll-over should be made available at either investment entity or member/investor level will be a policy issue in designing any such mechanisms.

Other provisions of the income tax law may result in a tax liability arising on the realisation of assets as part of any product rationalisation process. The potential application of such provisions in product rationalisations needs to be considered. For example:

- Currently, gains from the disposal of traditional securities are specifically included in assessable income under section 26BB of the *Income Tax Assessment Act 1936*.
- In some situations, gains on disposals of assets may also give rise to ordinary assessable income. This occurs where the nature of the gain is such that it would be characterised as income according to ordinary concepts under principles laid down by the Courts over the years.
- CGT roll-overs do not apply to gains which are ordinary income or non-CGT statutory income.

Specific provisions in the income tax law specify the taxation treatment of bonuses paid on life insurance policies. If a policy has been held for less than ten years, the policyholder is taxed on some or all of the proceeds and is entitled to a tax offset to compensate for the tax paid by the life insurance company. The ten year period starts from the date of commencement of risk under the policy.

- Consideration needs to be given to whether rules are needed to ensure that the ten year period does not restart as a consequence of product rationalisation arrangements.

Consultation with the relevant units within Treasury and the Australian Taxation Office will be held to consider these and other issues identified in further detail.

Other issues may arise that have not been discussed to date. For example, liability for State taxes may arise because of a product rationalisation transfer. Further consideration of these issues may be required if they present a genuine obstacle to product rationalisation transfers.

Discussion points

- 14 Do you agree with the issues as outlined above and with the general approaches proposed to address them? If not, why not? Are there other ways to achieve the intended outcomes?
- 15 Are there other tax issues that should be considered? What are they, why are they important in this context and how do you think they could be addressed?

4.7 DISCLOSURE

Appropriate information in relation to a product rationalisation proposal should be provided to beneficiaries and a sufficient period of time allowed for them to consider their options where available.

It is noted that beneficiaries may have certain options which they may take up in preference to the product rationalisation scheme offered by the product provider. Beneficiaries in managed investment schemes may always opt to liquidate their investments and withdraw the funds for their own use, subject to any liquidity constraints. Beneficiaries in superannuation funds may not liquidate their investments under the preservation rules, but can exercise the right of choice given to them by the Australian Government under its Choice of Fund policy.

The issue arises in this context what information should be provided to beneficiaries concerning proposed product rationalisation schemes and the options open to them. This information may be prescribed in the legislation, and other requirements may also be considered appropriate, for instance approval by a regulator.

A question has been asked above under section 4.2 in relation to potential objections by beneficiaries and the consequences that could ensue if objections exceeded a certain critical level. If such a mechanism were to be included, any right of beneficiaries to object and the ensuing consequences would have to be disclosed in detail.

Arrangements relating to disclosure requirements need to take into account the existing obligations imposed under Chapter 7 of the Corporations Act.

Procedures may need to be developed for dealing with lost beneficiaries who cannot be tracked and their investments.

Discussion points

- 16 With respect to pre rationalisation disclosure, what information would need to be given to beneficiaries? Should the disclosure documentation need approval, for example by the regulator? Should the regulator or other approving entity be able to impose special requirements in individual cases?
- 17 If a right to object is included, how much time should beneficiaries be given to respond? Is there a need for special rules to apply if beneficiaries do not respond?
- 18 What procedures should apply in the case of lost beneficiaries? Should they be automatically transferred to the new product? If yes, what conditions should apply? If not, what should be done with their investments?
- 19 As regards post rationalisation disclosure, should there be any special requirements other than notification of new allocations?

4.8 COMPLAINT AND COMPENSATION MECHANISM

A complaints and compensation mechanism could address the issue that the particular circumstances of an individual beneficiary have been overlooked. As a result the individual beneficiary may be disadvantaged by a particular product rationalisation proposal. This may happen even if the majority of beneficiaries derive benefits from the proposal. The complaint and compensation mechanism could

be designed to provide a convenient method for such individuals to put forward their cases and be awarded appropriate remedies after a fair and speedy hearing.

There are various entities in existence which assess complaints and compensation claims in the financial sector. Examples are the external dispute resolution schemes in the financial services sector, which are approved by ASIC, or the Superannuation Complaints Tribunal. It is possible that one or more of these could operate as appropriate entities for assessing complaints and compensation claims for product rationalisation cases.

Alternatively, complaints and compensation claims could be assessed by a new entity to be established in the context of the introduction of a product rationalisation mechanism. This need not imply another dedicated dispute resolution scheme, but could for instance be the same entity responsible for assessing and approving product rationalisation proposals. An example could be the independent tribunal discussed under section 4.5, if it were established.

Additional questions would then need to be answered in relation to the processes that would apply as well as the nature of the remedies that could be awarded:

- Would the compensation mechanism be allowed to interfere in ongoing product rationalisation cases?
- Would it be limited to hearing complaints and claims relating to completed transfers?
- Who would be responsible for bearing the costs of the mechanism and its awards?
- How long should the right to claim compensation persist (as it is conceivable that there will be cases where claims will emerge some time after the transfer has occurred)?

Discussion points

- 20 Can one entity cover complaints and compensation regarding all products, or is more than one required? If one entity only, which entity would you suggest? If more than one, which ones would you suggest and how should their functions be separated?
- 21 What process and timeframes should apply to applications to this body? Should there be a time limit within which claims can be brought forward?
- 22 What is the appropriate scope of the claims and complaints the scheme may hear? Should it be limited to assessing claims for monetary compensation? If the scheme may determine compensation amounts, should it be subject to some sort of cap? If the scope of the mechanism were wider than monetary compensation, what types of remedies should the scheme be able to impose? How long should the right to claim compensation endure after the product rationalisation has occurred?
- 23 Who should bear the costs associated with the operation of the entity and the compensation awards? Should it be the product providers, the schemes or funds, or should there be some measure of sharing, and if so what should it be? Alternative arrangements are also conceivable, for example a compensation pool funded by the industry. Is this or some other arrangement a preferable solution? If so, what should it be and how should it operate?

4.9 ALLOCATION OF COSTS AND BENEFITS

Preparation and implementation of product rationalisation proposals are likely to give rise to considerable costs. Examples are fees for independent expert advice, costs of communicating with beneficiaries and the costs of operating the approval and compensation mechanisms discussed above.

Conversely product rationalisation transfers will also generate cost savings, notably in the form of reduced operating and administrative costs achieved through the removal of legacy systems.

The question addressed in this issue is who receives the costs and savings of implementing a product rationalisation mechanism. Should they stay where they fall naturally or should they be reallocated among stakeholders, notably between product providers (including their shareholders) and beneficiaries of the schemes and funds affected by product rationalisation proposals.

Discussion point

- 24 Which parties should bear or enjoy the costs and benefits arising out of product rationalisation transfers? Should they be attributable solely to product providers and their shareholders, or should there be some sharing between shareholders and beneficiaries? If so, how could these costs and benefits be calculated?

4.10 EXIT FEES

High exit fees are a characteristic of some legacy products due to the way in which their payment flows were structured. As shown above, there are a substantial number of beneficiaries that may be affected by such fees, with their total amount estimated by ASIC at over \$950 million in a 2004 survey.

Experience shows that beneficiaries are unwilling to pay these fees which may become due when a transfer out of a legacy product is being considered, especially when low account balances are involved. Beneficiaries are thus locked into particular products, even if they wish to transfer to a different product.

The issue of high exit fees may be handled on a case-by-case basis through the equivalent rights and benefits test. It is possible that the fee structure may simply be replicated in the modern product.

Legal issues arise where a proposed solution imposes losses or other disadvantages on beneficiaries or product providers without adequate compensation. This could, for instance, be the case if beneficiaries are compulsorily transferred out of a legacy product and thereby become liable for exit fees. Conversely, a similar problem could arise if a solution envisaged a compulsory reduction of exit fees.

Discussion points

- 25 Should there be a special mechanism for resolving the problem of high exit fees? If so, what should it be?
- 26 Alternatively should exit fees be addressed as part of the equivalence test?

4.11 ONGOING MINIMISATION OF LEGACY PRODUCTS

The creation of legacy products is not confined to particular occasions, but is an ongoing process based on changes in legislation, technological developments and product innovation. In addition to establishing a mechanism for product rationalisation, reducing the rate of creation of legacy products could assist in managing this problem.

Methods for achieving this could be based on contractual provisions facilitating the transfer of beneficiaries, or the use of structures that would support such transfers. In such a case no regulatory intervention may be required to achieve this objective but the equivalence test and investor protections discussed in this paper would not apply.

Discussion point

- 27 Do you think that regulatory action is required to achieve a reduction in the rate of creation of legacy products, and if so what specific measures would have to be adopted?
- 28 What action do you think that businesses could take to reduce the rate of creation of legacy products, thereby lessening the need for government intervention? What measures could be taken to encourage businesses to adopt such practices?

4.12 EXISTING BENEFICIARIES

In many cases beneficiaries will be transferred out of legacy products into managed funds with existing beneficiaries. The question arises whether any special safeguards are required to ensure that continuing holders of products in a fund into which another fund is rationalised are not disadvantaged.

Discussion point

- 29 Do you think that beneficiaries of existing managed funds into which beneficiaries of legacy products are transferred require special protection measures?

4.13 TECHNICAL IMPLEMENTATION

The main laws that could require amendment for the creation of a product rationalisation mechanism are the SIS Act, the Corporations Act (Chapter 5C, possible also Chapter 7 on disclosure requirements) and the Life Act. Depending on the tax solutions adopted amendments to the tax laws may also be required.

A number of issues may arise with respect to the Insurance Contracts Act. For example amendments may be needed to clarify whether the policy owner would have a new duty of disclosure under section 21 of the Act if the policy owner's circumstances have changed since the original contract was entered into. Clarification might also be needed whether the three year period under section 29(3) of the Act during which an insurer can avoid a contract for innocent non-disclosure or misrepresentation start over again (that is, so the insurer has a further three years to avoid the contract).

These issues will need to be addressed when an outline of the product rationalisation mechanism is settled.

4.14 PARTICIPATING POLICIES

Participating policies may require special treatment as they pose specific problems and issues. Examples are the capital gains issues arising for last beneficiaries standing and the problem of how to manage and allocate excess provisions and reserves.

Discussion point

- 30 What are the specific problems posed by participating policies, and how should they be addressed?

4.15 OTHER ISSUES

Discussion point

- 31 Are there any other issues that need to be considered? How should they be addressed?

5. OPTIONS

The issues discussed in the last section represent individual elements that are required to make up a complete product rationalisation mechanism. These elements can be combined in different ways to create possible options for addressing the problem of legacy products. These options will have to be evaluated and compared in order to select the best possible solution to the problem.

In addition to addressing the specific issues set out above, you are encouraged to include in your submission to this paper your preferred option for a product rationalisation mechanism. In order to provide some idea of the range of options available, a number of them are presented in outline below.

The options presented here are provided for illustrative purposes only, and are intended to give some idea of the kinds of processes that could be considered. No preference is implied for any of the options listed here, and persons making submissions are free to propose other options not included below.

If you propose an alternative option, you are requested to do so in as much detail as possible, and to include the reasons for supporting it. An assessment of the impact of the preferred option on the various stakeholders in the process is desirable, including an evaluation of the costs and benefits associated with the option.

Option 1 — do nothing

This option would leave the current situation unchanged. Removal of legacy products would continue to proceed to a limited extent, particularly in the superannuation sector. A small number of product rationalisation transfers in managed investment schemes may also be able to proceed based on the agreement of scheme members. For life insurance products Part 9 procedures involving Federal Court approval would remain the only way to remove legacy products, other than through transfers based on the consent of policy owners.

Comment:

The main argument supporting this option would be that the current arrangements are appropriate, and provide an acceptable balance of costs and benefits as well as the protection of contractual rights. The relatively liberal regime for superannuation funds is justified given the special position and obligations of trustees. Because there is no strictly equivalent institution in managed investments and life insurance, it is appropriate that the hurdle for gaining approvals for product rationalisations is set higher in these areas. However, this option disregards the costs imposed by legacy products on stakeholders and the financial system as a whole.

Option 2 — one-off process

This option would allow a one-off clearing of legacy products from the system. It could comprise the following main elements:

- threshold conditions regulating which products would be admitted to the process;
- a special tribunal to assess product rationalisation proposals;
- an equivalent rights and benefits test to be used by the tribunal in assessing proposals;

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- a requirement for the provision of an independent opinion on the outcome of the rights and benefits test as applied in the proposal;
- a right for regulators to be heard by the tribunal;
- a right for beneficiaries to submit claims for compensation to the tribunal, which is to assess them and make awards; and
- special taxation treatment of transfers of beneficiaries for approved product rationalisations.

Comment:

The main argument supporting this option is that the rationalisation of legacy products constitutes an extraordinary interference with established rights and arrangements. It should therefore not be permitted to proceed on a regular basis, but should be viewed as an exceptional measure to deal with an accumulation of problems. Future requests for a similar action would have to be submitted afresh on an as-needs basis.

The main weakness of this option is that it does not provide for the rationalisation of future legacy products. Given the pace of regulatory change as well as of product and technological innovation it can be foreseen that there will not be an end to the creation of legacy products. It may therefore be questioned whether it makes sense to opt for a one-off solution when it is clear that the same problem will need to be addressed again in the future.

Option 3 — product provider self-assessment with independent confirmation

The key characteristic of this option is that it places the main responsibility for assessing product rationalisation proposals on product providers themselves. It could include the following elements:

- Threshold conditions could be used to define which products could be rationalised.
- An equivalent rights and benefits test would be prescribed.
- The product provider would be required to provide a detailed description of the application of the equivalent rights and benefits test.
- The product provider's analysis would have to be supported by an independent expert opinion. It would have to be specified what would constitute an acceptable opinion for this purpose.
- Further controls could be included in the mechanism. For instance, a requirement could be made that the product provider's analysis and the independent opinion would have to be copied to the regulator, who could be given powers to intervene if it were considered necessary.
- A complaint and compensation scheme; further details of the scheme would have to be specified in the legislation.

Comment:

This option places the main responsibility for operating the product rationalisation mechanism on industry itself. However, the extent of independent control and supervision included in the option can be varied, and could impose significant controls on product providers' actions. Relevant elements for achieving this would be the role of the regulators or some other independent party, as well as the detailed provisions of the complaints and compensation scheme.

This option would place a high degree of reliance on the statutory duties of product providers to act in the best interests of beneficiaries. Relevant provisions include the duty of directors of a life company to give priority to policy owners, as specified in the Life Act, or the provisions in Chapter 5C of the Corporations Act relating to the duties of the responsible entity as well as its officers and employees. A question to be answered in this context would be whether the current role of superannuation trustees in successor fund transfers should be preserved as part of this option.

Overall, the main question in relation to this option concerns the degree to which product providers can be relied on to act in the best interests of beneficiaries, given the existing statutory requirements cited above, and the extent of independent control required to ensure this occurs. In addition, the statutory requirements applying to product providers could be strengthened as part of the measures implementing this option.

Option 4 — regulator approval

This option could include the following:

- Threshold conditions could apply.
- Right of industry to bring forward product rationalisation proposals, possibly augmented by the right of beneficiaries and regulators to do likewise. The main element of any proposal must be a detailed application of the prescribed equivalence test, with clearly satisfactory results for beneficiaries.
- Product rationalisation proposals may be supported by expert assessment, but such assessment would not be mandatory. This would avoid imposing unnecessary processes where the benefits to beneficiaries are unequivocal. However, regulatory agencies could in certain cases require the provision of an expert opinion.
- Consultation with beneficiaries would be required, allowing sufficient time for beneficiaries to consider proposals. Consideration should be given to including additional checks if a certain proportion of beneficiaries object.
- Assessment by a regulatory agency would be required. Options available to the agency could include the following:
 - rejection, with a right of appeal, for instance to the Administrative Appeals Tribunal (AAT);
 - unconditional approval;
 - approval with conditions – for example an obligation to provide an independent expert assessment, or to provide compensation to individual beneficiaries or classes of beneficiaries;
 - referral to a court for assessment and decision – this would apply in exceptional cases only;
 - : Decisions to refer proposals to the court could be restricted such that they could only be made with regard to a number of specific factors. Examples could be the presence of factors such as ambiguous results of the equivalent rights and benefits test, high impact due to particularly large numbers of beneficiaries being affected, and the potential need to compensate large groups of beneficiaries; and
- Consideration would need to be given as to which entity should hear and decide compensation claims.

Comment:

This option could be justified by the argument that the regulators are well-placed to assess product rationalisation proposals, given their understanding of the market and their independent position. However, the view could also be taken that regulators do not have sufficient expertise to assess all aspects of product rationalisation proposals, and that their regulatory role could be regarded by some stakeholders as creating a bias towards rejecting proposals or referring them to another institution for final assessment. The role of the regulators would be of limited practical use if they were to refer most cases, for instance to the courts, for decision. In addition, if a regulator has approved a proposal, it may be less willing to pursue appropriate remedies if the implementation of the proposal leads to inappropriate results. The key questions in relation to this option are therefore whether regulators are qualified to exercise the functions given to them, and whether it is reasonable to expect regulators to exercise them according to the intent of the legislation.

Furthermore, decisions made by a regulator do not carry the same weight of authority as a court judgment and may be open to challenge through the Administrative Appeals Tribunal and the courts. Consideration would therefore be required as to whether this drawback is compensated for by the advantages of a process based on assessment by a regulatory agency, such as efficiency and understanding of the industry.

Any function for the courts under this or subsequent options would need to be carefully framed in the light of their appropriate role.

Option 5 — independent tribunal approval

All the elements of Option 2 would remain the same, subject to the following:

- This option would remain available on an ongoing basis.
- Examination and approval by an independent tribunal for all product rationalisation proposals would be mandatory.
 - The constitution of the tribunal would have to be prescribed in the legislation. In addition, the qualifications, experience and expertise of the tribunal members would be included in the legislation.
- Regulatory agencies may play an important role in the assessment process under this option, however final approval power would be reserved for the tribunal.
- Referral to a court by the tribunal for final approval would only be available in case of exceptional circumstances or would not be available at all (noting however that it will not be possible to exclude appeals to a court for judicial review of tribunal decisions).
- Consideration would need to be given as to which entity should hear and decide on compensation claims.

Comment:

The attraction of this option is that it provides a clear method for achieving an independent and expert assessment of product rationalisation proposals. The establishment and operation of such a tribunal, on the other hand, would create costs, which would ultimately have to be borne by stakeholders or taxpayers in general. The key question is therefore whether the costs associated with this option are justified in view of the benefits it provides.

Furthermore, decisions made by a tribunal do not carry the same weight of authority as a court judgment and may be open to challenge through the courts. On the other hand, a tribunal system would provide efficiency and flexibility.

Option 6 — court approval

- Under this option all product rationalisation proposals would have to obtain court approval in order to proceed.
- Regulatory agencies might play an important role in the assessment process under this option, however final approval power would be reserved for the court.
- Compensation claims could be heard by the court or dispute resolution scheme to ensure access by beneficiaries to fast and inexpensive redress.

Comment:

The main advantage of this option is that it would provide all stakeholders with the highest level of assurance that an independent assessment of product rationalisation proposals will be conducted. Appeals against court judgements may also be expected to be limited to the most controversial cases only. However, court processes are slow and would impose significant costs on industry in particular, due to the need for legal advice and assistance in submitting proposals to the court. It may therefore be expected that under this option a relatively smaller number of product rationalisation proposals would be brought forward, as industry would require a commensurate level of benefits to justify the high costs involved. The key question with respect to this option is therefore whether the extensive protection of beneficiaries' interests justifies the costs imposed on industry.

Furthermore, any provisions requiring court approval would need to be framed following consideration as to the appropriate role for the court, as mentioned under Option 4.

6. SUMMARY

The information requested in this paper falls into two categories, as follows:

- Information on specific issues, as set out in Section 4. Submissions on these issues are requested to address them in detail, and to set out in full the reasons why a particular issue is supported or opposed in a particular fashion.
- Information relating to preferred options for product rationalisation mechanisms, as set out in Section 5. It is again emphasised that the Government does not endorse any of the options presented. The range of options presented is not comprehensive, and you are therefore invited to comment on the options or to submit new options. In all cases you are requested to include the reasons why a particular option is preferred, and in what way it is superior compared to the other options.

Information on making written submissions, including the deadline, is provided on the page immediately following the title page.

It is important to understand the impact of any specific measures or options on stakeholders, and in particular to obtain detailed information on the costs of these measures or options. In providing a submission, you are therefore asked to provide detailed cost information. If detailed actual costs are not available, estimates made on a reasonable basis would also be welcome.

- For example, if a submission supports or opposes a requirement for court approval for product rationalisation approvals, information on the costs to businesses of such a requirement should be included. This could consist of the cost of legal advice, services of a barrister and internal costs for staff time spent in preparing the court submission. Such information could for instance be provided by a person who had been involved in a Part 9 transfer under the Life Act.
- Other relevant cost data would include the preparation of independent expert reports (for example actuarial reports), in-house costs for preparing a product rationalisation proposal, and costs associated with disclosure and communication with beneficiaries in relation to product rationalisation proposals.

Quantitative cost and other information in relation to the issue of legacy products would also assist. This would include information concerning:

- the extent of the legacy product problem, such as the number of legacy products, or the total funds under management in legacy products;
- the costs of legacy products, for example direct costs related to the maintenance and operation of legacy systems, costs associated with errors or fraud related to legacy systems, and higher fees paid by beneficiaries;
- information on indirect costs imposed on stakeholders is also of interest. Examples are reduced rates of return attributable to legacy products, or costs related to management time spent on dealing with legacy products.

This information is needed to undertake the regulation impact statement which is required before any significant new regulation is made.

7. CONCLUSION AND NEXT STEPS

The Australian Government is aware of the problems created by legacy products.

The first step in addressing it is to consult with stakeholders on the issues which need to be considered in order to identify an appropriate solution.

The main reasons for supporting the introduction of a product rationalisation mechanism are the benefits that it could provide for consumers, the removal of systemic risks and the support of product and technological innovation.

However, any product rationalisation mechanism would need to include adequate measures to protect beneficiaries' interests. At the same time a balance needs to be struck to avoid imposing excessive costs and delays on industry through an overly protective regime, since this could result in fewer product rationalisation proposals being brought forward, thus defeating the point of the exercise.

This Issues Paper is therefore being released to promote discussion and seek submissions from all stakeholders in this matter. Given the complexity of this issue, ample time is being allowed for stakeholders to prepare their submissions.

Following its release, Treasury officers will provide it to State and Territory officers with a view to commencing a discussion regarding the imposition of State/Territory taxes in connection with product rationalisation mechanisms.

After receiving the responses to this Issues Paper, it is intended that the analysis of the submissions will be used to formulate a detailed proposal for a product rationalisation mechanism. This proposal would then form the basis of a second round of consultation.

This assumes that a fundamental consensus exists among stakeholders supporting the introduction of a product rationalisation mechanism. The Australian Government may reconsider its approach if the submissions from stakeholders indicate that such a consensus does not exist.