PRODUCT RATIONALISATION WORKING GROUP PROPOSAL

RECOMMENDATION 43

Introduce a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investment sectors.

BACKGROUND:

A comprehensive product rationalisation regime would provide better consumer outcomes by creating greater efficiency in the industry and access to more modern and relevant offers for consumers. Indeed, the current mechanism for rationalising managed investment schemes, life insurance legacy products and other related products or structures is too difficult and expensive. As a result consumers remain in financial products that suffer from a higher cost base and carry operational risk from outdated technology and products that are difficult to support.

A comprehensive proposal for product rationalisation was first put to Government by the FSC in July 2005. That submission was followed in May 2006 with a regulation impact statement also prepared by the FSC.

Unfortunately, the problem still exists and has resulted in the creation of over 600 legacy structures amongst FSC members, each of which may contain multiple products, affecting an estimated 2.44 million consumers.

The FSC surveyed members to develop conservative estimates of the benefits that an effective product rationalisation regime would deliver in the near term:

- 38 individual IT systems could be closed, of 79 legacy IT systems across the sample;
- 286 life products and 77 managed investment schemes could be closed; and
- $22.6 billion in funds under management could be transferred to contemporary products.

FSC members forecast that through these changes they could achieve $94 million in cost reductions over the near term through a staged rationalisation program, which would result in a more efficient and sustainable industry.

Although a financial product may be closed and is of low scale, it still needs a broad range of services similar to those provided to an on-sale product, including technology, accounting, audit, disclosure, legal, actuarial, product and tax services as well as being supported by an administration team and front line call centre staff who need to be trained on the particular product.

Continuing to manage bespoke financial products that are highly aged and whose promotion predates the majority of employees' tenure is a significant challenge for most financial services companies. This is both from an operational risk perspective but also in maintaining aged systems that are typically less agile or economical to run and keep updated (including for regulatory change), less able to support a modern service to customers and more challenging to locate appropriately skilled support staff.

For example, while each product within a particular group shares certain characteristics, there are typically individual differences which must be monitored to ensure promises made to customers are met and this layering of iterative legacy product complexity is a material compliance burden, a barrier to organisational change and diverts resources from more customer value added activity.

If the problem isn't fixed, providers will not be able to rationalise products in the overall interests of consumers. It is going to become increasingly risky and expensive to administer products. Consumers would become worse off due to increasing costs (exacerbating underinsurance) and reduced service, and also run the risk of being trapped in out of date products – products which may have become obsolete as a result of changing tax, legal and social security regimes and also shifts in consumer sentiment and demand.

Furthermore, it is hard for product issuers to justify investment in new tools for legacy products and other enhancements beyond what is legally required. Because of this consumers of legacy products lose out on that upside benefit. For example, a legacy product will not typically offer online access and other digital features that are being built into new products.

PRODUCT RATIONALISATION IN SUPERANNUATION

The current rationalisation regime in superannuation works well from a consumer and product issuer perspective and has been used considerably by the industry in recent years to the benefit of all industry stakeholders.

The central thrust of the regime is that a consumer can be transferred to another product, or have their existing product changed, broadly if the Trustee determines it to be in the interests of those consumers.

On a transfer between products, the precise nature of the test is determined by whether the customer is moving:

- between different super funds (called a successor fund transfer or SFT); or
- to another product within the same super fund (known as an intra-fund transfer or IFT).

In both cases, if the bundle of rights consumers enjoy in the current product can be met by an alternative product that passes the consumer interest test, the trustee may approve the transfer without consumer consent. The key difference is that for a SFT, the test is undertaken at an individual consumer level, versus as a group of consumers for an IFT. In both cases, if the bundle of rights consumers enjoy in the current product is equivalent (for SFTs) or bettered (for IFTs) in the new product, the trustee may approve the transfer without consumer consent.

Our view is that the rationalisation regime for other product types should be modelled on that for super, with the exception that the relevant test be undertaken at the collective consumer level in all cases to improve stakeholder outcomes. To do otherwise could prevent some rationalisations that are in the interests of the majority from going ahead because of a minority impact.

FSC PROPOSAL:

The FSC's proposed product rationalisation mechanism leverages that of superannuation and is focused on consumer protection and industry efficiency. The proposal outlined in the attached submission ensures that:

- Consumer rights are protected through the requirement for the product issuer to ensure the change is in the interests of consumers.

- A consumer interest test is applied at the collective level, rather than the individual level to enable the maximum number of consumers and other stakeholders to benefit, driving overall industry efficiency.

The proposed product rationalisation framework would result in improved disclosure, lower operational risk and access to more relevant and modern product solutions for consumers. It would also promote competition and productivity within the industry and reduce costs for industry participants.

The FSC proposes a common rationalisation regime that can be applied to the following product types or structures:

- Life insurance products (risk and investment)
- Managed Investment Schemes and Investor Directed Portfolio Services
- Underlying investment structures, including deferred annuities

Common rationalisation regime

A consistent approach to rationalising legacy products is an achievable outcome and is desirable for financial product providers. The FSC proposes that a standardised consumer interest test would apply across financial products, but excluding superannuation which has an existing rationalisation mechanism.

a. Consumer interest test

The aim of a financial product provider in rationalising legacy products is to remove economically inefficient or out-dated products and to elicit a fair outcome for consumers.

To achieve that outcome for consumers, the FSC proposes that a consumer interest test apply at group or class level to assess whether a financial product or group of products can be rationalised.

As in Part 9 of the *Life Insurance Act* 1995 and successor fund transfer processes of Part 18 of the *Superannuation Industry (Supervision) Act* 1993, the consumer interest test should be:

- Based on the monetary benefits and rights enjoyed by the consumer as at the Transition Date (rather than intangible product features, unless these represent a monetary benefit or right);
- Determined as the accrued value of those benefits;
- Calculated by an independent expert or the Appointed Actuary; and
- Based on the overall bundle of rights consumers have and not at the individual feature level.

b. Tax implications and relief requirements

There is a range of tax implications that flow from activities designed to rationalise legacy products. As a general rule the FSC's position is that the tax attributes of the original vehicle should be able to roll over to the destination vehicle.

This document is intended to be a high-level principles based approach to the issues and there will ultimately be further consultation required to refine some aspects of the proposed approach.

We would be pleased to provide further input into this process on specific drafting points and also in relation to expanding upon the taxation and relief elements in more detail.

Appendix A to this submission outlines the FSC's rationale and proposal for product rationalisation in the following areas:

1. Financial product rationalisation scenarios; and
2. Application of rationalisation mechanism for different product types.

APPENDIX C – PROPOSED PRODUCT RATIONALISATION MECHANISM

1. FINANCIAL PRODUCT RATIONALISATION SCENARIOS

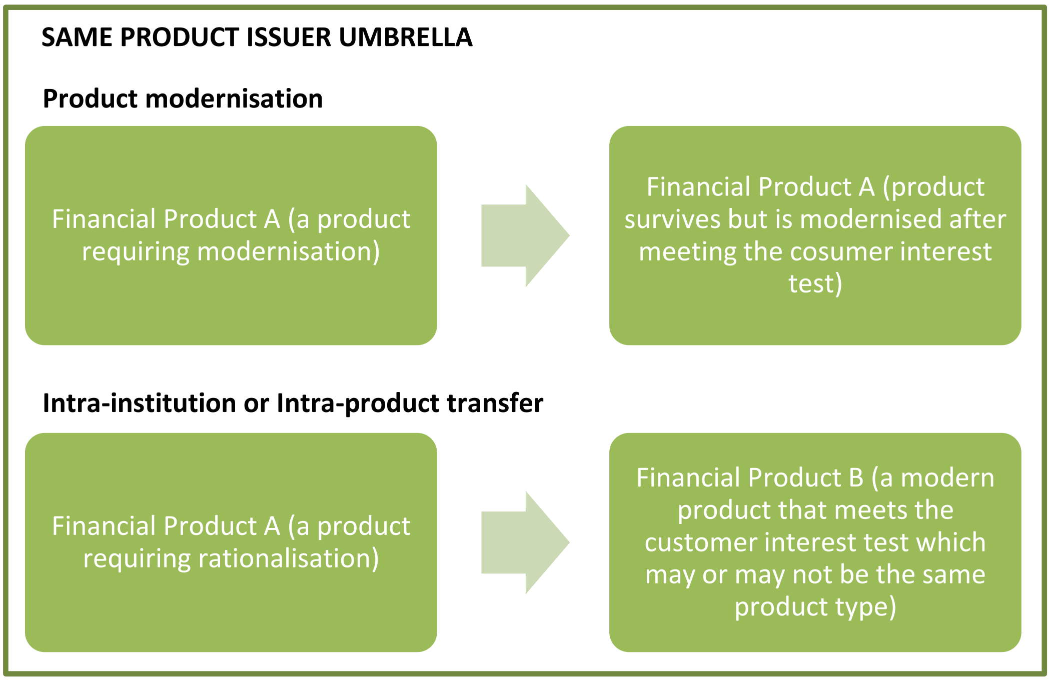
Under Part 9 of the Life Insurance Act 1995 (Cth) and the Financial Sector (Business Transfer and Group Restructure) Act 1999 (Cth), there is a process for the merger of the statutory funds of two life companies or the transfer of part of the life insurance business between them however this is too complex and expensive for wide scale use.

Enabling consumers to move into a more competitive, efficient and modern product will improve competition and efficiency in the industry. In practice, achieving this outcome may involve the transfer or simplification of a financial product under a range of different scenarios. The FSC has captured these scenarios below and believes all can be achieved by leveraging the common framework proposed above. We would be pleased to provide more detailed information and also to elaborate further on being able to transfer consumers between product types which would provide positive consumer and industry outcomes.

a. Internal simplification

This scenario involves:

- Transferring a consumer from one product to another issued by the same product issuer; or
- Leaving the consumer in the product they are currently in and changing it, or an underlying structure which supports the product, such as an investment structure.

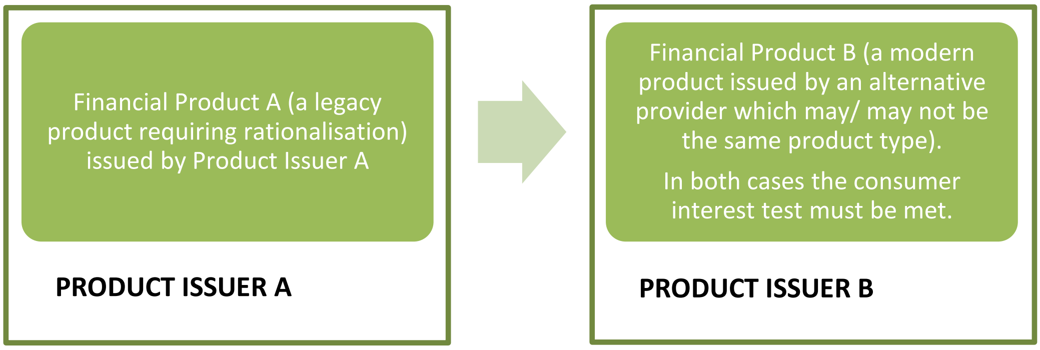


b. External simplification

This scenario involves:

- Transferring a consumer from one product to another issued by a different product issuer, whether that product is of the same kind or a different financial product. In practical terms this could be a life product to life product transfer or the transfer from one financial product to another financial product; or
- Substituting the current product issuer for another product issuer.

Inter-institution transfer or Inter-product transfer



c. Termination of product

When a product is no longer economically viable and has a very small number of remaining customers, a product provider can either terminate a product on the basis of the interests of consumers (returning their monies) or transfer the client(s) to a substitute product.

This mechanism would obviate the need to increase fees to in order to pass on the high costs of operating legacy products and the continuing cross-subsidisation of legacy products by the majority of consumers who are invested in contemporary products. This termination mechanism should be able to be exercised unilaterally by the product issuer and override any individual arrangements between the product issuer and the client.

2. APPLICATION OF TEST UNDER DIFFERENT PRODUCT TYPES

a. Life Insurance

Life Insurers cannot rationalise products under the current legislation, which requires the life insurer to ensure each individual policyholder is no worse off under any individual policy condition, despite such change being:

- In the **interest of the majority** of consumers.
- **As an overall package** of benefits and services, in the interests of an individual consumer, despite an individual condition being less advantageous.

While in theory consumer consent could be obtained to upgrade consumers, this is impractical. Under Part 9 of the Life Insurance Act 1995 (Cth) there is a process for the merger of the statutory funds of two life insurance companies. However, this provides limited practical benefit even in a merger (as only minor changes can be made) and does not assist a life insurer rationalise its own portfolio.

Over time and to meet prevailing market needs, a life insurer may have issued hundreds of individual products, which may also have been further customised for individual customers. Given the significant variation between policy terms, life insurers are effectively locked out from upgrading consumers to modern products as the current exercise of ensuring all consumers are no worse off is too arduous and unsustainable for life insurers to participate in.

The lack of a product rationalisation framework for life insurance is a significant barrier to product innovation in life insurance because life insurers don't want to be left with small portfolios of policies from innovation initiatives which are costly to administer. This stifles product innovation and in fact makes innovation very difficult. Ultimately the consumer loses as a result

Reinsurers also play an important role in the viability of any future rationalisation framework as should they reinsure the policy, they would need to consent to changes. Reinsurers should provide consent on the basis of independent actuarial advice confirming that they are not materially impacted.

Recommendation:

1. Amend the Insurance Contracts Act to allow life companies to unilaterally amend policy terms where a consumer interest test is satisfied when comparing the overall bundle of benefits the consumer currently has versus the proposed changes.
2. If a reinsurer is involved, independent actuarial advice should be sought prior to the action that confirms reinsurers are not materially impacted by product rationalisation and if so, they should provide consent to the change.

b. Managed Investment Schemes and IDPS

Many organisations operate managed investment schemes (registered or unregistered) which, due to their size or numbers of members are no longer efficient to operate. This may arise because a scheme is closed to new members and over time redemptions have reduced the size of the scheme (but the cost base has stayed the same or increased) or because mergers have resulted in duplication in the investment strategies of funds in the group.

For example, post merger a group may operate two emerging markets funds and it would be more efficient (and cost savings could be passed on to investors) if the funds could be merged.

It is difficult under the current legal framework to transfer investors from inefficient schemes to more modern or more sufficient schemes. For registered and unregistered schemes generally a ‘trust scheme’ is needed which requires meetings to be convened and generally requires applications to court for judicial advice, the outcomes of which are uncertain and the costs of which can be significant.

If transfers are not viable the only other real alternative is termination. Again, the outcome may be uncertain and the costs may be significant as a meeting may be required to amend the trust deed or seek member approval (a meeting is mandated by the Corporations Act for a registered scheme) and judicial advice may be needed. The termination of the fund may also crystallise any capital gains for the investor.

As these managed investment scheme problems arise in relation to all types of schemes the FSC proposes that the solution be made available to all categories of managed investment scheme, including:

- IDPSs, which are generally classified as unregistered managed investment schemes (because investors have the expectation of cost savings or access to investments that would not otherwise be available to them and are exempted from registration where they meet certain conditions); and
- IDPS-like schemes which operate similarly to IDPSs but are registered managed investment schemes.

Recommendation:

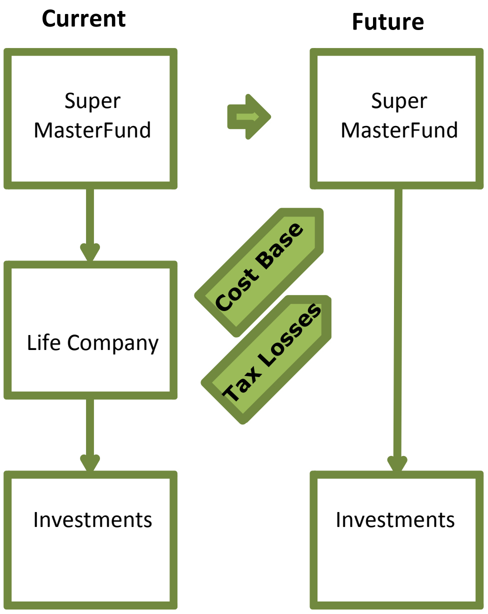
3. Permit the transfer of all the members from a legacy scheme (e.g. a scheme that is economically inefficient or out-dated) to another fund where the responsible entity or trustee considers on reasonable grounds that those transfers are in the interests of those members as a whole.
4. Introduce a more streamlined regulatory regime for the transfer of REs within a corporate group.

c. Underlying Structures

Facilitation of transfers between investment portfolios applicable to a financial product should apply to both life-backed investment portfolios as well as investment portfolios structured as managed investment schemes or pooled superannuation trusts. Such facilitation would allow for a transfer between portfolios without consent of affected investor(s) but subject to the consumer interest test.

For example, “life-backed superannuation product” is a commercial term that describes a superannuation fund offering super products with investment options invested through an investment policy from a life insurance company. The investment policy comprises of investment options similar to those offered by the superannuation fund.

The life insurance company invests the moneys “assigned” to those investment options under the investment policy under a mandate which supports the investment aims of the corresponding option offered by the super fund (e.g. growth option, conservative option, or in the case of the default fund, the life company would commonly invest the moneys assigned to either a balanced investment option or the appropriate life cycle options).



For many providers, the investment structure of life-backed superannuation products is a legacy of retail funds seeking to utilise benefits associated with the life insurance structure which were of greater benefit historically than today. For many providers, these benefits have now been eroded however the trustee and consumers remain “trapped” in the life policy structure which now results in an unnecessary impost of inefficiency, additional cost and red tape. Importantly, our proposal mirrors that of the existing rollover relief for the merger of superannuation funds, so is building on an already established framework.

Recommendation:

5. Having met the consumer interest test, the transfer of investment portfolios including life backed superannuation products to a modernised regime should involve:

   a. Members are switched from an investment option under a life policy to which they are invested into a corresponding investment option that is offered in the new directly investing product in the same superannuation fund.
   b. The manager of the investment option (in the case of life policy, the life company) disposes of the assets (the units in investment trusts)
   c. The superannuation MasterFund will withdraw its investment policy with the Life Company.
   d. The Superannuation MasterFund will acquire the same units in investment trusts, as disposed of by the manager of the investment option.
   e. The rationalisation mechanism should operate without tax consequences.

6. Having met the consumer interest test, the transfer of life company superannuation annuities to a modernised regime (a regulated superannuation fund) should involve:

   a. Policyholders switched from an investment option under the superannuation policy to which they are invested into a corresponding investment option that is offered in the superannuation fund.
   b. The life company transfers the assets to the trustee of the superannuation fund.
   c. The policyholder's rights under the superannuation annuity are extinguished and replaced by an interest in the superannuation fund.
   d. The superannuation fund will acquire the same units in the investment trust as disposed by the life company or acquire an investment-only policy with the life company relating to the same investment options.

3. OTHER CONSIDERATIONS

Overall the super mechanism works well from a consumer and product issuer perspective and has been used considerably by the industry in recent years to the benefit of all industry stakeholders.

Although it is outside of the scope of the FSI Panel's recommendation, which deals exclusively with life insurance and managed investment scheme legacy books and underlying structure rationalisation, there is scope to revisit one element of the current superannuation rationalisation mechanism.

Allowing holders of a term allocated pensions (TAPs) and other exempt pensions to easily commute their benefits into an account-based pension where they no longer receive any social security benefit from maintaining the pension would be a valuable improvement to the existing regime.

This would provide existing TAP and other pension holders with greater flexibility and choice in relation to how they can manage their retirement benefits.