FSC Submission on the 2018–19 Federal Budget

December 2017

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List of Recommendations

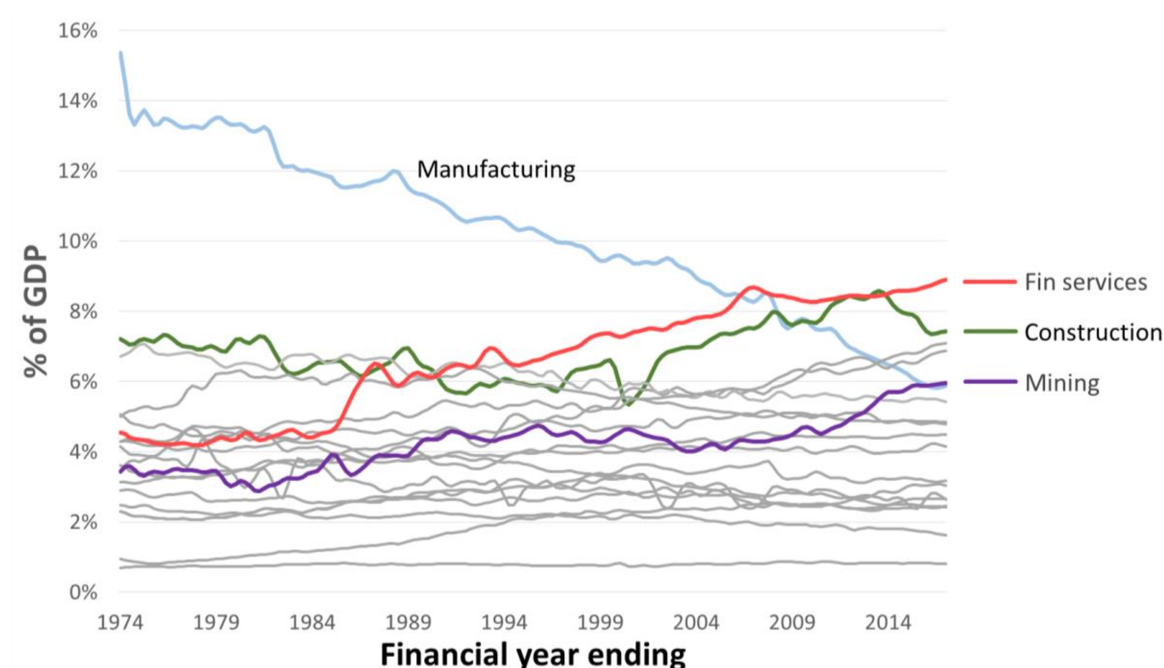
The FSC makes the following recommendations in this submission:

- The Government should prioritise the implementation of existing commitments to facilitate the rationalisation of legacy products in financial services, involving a consumer interest test applied at a collective level; roll over of all tax attributes to the new vehicle; and no tax implications of the rollover itself.
- The Government should maintain its commitment to increase the Superannuation Guarantee (SG) to 12 per cent.
- The Government should commission an inquiry, preferably by the Productivity Commission, into the impact of potential changes in the labour market on tax revenue, superannuation, life insurance, and retirement savings. The changes that should be examined include automation, self-employment, contractors and the 'gig economy'.
- The Government should use the 2018–19 Budget to pre-announce tax reforms applying after the tax cap is reached with no effect on the Budget, for example personal tax reductions. The Government should also reconsider the need for the Medicare Levy increase given this tax increase will effectively raise no net revenue after the tax cap is reached.
    - The 2018–19 Budget should also explain how this tax cap operates so that it is clear the announced tax reductions are delivering on an existing Budget commitment and so they have no net effect on tax revenue.
- The Government implement a zero rate of NRWT on ARFP payments excluding both direct and indirect income from Australian real property.
- The Government place a priority on negotiating a tax treaty with Luxembourg and Hong Kong and addressing financial services issues in existing tax treaties. We also encourage the Government to ensure that any new Free Trade Agreements are accompanied by a tax treaty.
- The Government continues to pursue a reduction in the overall corporate tax rate to 25%, preferably lower.

Introduction: Importance of Financial Services industry

The financial services industry is the largest industry in the Australian economy, contributing about 9% of Australia's GDP. It is larger than the mining, manufacturing, education or construction industries as shown in Figure 1 below.

Figure 1 – Industry share of GDP



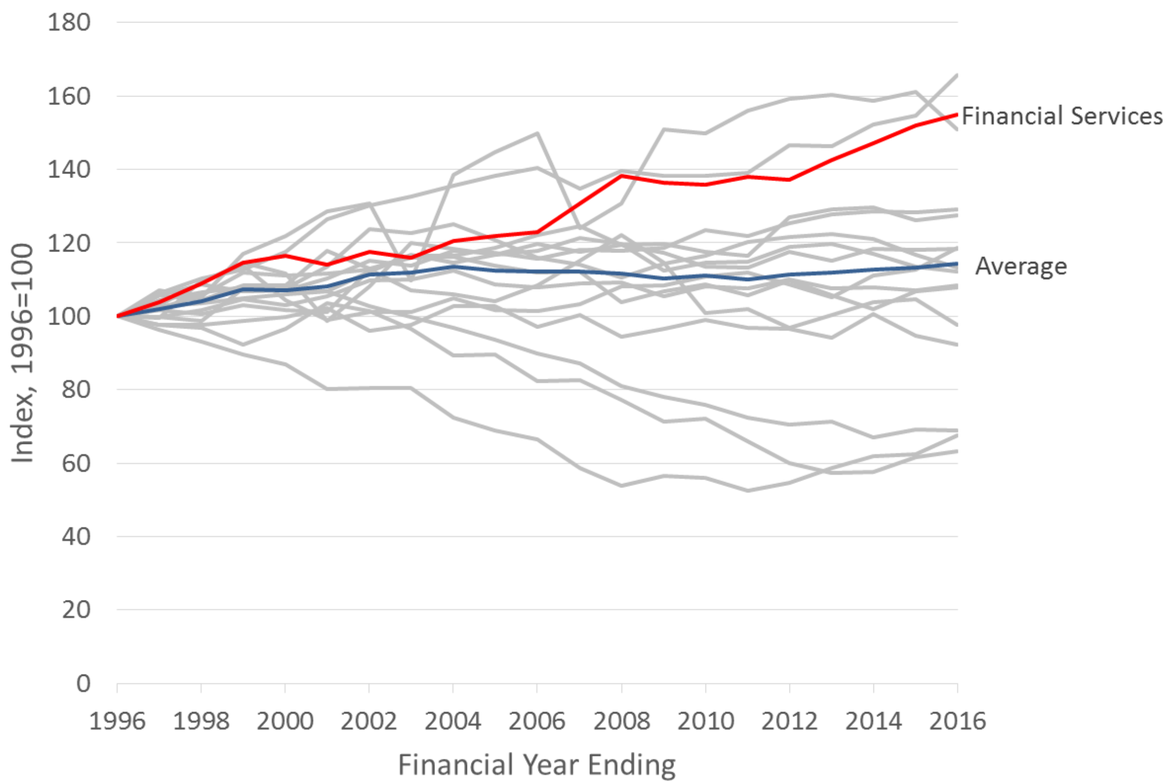
Source: ABS Australian National Accounts: National Income, Expenditure and Product, Table 6.

The industry also employs over 400,000 people,[1] and has been one of the best performances for productivity, with multifactor productivity growth since 1996 the second highest of any industry,[2] as shown in Figure 2 below.

[1] ABS Labour Force, Australia, Detailed, Quarterly, Nov 2017.

[2] The best performer is wholesale trade and the third best is agriculture.

Figure 2 - Total productivity growth since 1996

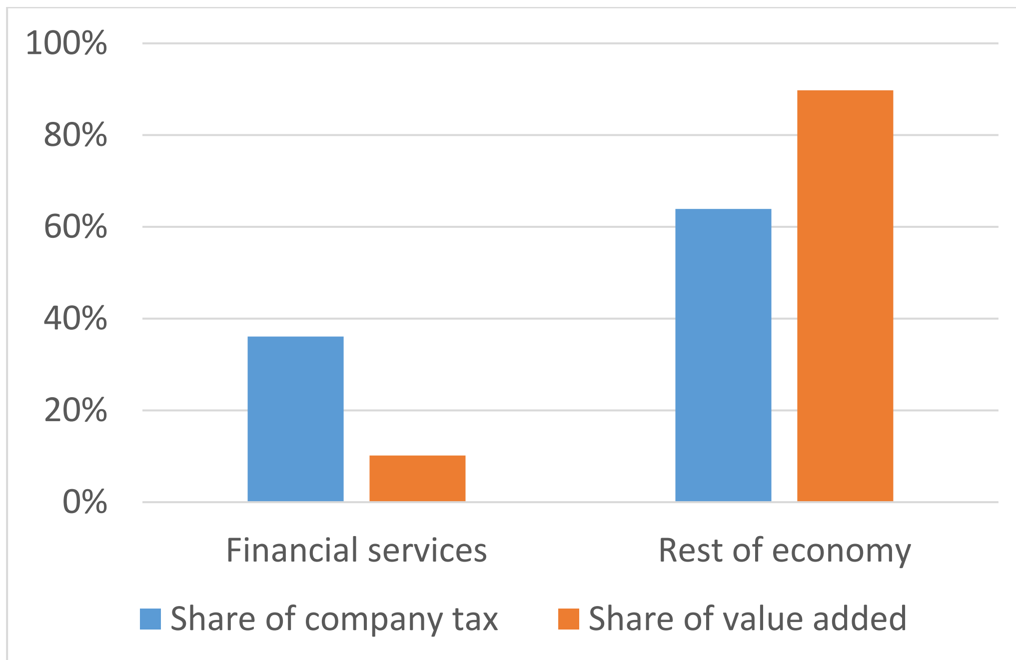


Source: ABS Estimates of Industry Multifactor Productivity, 2015-16. Figures are for multifactor productivity growth. Financial services also perform strongly on labour productivity growth.

The financial services industry pays a disproportionate level of company tax — see Figure 3 below showing financial services as a share of the economy and as a share of corporate tax. This confirms earlier more detailed analysis by Treasury.[3]

[3] Chart 1 of John Clark, Peter Greagg and Amy Leaver (2011) "Average rates of company tax across industries revisited", *Economic Roundup* Issue 2.

Figure 3 – Financial services share of tax vs share of economy (2014-15)



Sources: ATO Taxation Statistics 2014–15 and ABS Australian National Accounts: National Income, Expenditure and Product, Table 6. Value added is GDP omitting tax and subsidies; this explains the difference with the earlier graph.

More data on the financial services industry is in the funds management competitiveness & exports section below.

Product rationalisation

Recommendation: the Government should prioritise the implementation of existing commitments to facilitate the rationalisation of legacy products in financial services, involving a consumer interest test applied at a collective level; roll over of all tax attributes to the new vehicle; and no tax implications of the rollover itself.

Product rationalisation was a recommendation of the Government's Financial Services Inquiry (FSI) in 2014, and in 2015 the Government announced it accepted this recommendation.

The FSI argued:[4]

> ***Recommendation 43: Legacy products***
>
> *Introduce a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investments sectors.*

In response, the Government made the following commitment:[5]

> *The Government agrees to facilitate the rationalisation of legacy products, in light of consumer, constitutional and fiscal issues.*
>
> *It is important that consumers should not be worse off due to any transition to a newer product. Under the existing framework there are possible tax implications of facilitating the transition away from legacy products, which will be explored in the context of the Government's Taxation White Paper process.*

No major progress has been made on product rationalisation, so this remains as unfinished work from the FSI, and a long-standing concern of the FSC remains unaddressed — the FSC first put forward a proposal for product rationalisation to the Government in July 2005 and in other forums since then.[6]

Background

Many FSC members have legacy products in managed investment schemes, life insurance and other related products or structures. Our members have updated and modernised their product offerings over time, but customers who have purchased earlier products cannot easily be transferred into the newer products.

As a result, the number of legacy products has increased and we estimate there are over 600 legacy structures amongst FSC members, each of which may contain multiple products, affecting an estimated 2.44 million consumers.

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

- 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.

[4] http://fsi.gov.au/publications/final-report/executive-summary/#recommendations
[5] https://static.treasury.gov.au/uploads/sites/1/2017/06/Government_response_to_FSI_2015.pdf
[6] For example: Phase Two submission to FSI; and Product Rationalisation — Managed Investment Schemes and Life Insurance Products Proposals Paper, 26 February 2010.

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. Rationalisation also allow consumers to access more modern and relevant offers.

However, the current mechanism for rationalising products is too difficult and expensive. As a result consumers remain in financial products have a higher cost base.

Although a financial product may be closed and is of low scale, it still needs a broad range of behind the scene support 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. Legacy products have caused some absurd problems for FSC members, including:

- One life insurer needed to hire a computer programmer fluent in FORTRAN — a largely defunct programming language developed in the 1950s — to implement a regulatory system change.
- Another has customer records stored on microfiche.
- While a super fund had to buy a spare part on eBay for one of its legacy systems because the manufacturer doesn't make or supply it anymore.

Addressing product rationalisation will provide a number of significant benefits, including:

- Allowing use of updated technology, to make systems more resilient and more productive.
- Increased product innovation, as the costs of innovation will decline. Innovation creates legacy products; and if legacy products cannot be rationalised this increases the costs of innovation.
- Reduced complexity and compliance costs
- Improved services to consumers, with more customers using modern products.
- Reduced operating costs, resulting in lower costs to consumers and increased demand for financial products

Conversely, continuing to manage bespoke financial products that are highly aged and were in use before most employees were around is a significant challenge for most financial services companies. This causes many problems including:

- increased operational risks — failures of aged systems are more likely because they are less resilient and harder to restore.
- problems maintaining aged systems that are typically less agile or economical to run and keep updated (including for regulatory change)
- greater challenges to locate appropriately skilled support staff
- increased difficulties caused by the need to ensure customer requirements are kept
- barriers to organisational change
- resources diverted from other activities that add customer value

If the problem is not 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 will be worse off due to increasing costs 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 legacy products to provide new tools and other enhancements beyond what is legally required. Because of this consumers of legacy products lose out on that 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, providing significant benefits to consumers.

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. The precise 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, whereas the test is taken 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 better (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 the regime for super, with the exception that the relevant test be undertaken at the collective consumer level in all cases.

FSC proposal

The FSC's proposed product rationalisation mechanism leverages that of superannuation and is focused on consumer protection and industry efficiency. The proposal is that consumer rights are protected through the requirement for the product issuer to ensure the change is in the interests of consumers.

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 any financial product — apart from superannuation which has an existing rationalisation mechanism — in particular, 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

The rationalisation scheme would have several components discussed below.

Consumer interest test

Rationalisation should remove economically inefficient or outdated products while providing 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.

It is proposed that the test be 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. To do otherwise could prevent some rationalisations that are in the interests of the majority from going ahead because of a minority impact.

The FSC also proposes ASIC should play a role in this process to ensure that, on balance, customers are better off as a result of the rationalisation. There would be a requirement that the provider initially conducts the assessment with oversight from ASIC.

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.

Tax implications and relief requirements

There is a range of tax implications that flow from activities designed to rationalise legacy products. As a general the tax attributes of the original vehicle should be able to roll over to the destination vehicle, and there should be no tax implications of the roll over itself.

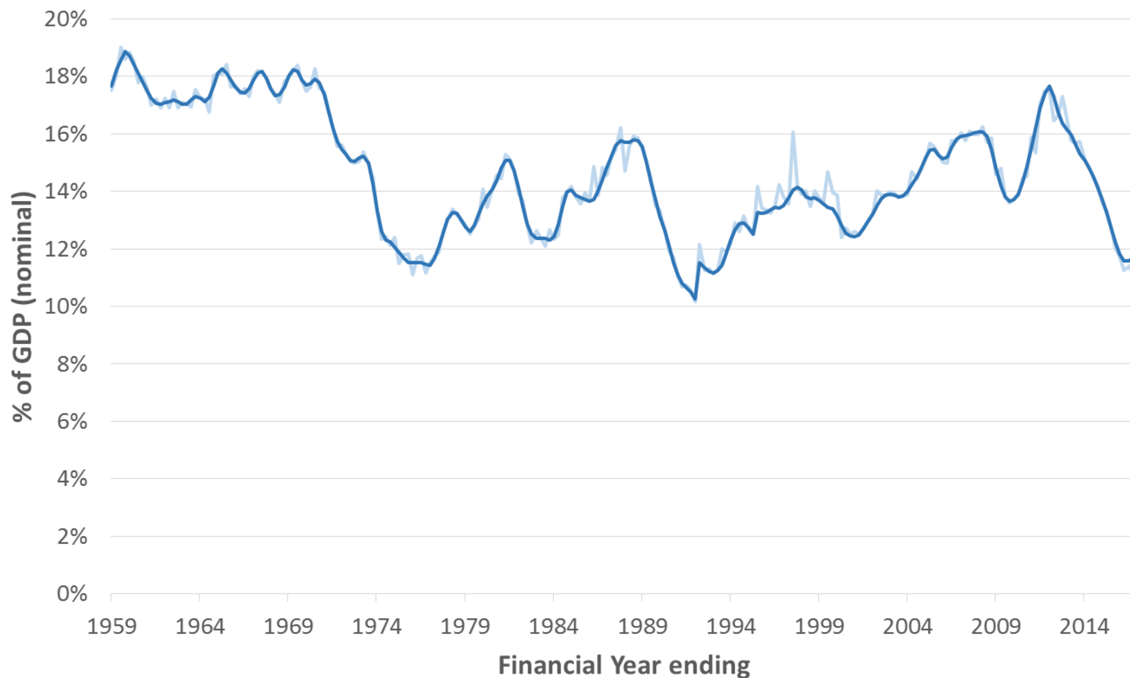
In particular, Capital gains tax (CGT) and State stamp duties should not be levied when rationalisation occurs.

The **Appendix** to this submission outlines more details of the FSC's product rationalisation proposal in relation to financial product rationalisation and the application of rationalisation mechanism for different product types.

Australia's investment problem & savings gap

Business investment in Australia is at very low levels, well below the levels from before the mining boom as shown in Figure 4 below. There has been a small rebound recently, but more needs to be done to promote investment.

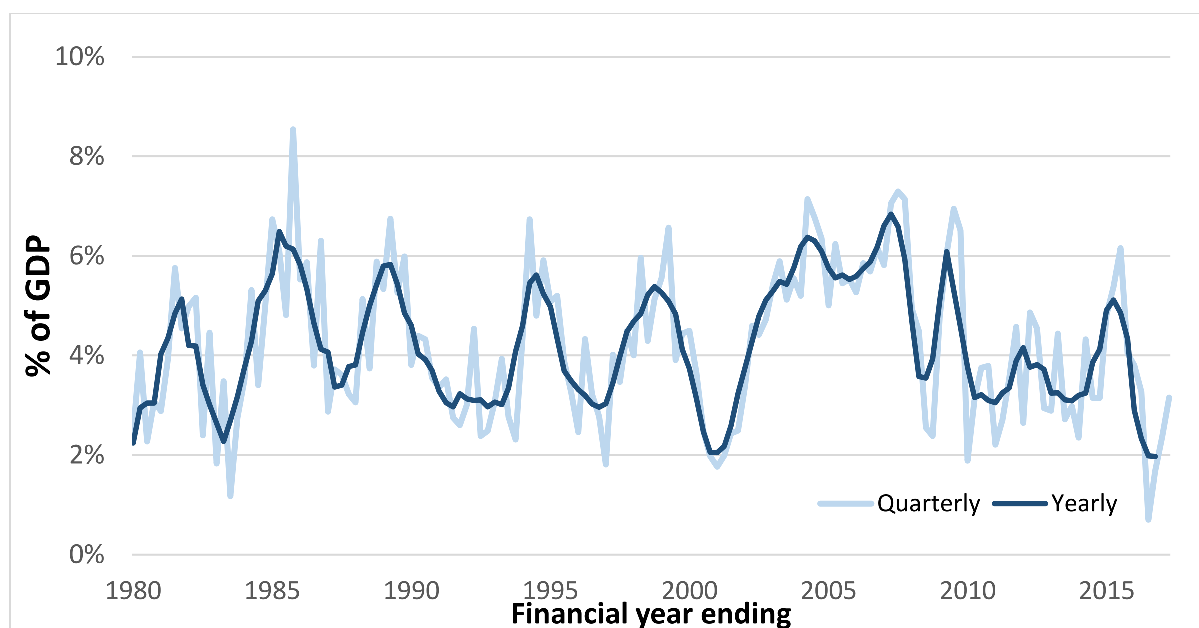
Figure 4 – Business investment as % of GDP



Source: ABS National Australian National Accounts: National Income, Expenditure and Product, Table 3. Light line is seasonally adjusted figures; dark line is trend.

Similarly, inflows of financial capital to Australia have recently rebounded but remain at low levels. The flow of financial capital into Australia for the year to September 2017 is 2.0% of GDP; it has not been this low since September 1980. This is shown in the graph below (the lighter line shows quarterly flows).

Figure 5 – financial inflows to Australia as % of GDP



Source: ABS Balance of Payments and International Investment Position, Table 1.[7]

These two issues are linked. The decline in foreign capital inflow into Australia (Figure 5) is cutting one source of funds for business investment (Figure 4). The other source of funds for business investment is domestic savings, which is at recent lows.[8] So the weakness in foreign capital inflow and domestic savings are inextricably linked with the weakness in business investment. As a result, measures to promote both will help address the business investment problem. Two policies are a focus of this submission:

- An increase in the superannuation guarantee to 12%, which will increase domestic saving.
- A reduction in the company tax rate to 25%, which will increase foreign capital inflow into Australia.

These proposals are discussed in more detail below.

[7] Yearly figures have been moved two quarters earlier to synchronise better with quarterly figures.

[8] See: http://www.abs.gov.au/ausstats/abs@.nsf/Latestproducts/5206.0Main%20Features2Sep%202017?opendocument&tabname=Summary&prodno=5206.0&issue=Sep%202017&num=&view=

Maintain commitment to increase Super Guarantee to 12%

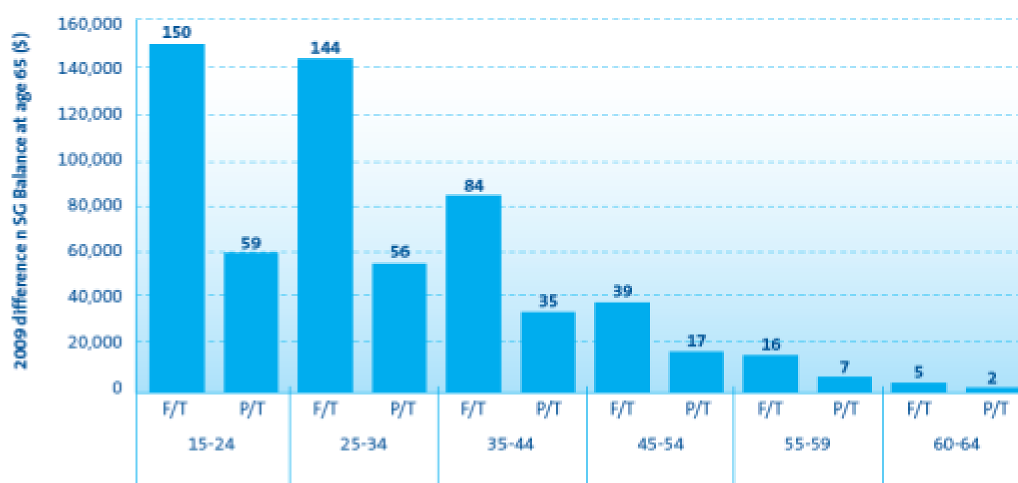
Recommendation: the Government maintains its commitment to increase the Superannuation Guarantee (SG) to 12 per cent.

An increase in the SG will generate long-term economic benefits and continue to address the national shortfall in savings that is causing significant economic challenges for Australia.

As noted earlier in this submission, Australia has an issue with inadequate funds available for business investment. We also have a significant 'savings gap,' the difference between the amount required to be saved by the nation as a whole to ensure adequacy in retirement and the amount that will be saved in the superannuation system by the current workforce. Rice Warner Actuaries has determined that under an SG of 12 per cent the savings gap is over $1 trillion when account is taken of increased life expectancy.[9]

A University of Canberra NATSEM Report modelled the importance of an increase in the SG rate to 12 per cent to address the gap by growing individual account balances as shown in Figure 6 below.

Figure 6 – Projected difference in super balance at age 65 by age group and labour force status



Note: The values shown are the projected difference between SG contributions of 12% and 9% per annum until age 65. The projections assume real wages growth of 1% per annum and real superannuation returns of 4% pa.

Source: *NATSEM estimates based on HILDA data.*

Source: NATSEM Report, Saving Tomorrow April 2010

Increasing the SG to 12 per cent achieves a long-term benefit for younger working Australians. Employees aged 15 to 24 will benefit from the increase in the SG to 12 per cent by the reform adding $150,000 to their retirement savings by age 65. NATSEM concluded that "clearly an additional $150,000 in superannuation will make a major difference to a person's standard of living in retirement and help reduce the fiscal pressure on future governments."[10]

[9] *Longevity Savings Gap Research and Policy Options*, Rice Warner Actuaries, September 2012
[10] NATSEM Report, Saving Tomorrow April 2010 at 24

An increase in the SG is also supported by the overwhelming majority of the population, with 80% support for the SG increase shown in a survey conducted by FSC and ING DIRECT, and 49% strongly support the increase.[11]

Impact of two-year delay in SG rate increase

The two-year delay in the scheduled increase in the SG undermines the effectiveness of the increase. For those who are likely to retire over the next decade, the delay detracts from the forecast $39,000 increase in individual retirement savings that they would otherwise have accrued. The delay to the increase in the SG to 12 per cent will result in a cumulative impact of around $40 billion less in super savings in the system over the next seven years.

The FSC strongly recommends that there be no further delays to the increase in the SG to avoid exacerbating inter-generational pressure on public finances resulting from demographic change in Australia's population.

The Treasury projections outlined in the 2010 Intergenerational Report (IGR) demonstrated how the ageing of Australia's population will pressure public finances. The IGR concluded that:[12]

- the ratio of working aged people relative to retired people will halve, from around 5 today to 2.7 by 2050;
- between 2010 and 2050, the proportion of Australians aged 65-84 will double, whilst the proportion of people aged 85 and over will quadruple; and
- the proportion of Australians of working age will fall by seven percentage points to 60 per cent of the total populace in 2050.

These demographic changes will generate the problem of a shrinking tax base compounded by increased spending on health and pension costs. Health costs will almost double by 2050 to 27 per cent of GDP while pension costs are expected to rise from 2.7 per cent to 3.9 per cent of GDP over the next 40 years.

Any shortfall in retirement savings arising from the delayed increase in the SG increases the number of retirees who will receive the age pension, and increase the amount of age pension they will be paid over their retirement. It will therefore accentuate the impact of the aging population on the Government and future tax payers.

SG impact on the economy

The FSC considers the increase to the SG should not be a tax on business or negative for business generally. The implementation schedule was specifically designed to allow employers to take the increased SG contributions into account when negotiating wages.

The experience following the introduction of the SG and during the increase to 9 per cent shows that business conditions in Australia actually improved significantly:

- Profits as a share of GDP increased during this period, growing from around 6 per cent of GDP in the early 1990s to around 8 per cent in the early 2000s.
- At the same time, productivity rose as real unit labour costs fell.
    - The decline in real unit labour costs was particularly pronounced between 1998 and 2003 when the SG rose from 6 to 9 per cent.

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[11] Page 20 of https://newsroom.ing.com.au/wp-content/uploads/2016/08/FSC_ING_Direct_Your_Super_Future__FINAL_.pdf

[12] The 2010 Intergenerational report, The Treasury - http://www.treasury.gov.au/igr/igr2010/

- The unemployment rate declined steadily to its lowest level in decades.

There is also a significant positive impact on the economy of increasing the pool of national savings, helping address the shortfall in business investment noted earlier in this submission. Higher savings through an increase in the super guarantee should help address this problem. For example, one study suggests an increase in Australian saving by $1 causes an increase in investment of 50–60c.[13] Therefore, resuming increases in the SG should go a long way towards addressing Australia's current problems with business investment.

Superannuation also stabilised the Australian economy during the financial crisis by providing a domestic pool of funds on which Australian businesses were able to draw. It is estimated that Australia accounted for $90 billion or 10 per cent of the world's total recapitalisation in 2009 allowing Australian businesses to be less reliant on the vagaries of international credit markets.

[13] Saten Kumar, Scott Fargher and Don Webber (2009) "Testing the Validity of the Feldstein-Horioka Puzzle for Australia", *Applied Economics*, 44 (5), pp599–605.

Future of employment – impact on superannuation

The nature of employment is changing. The era of job certainty, regular hours, and little or no part time work is over. However, it is unclear where the labour market is going and there is much speculation over the jobs of the future. Some are concerned about increased automation causing the abolition of many existing jobs,[14] while others are much more sanguine about the ability for the economy and labour markets to adapt.[15]

With all this potential change, it is important for Government policy to be prepared for potential disruption, including to tax revenue, superannuation and retirement incomes. Labour market disruption could result in large increases in self-employment, including through the so-called 'gig economy'. Another (less likely) possibility is disruption could cause substantial increases in unemployment. Either of these possibilities will have dramatic impacts on the superannuation industry and retirement incomes.

For example, there is a requirement for employees to put aside funds for retirement through the superannuation guarantee, and no such requirement applies to the self-employed. As a result, the super balances of the self-employed is substantially lower near retirement. The prevalence of life insurance would also be lower with the self-employed.[16]

As a result, these possibilities — and others —should be considered in detail by a Government inquiry. The FSC considers the Government, and the economy more broadly, would be better prepared for these type of developments if a detailed inquiry occurs now, before major disruption occurs. It is better to be prepared rather than react in haste right in the middle of a major change.

Recommendation: the Government commission an inquiry, preferably by the Productivity Commission, into the impact of potential changes in the labour market on tax revenue, superannuation, life insurance, and retirement savings. The changes that should be examined include automation, self-employment, contractors and the 'gig economy'.

[14] See for example Adrian Blundell-Wignall (2017) "Why driverless cars really are a worry" *Australian Financial Review,* 7 December; Dan Shewan (2017) "Robots will destroy our jobs – and we're not ready for it", *The Guardian*, 11 January.
[15] See for example Barry Eichengreen (2017) "Technology is not about to destroy your job. That's a myth" *Australian Financial Review*, 13 December.
Follow us: @FinancialReview on Twitter | financialreview on Facebook
[16] https://www.superannuation.asn.au/media/media-releases/2017/media-release-7-september-2017

Tax reform

Government's cap on total tax revenue

The Government has made a commitment to cap the total federal tax burden at 23.9% of GDP.[17] It is commendable to implement a cap on the overall burden of tax, as this burden would otherwise increase cumulatively every year due to bracket creep.

- bracket creep occurs when incomes grow over time but tax thresholds remain unchanged, meaning taxpayers face tax on a larger proportion of their incomes every year.[18]

A broad estimate is that bracket creep would cause the tax burden to increase each year by about 0.3 percentage points of GDP (or $5–6 billion) if nothing is done.[19] So the Government is effectively committing to a net tax cut of this value every year once the tax cap is reached (currently forecast to be in 2021–22).

This tax cap has some interesting effects that are not clearly understood.

First, tax policy changes will only result in a redistribution of the tax burden after 2021, and will not change the total amount of tax raised. In particular, an increase in one tax will just mean the Government needs to implement a fully offsetting reduction in other taxes. In all cases, total tax revenue will remain at 23.9%.[20]

Second, tax revenue measures (both increases and decreases) implemented today have no net impact on the budget after 2021, as the tax cap policy requires that the total tax burden remains unchanged at 23.9%. The tax cap means the Government will need to take decisions to fully offset any previous tax policy changes. This includes tax increases that have been put in place today — revenue from these tax increases effectively have no impact on the budget after 2021. So for example:

- The Medicare Levy increase only raises revenue before 2021, and has no net effect on revenue after 2021. The tax cap means the Government has committed to fully offset the higher Levy with reductions in other taxes.
- BEPS measures have no net effect on total tax revenue after 2021, as they will be offset.
- The increase in the personal tax threshold from $80,000 to $87,000 (announced in the 2017–18 Budget) only has a Budget impact before 2022.

Third, the tax cap means the Government can announce tax reductions today and they would have no net budget impact after 2021. The budget in effect already assumes there will be tax cuts after 2021, so an announcement today of tax cuts after 2021 is delivering on an existing commitment. This clearly applies to the Government's company tax cut policy — this tax cut is one way of delivering on

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[17] See for example: http://www.financeminister.gov.au/speech/2017/11/23/address-business-council-australia

[18] See more details on bracket creep here: http://bettertax.gov.au/our-tax-system/individuals-income-tax/bracket-creep/ Modelling of the impact of bracket creep by the PBO is here: https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Budget_Office/Reports/Research_reports/Report_03_2017

[19] The forecast increase in the personal tax to GDP ratio is 0.30 percentage points per year from 2018–19 to 2020–21, or $5.4 billion in today's money.

[20] The *forecast* tax revenue would need to be 23.9% of GDP; the actual level of revenue may be slightly above or below 23.9% due to forecast errors.

the tax cap. In other words, the corporate tax cuts are fully funded after 2022 and have no impact on the budget (company tax is further discussed later in this submission).

As a result, the Government can make substantial tax policy announcements in the 2018–19 Budget with no net cost to the budget — any announcement in the upcoming Budget would be delivering on an existing promise to cut taxes every year after 2021.

Recommendation: the Government use the 2018–19 Budget to pre-announce tax reforms applying after the tax cap is reached with no effect on the Budget, for example personal tax reductions. The Government should also reconsider the need for the Medicare Levy increase given this tax increase will effectively raise no net revenue after the tax cap is reached.

The 2018–19 Budget should also explain how this tax cap operates so that it is clear the announced tax reductions are delivering on an existing Budget commitment and so they have no net effect on tax revenue.

Funds management competitiveness & exports

Australia's financial services industry is particularly important to our economy, as noted in the introduction to this submission. In addition, Australia has one of the largest pools of managed fund assets in the world, and is the largest in the Asian region.[21] Assets under management are over $3 trillion.[22] However, our financial services exports lag well behind the relative contribution of our industry.

In particular, Australia only sources about 3.5% of total funds under management from offshore,[23] so we are only capturing a small share of global funds under management. By comparison, many other countries with large funds management industries have much larger proportions of funds sourced from offshore. This includes the United Kingdom (31 per cent sourced from offshore), Hong Kong (68.5 per cent), Singapore (80 per cent) and Luxembourg (99 per cent).

The FSC therefore considers more needs to be done to promote Australia as an exporter of financial services. If nothing is done, then the industry is likely to face sustained pressure from other more competitive jurisdictions, slowing growth and harming the whole economy.

The Asia Region Funds Passport (ARFP) presents significant opportunities for Australian funds to increase exports to Asia. However, the ARFP will also reduce barriers for foreign funds wishing to enter Australia. If the policy settings are not right, fund managers might prefer to service Australian investors from offshore (particularly from Singapore if they join the ARFP) rather than locally.

The Government has already taken important steps to improve the competitiveness of funds management, including through the Management Investment Trust, Attribution Management Investment Trusts (AMIT) and Investment Manager regimes, announced technical changes to improve the operation of AMIT, and consultations on implementing a Corporate Collective Investment Vehicle (CCIV). These reforms reflect long-standing tax policy settings to enhance Australia as a funds management jurisdiction and are helping address the concerns raised in the

[21] Austrade (2017) Australia's managed funds 2017 update, April

[22] ABS Managed Funds Australia, September 2017

[23] Sources: total funds: ABS Managed Funds, Australia, Jun 2017, Table 1; overseas sourced funds: ABS Managed Funds, Australia, Jun 2017, Table 9.

Financial Systems Inquiry and other reports[24] that Australia has work to do to enable Australia's funds management industry to compete in our region.

Improving the competitiveness and exports of the financial services industry would have substantial economy-wide benefits. Research by Deloitte for the FSC shows that increasing Australia's funds management exports to the same level as Hong Kong by 2023–24 would have significant flow on effects, including that:

- GDP would increase by $4.2 billion by 2029-30 and around 10,000 additional jobs would be created;
- fees received by fund managers would lead to an increase in income and payroll tax;
- an increase in funds management exports would lead to a net increase in the amount of foreign assets invested in Australia; and
- the Government would receive an additional $1.7 billion in tax revenue in 2024-25, stabilising to $1.2 billion in 2029-30.

There remains significant unfinished business in improving the competitiveness of financial service in Australia. The key priorities for the FSC are discussed in more detail below.

Non-resident withholding tax

Australia's current withholding tax rates will not be competitive in the Asia Region Funds Passport (ARFP). Australia's non-resident withholding tax (NRWT) is noticeably higher than the equivalent tax rates in other ARFP jurisdictions as shown in the FSC's research.[25] The NRWT system is also particularly complex compared to other ARFP countries, as a result of:

- multiple rates
- complexity and difficulty of determining appropriate rate;
- interactions with tax treaties (including how the treaties deal with trusts);
- no overarching consistent principle of application; and
- relatively more simplistic approaches in competitor jurisdictions, with Singapore in particular charging a zero withholding tax rate.

The complexity of the application of Australia's NRWT means the possible tax consequences for foreign investors cannot be explained a simple and easy to understand manner. The ARFP is specifically designed for retail investors so the inability to explain tax simply will put Australia at a substantial disadvantage.

As a result, Australia's NRWT regime is not globally competitive or congruent with Australia's aspirations of becoming a global financial centre and exporting fund management services to the rest of the world and in particular Asia. The policy argument for reducing or removing NRWT is similar to the argument for the Offshore Banking Unit (OBU) concession — the lower tax rate encourages funds to come to Australia that would otherwise not come.

In addition, other countries are reducing their NRWT over time, making our system more uncompetitive as time passes. Therefore, if Australia does not set NRWTs at a competitive rate determined in the appropriate international context, funds won't be invested in Australian vehicles and the ATO will receive 100% of nothing, while Australia will miss out on revenue, jobs and growth

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[24] Including the 1997 *Investing for Growth* plan of the Howard Government (which resulted in the expansion of the Offshore Banking Unit concession to include funds managers and a broader range of funds management activities) and the 2010 report to the government *Australia as a Financial Centre: Building on our strengths* (the Johnson Report)

[25] See FSC (2015) *MYEFO consideration – competitive withholding taxes* – letter to Treasury; and KPMG (2016) *Asia Region Funds Passport – comparison of withholding taxes*. Papers available on request.

of our funds management industry. The benefits are likely to include back end operations as well as higher value added operations such as investment management.

Investors will be choosing Passport products from a number of competing jurisdictions and Australia's current withholding tax will place Australian funds behind others on a like-for-like comparison. If tax disadvantages are removed for Australian funds then Australian fund managers will be able to compete on a like-for-like basis. In addition, a globally competitive non-resident withholding tax regime would remove the largest barrier to the success of Australia's funds management export industry.

Recommendation: the Government implement a zero rate of NRWT on ARFP payments excluding both direct and indirect income from Australian real property.

Potential budget impact

The ARFP only allows investments into very simple ('vanilla') products such as listed equities and bonds. This means that income generated by non-resident investors will comprise dividends and interest.

Analysis of these income types shows that little government revenue from NRWT (outside of property) will be received as a result of ARFP funds under existing policy settings:

- Just over 90% of Australian top 100 company dividends are franked therefore dividend withholding tax collections will be small. A portion of the remaining unfranked dividend also qualifies for conduit foreign income (CFI) exemption. For example, the unfranked component of AMP's dividends has historically been CFI and therefore withholding tax free.
- Interest will be either overseas sourced or substantially subject to section128F; as a result it would not be subject to NRWT.
- Capital gains from Australian assets that are not taxable Australian real property are not subject to a withholding obligation when derived by non-residents. The permitted investment class only allows for listed equities which are all treated as non-taxable Australian real property.
- Some treaties may operate to allocate the taxation of gains to the treaty partner.

As a result of these points, a reduction in NRWT on the ARFP will have limited budget impact, however it will have significant impact on the ability of Australian managers to market their funds, as it will allow confident statements to be made about the taxation impact of investing in an Australian fund.

There are two additional cases where the current positive rate of NRWT is incorrect and we consider no NRWT should be levied on *any* payment of these types: These are hedging profits and profit on traditional security sales, discussed in more detail below.

Profits on foreign exchange hedging activity are normally treated as being on revenue account and therefore potentially bear MIT withholding tax. This has been a source of frustration to the industry for many years as such hedging is incidental and normally related to the holding of foreign assets which generate income and gains that are exempt from withholding tax.

On the FSC's recent delegation to Korea, one of Korea's largest investment managers specifically raised the issue of Australia's taxation treatment of FX hedging being a barrier to offering their Australian asset funds in Korea won. Their Korean investors would prefer to bear the foreign exchange risk themselves, by investing into an Australian dollar fund and undertaking their own hedging back to Korean won, as opposed to having the hedging undertaken in the fund. They noted

that this was an Australian-specific problem that they did not have when investing in other jurisdictions.

The FSC has previously suggested that section 230E of the TOFA provisions be clarified to eliminate uncertainty as to its application to passive investment portfolios. In the absence of such clarification it would be appropriate to effectively exempt FX hedging profits from MIT withholding tax as part of a general NRWT exemption for ARFP vehicles.

Bond sale profits are really akin to interest but arguably are ordinary income and potentially subject to MIT withholding tax. In order to eliminate the risk of a technical application damaging the ARFP message we suggest a complete exemption.

We also understand previous costings of this proposal have used data from the ATO's Annual investment income report (AIIR). However this data is misleading as it combines property income to foreigners and non-property income to foreigners. This means the AIIR data (at least in in its current form) is unlikely to be helpful for this costing.

We expect this change will reduce compliance costs for all funds without property income, as only one rate of withholding tax will apply. A fund with property income might face higher compliance costs from complying with the property-related NRWT, but this will be offset by a reduction in compliance costs from collapsing multiple non-property rates into one rate.

Tax Treaties

Australia's competitiveness for financial services needs to be underpinned by an effective tax treaty network, as the attractiveness of Australia's funds management industry to foreign investors is reduced without the certainty provided by a tax treaty. An effective tax treaty increases the attractiveness of Australia as a destination for capital and it significantly improves the ability of Australian fund managers to compete in managing global capital on behalf of foreign investors.

The FSC argues that the flow-on effects of increasing funds management exports should be given consideration when Treasury is forecasting the cost implications and 'trade-offs' associated with tax treaties. Initially, tax treaties may result in a loss of revenue, but FSC considers the better view is to consider the broader economic and competitive context in which Australian financial service providers are operating. Longer-term 'second round effects' (such as increases in jobs or economic activity) traditionally not accounted for in Treasury estimates have the potential to outweigh short-term losses in revenue, especially when combined with specific policy changes directed at increasing certain activities – such as the recommendations of the *Johnson Report.*

This is particularly relevant for taxation of international capital flows, which are very sensitive (elastic) to tax changes. Treasury has repeatedly noted the sensitivity of international capital flows to tax.[26]

Recommendation: The Government place a priority on negotiating a tax treaty with Luxembourg and Hong Kong and addressing financial services issues in existing tax treaties. We also encourage the Government to ensure that any new Free Trade Agreements are accompanied by a tax treaty.

[26] See for example Michael Kouparitsas, Dinar Prihardini & Alexander Beames (2016) *Analysis of the long term effects of a company tax cut*, Treasury Working Paper 2016-02; and The Treasury (2008) *Architecture of Australia's Tax and Transfer System*, Box 8.8: Taxation and foreign direct investment (FDI).

Luxembourg and Hong Kong

The FSC submits that the Government should seek to conclude tax treaties with Luxembourg and Hong Kong as a matter of priority. These two jurisdictions are significant global funds management centres. Luxembourg funds have about $US 4.5 trillion in net assets under management, by far the largest asset pool in Europe.[27] Hong Kong unit trusts and mutual funds have about $US 1.3 trillion under management.[28] These are two of the largest asset pools in the world, but Australia does not have tax treaties with these countries. We understand Hong Kong is currently considering some of its tax policy settings so this might be an opportunity to discuss a tax treaty.

The ability of Australian fund managers to provide asset management services to foreign investors has been hampered by uncertain tax outcomes arising from Australia's source and permanent establishment taxation rules. The Investment Manager Regime (IMR) seeks to address these uncertainties and remove barriers for foreign investors wishing to utilise the expertise of Australian managers.

The IMR is only available to foreign investors from jurisdictions with an 'effective exchange of information agreement'. This requirement rules out foreign investors from both Luxembourg and Hong Kong. The lack of effective tax treaties with these two economies means Australian fund managers are at a significant disadvantage when competing to manage funds flowing from, or through, these locations.

The Government is currently working towards starting formal negotiations on a free trade agreement with the European Union. The value of a free trade agreement relating to financial services would be significantly diminished in the absence of a tax treaty with Luxembourg.

Australia already has a tax agreement with many of the EU countries, as shown in the table below — Luxembourg is the clear gap in terms of the financial sector. The priority placed on tax treaties with other EU countries suggests higher priority has been placed on industries other than financial services in the prioritisation of treaties. For example, Australia has a tax treaty with Romania and Slovakia who each have funds under management of less than $US 10bn, compared to Luxembourg funds under management of $US 4.5 trillion.[29]

Table 1 – DTAs with Australia in the European Union

EU Country	DTA with Australia
Belgium	yes
France	yes
Germany	yes
Italy	yes
Luxembourg	no
Netherlands	yes
Denmark	yes
Ireland	yes
United Kingdom	yes
Greece	only Airline Profits Agreement
Portugal	no

[27] Investment Company Institute Worldwide Public Tables, 2017 Quarter 2, available from: https://www.ici.org/research/stats/worldwide
The next highest stock of funds are held in Ireland, worth $US 2.5trn.
[28] Hong Kong Securities and Futures Commission Statistics Table D3 as at December 2016, available from: http://www.sfc.hk/web/EN/files/SOM/MarketStatistics/d03.pdf
[29] Investment Company Institute Worldwide Public Tables, 2017 Quarter 2 as above.

EU Country	DTA with Australia
Spain	yes
Austria	yes
Finland	yes
Sweden	yes
Cyprus	no
Czech Republic	yes
Estonia	no
Hungary	yes
Latvia	no
Lithuania	no
Malta	yes
Poland	yes
Slovakia	yes
Slovenia	no
Bulgaria	no
Romania	yes
Croatia	no

Source: https://treasury.gov.au/tax-treaties/income-tax-treaties/

Coverage of superannuation funds and collective investment vehicles

In negotiating future tax treaties and revising existing agreements, the FSC considers the provisions contained in the recent Australia-Switzerland DTA covering collective investment vehicles and complying superannuation funds should be considered a benchmark that future treaties should meet. The unique nature of Australia's superannuation system means that using a "pension scheme" description in treaties often does not provide industry with necessary certainty in applying the treaty (take for example the uncertainty which has been raised by industry in relation to the application of the Australia-US DTA to superannuation schemes under FATCA).

The FSC also submits that the Complying Superannuation business of life insurance companies ("VPST" business) and pooled superannuation trusts should also be provided coverage in future treaties as these businesses operate consistently with standalone superannuation funds. This is due to statutory obligations under both *Income Tax Assessment Act 1997 (Cth)* (Division 320) and the *Life Insurance Act 1995 (Cth)* for life insurance companies to separate out their complying superannuation businesses. Further, the complying superannuation business of a life insurance company invests under its own rights and can enter into agreements with third parties.

China

The FSC submits that the existing Article 13 in the China-Australia DTA be aligned with the corresponding Article in Chinese DTAs recently negotiated with other governments to provide relief for Australian residents from capital gains on their Chinese portfolio investments. This consistency will ensure Australian residents trading Chinese securities will be afforded the same concessions as their foreign counterparts and is a key element to establishing Australian access to Chinese capital markets.

Under the existing Australia China DTA there is no protection from the Chinese Tax Authorities imposing CGT on any gains derived by either an Australian QFII or an Australian investor looking to dispose of a non-controlling interest. CGT has been charged on QFIIs in certain circumstances, but there is some uncertainty over this. Both the taxation of QFIIs and the uncertainty over taxation creates uncertainty and acts as a disincentive to foreign investors fully exploiting QFII status.

Australian investors also look to invest into Chinese private equity or other private investments, i.e. outside of the stock exchanges and without QFII qualifications. Where such investment activity specifically involves the Australian investor taking a non-controlling interest of less than 25 percent in a Chinese Company (and its assets do not consist of 50% or more Chinese immovable property), the non-controlling investment is currently still subject to CGT in China on disposal.

Most of China's recent treaties entered into with the UK, Singapore and France contain a protection from Chinese CGT for portfolio interests held in Chinese companies. For example Article 13 of the UK/China DTA provides that UK residents will only be subject to Chinese CGT on land rich securities and interests of 25% or more in Chinese companies. The FSC submits that the same article be included in a revised China/Australia DTA.

The absence of any concession is inconsistent with DTAs that China has executed with other jurisdictions. Since the introduction of the China Australia DTA and the opening of Chinese capital markets to foreign investors, there has been a growing trend in China DTAs to concede taxing rights on non-resident capital gains from shareholdings of less than 25% in non "land-rich" Chinese companies. Recent examples include the DTAs between China and:

- Hong Kong, SAR in 2008;
- Singapore in 2010; and
- The United Kingdom in 2013.

A failure to renegotiate Article 13 as suggested will leave Australian investors (both QFII and non-QFII) at a distinct competitive disadvantage to their non-Australian counterparts, and would represent a missed opportunity to fortify the Australian Government's creation of more competitive avenues for Australian outward investment into Asia.

United States of America

The application of the existing Australia-US tax treaty provisions to superannuation funds is particularly uncertain. The FSC has received numerous queries from members of the public relating to the tax status of earnings from superannuation funds during the accumulation phase. Some tax advisers are indicating that clients may have US tax liabilities on these investment earnings due to insufficient treaty coverage. If this advice is correct the result would clearly be an unintended consequence from the perspectives of both countries.

The US DTA also denies treaty relief in the common circumstances where an Australian resident fund invests into US investments via a Cayman feeder fund. The FSC submits that this issue should be rectified.

General

There are inconsistencies between the features of existing tax treaties. The FSC submits that these inconsistencies should be rectified when these treaties are reviewed, to improve the global competitiveness of Australia's funds management industry.

Issues include:

- **Trusts** – most tax treaties do not provide trusts, particularly Managed Investment Trusts, with clear access to treaty benefits. Whilst certain treaties (USA, Canada and NZ) specifically mention trusts, others do not (such as the UK and India);
- **Interest withholding tax** – some DTAs do not provide an interest withholding tax exemption for interest paid to and derived by a financial institution which is unrelated to and dealing wholly independently with the payer. Currently included in the UK, US, NZ, Japan, French

treaties but importantly missing from German, Singapore, Hong Kong (no DTA), Canadian, Korean DTAs. Further, the FSC submits that this exemption should be widened to all financial entities within a financial institution group rather than just the ADI entity in the financial institution group.

- **Sovereign immunity** – codification of sovereign immunity and at source exemptions for entities wholly owned by Federal or State Governments. Currently included in the NZ treaty.
- **Deemed source** – many of Australia's treaties contain a deemed source rule, which as seen in recent court judgements (such as Tech Mahindra), may expand the breadth of items that Australia would otherwise tax. This raises the question of whether this is the appropriate setting to encourage investment in Australia.

Corporate tax rate

Recommendation: The Government continues to pursue a reduction in the overall corporate tax rate to 25%, preferably lower.[30]

The Government has already implemented the first part of lowering taxes on business, by legislating for a gradual reduction in company tax for smaller businesses to 25%.[31] However, the headline company tax rate remains at high levels for larger businesses. It is well known this headline tax rate for larger business is uncompetitive when compared to other developed countries, our region, and the whole world.[32] This needs to be addressed. Tax expert John Freebairn and others[33] have argued the economic benefit is greater from reducing the corporate rate on larger businesses.

Australia's uncompetitive high company tax rate is arguably one of the reasons for business investment currently being at very low levels (see Figure 4 above). Nevertheless, company tax reductions are dismissed for various reasons.

First, it is sometimes argued that Australia's imputation system reduces the effective company tax rate. However, imputation has negligible effect on international investors and so should be disregarded for international comparisons.

Second, a recent report by Treasury analysing wages outcomes in Australia[34] has been used to argue against the tax cut.[35] However, the Treasury report actually provides ***strong support*** for a tax cut for larger businesses: the Treasury report finds that wages are higher at big businesses, and wages growth at these businesses has been faster.[36] Maintaining a higher tax rate on larger business will hamper their growth, and mean fewer people are employed at larger businesses who pay higher wages. The report shows workers will lose out from policies to suppress growth by larger businesses.

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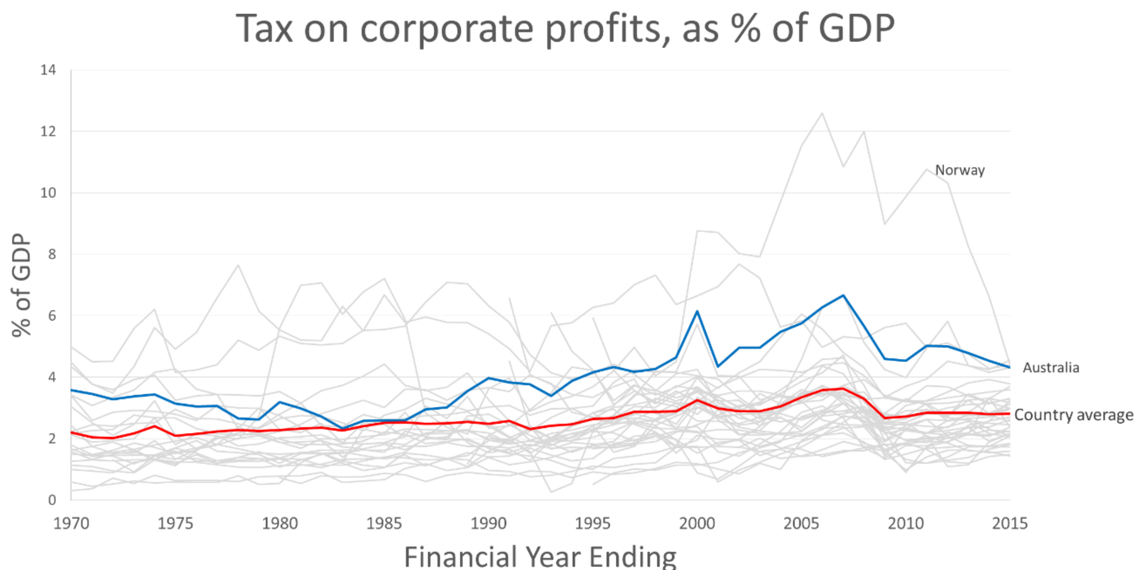
[30] The FSC argued in its submission to the Tax White Paper that there should be a medium term objective to reduce the corporate tax rate to 22% to better align with the average tax rate in the Asian region.
[31] See: https://www.ato.gov.au/Business/Small-business-entity-concessions/Concessions/Income-tax-concessions/Small-business-company-tax-rate/
[32] See for example http://www.abc.net.au/news/2017-10-13/fact-check-wii-australia-be-uncompetitive-on-company-tax/9033940
[33] John Freebairn (2017) Comparative Effects of a Lower Corporate Tax Rate on Small Versus Large Companies, paper presented to ANU Tax & Transfer Policy Institute; Michael Potter (2017) "Penalising big companies means a bonsai economy" *Australian Financial Review*, 5 April.
[34] Treasury (2017) *Analysis of wages growth*, Treasury Working/Technical Paper, 8 December.
[35] Jacob Greber (2017) "Treasury wage report undermines big business tax cut, Bowen says", *Australian Financial Review*, 8 December.
[36] Page 56 of Treasury (2017) *Analysis of wages growth*, Treasury Working/Technical Paper, 8 December.

Third, it is sometimes argued that Australian companies don't pay the headline rate of tax so international comparisons of the headline rate are not valid. It is argued the amount of tax actually paid by Australian corporates reveals a low tax burden on business.[37]

However, this view is not correct. Broad measures of effective tax rates (which measure tax actually paid) still show Australia's corporate tax system is uncompetitive. Several of these measures are reviewed below. Importantly, none of these figures include the impact of future global reforms, particularly in the US which will make Australia's corporate tax system for large business even more uncompetitive.

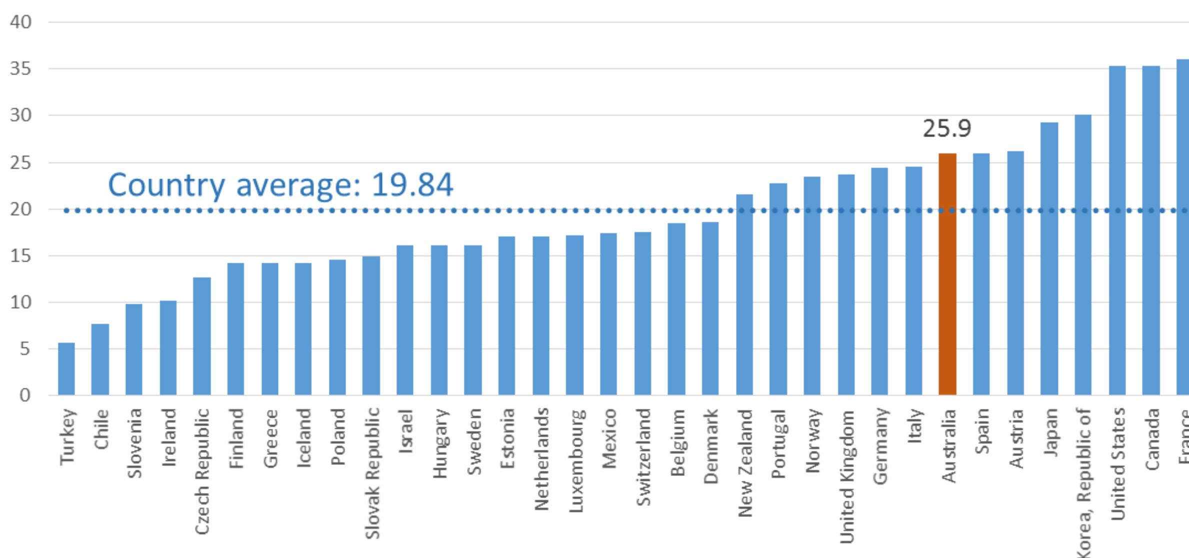
Australia levies much higher rates of company tax as a share of GDP than almost all other developed countries, as shown below, and Australia is still well above the average if imputation is removed.[38]



Source: OECD Revenue Statistics.[39] This does not include the impact of the US tax reforms.

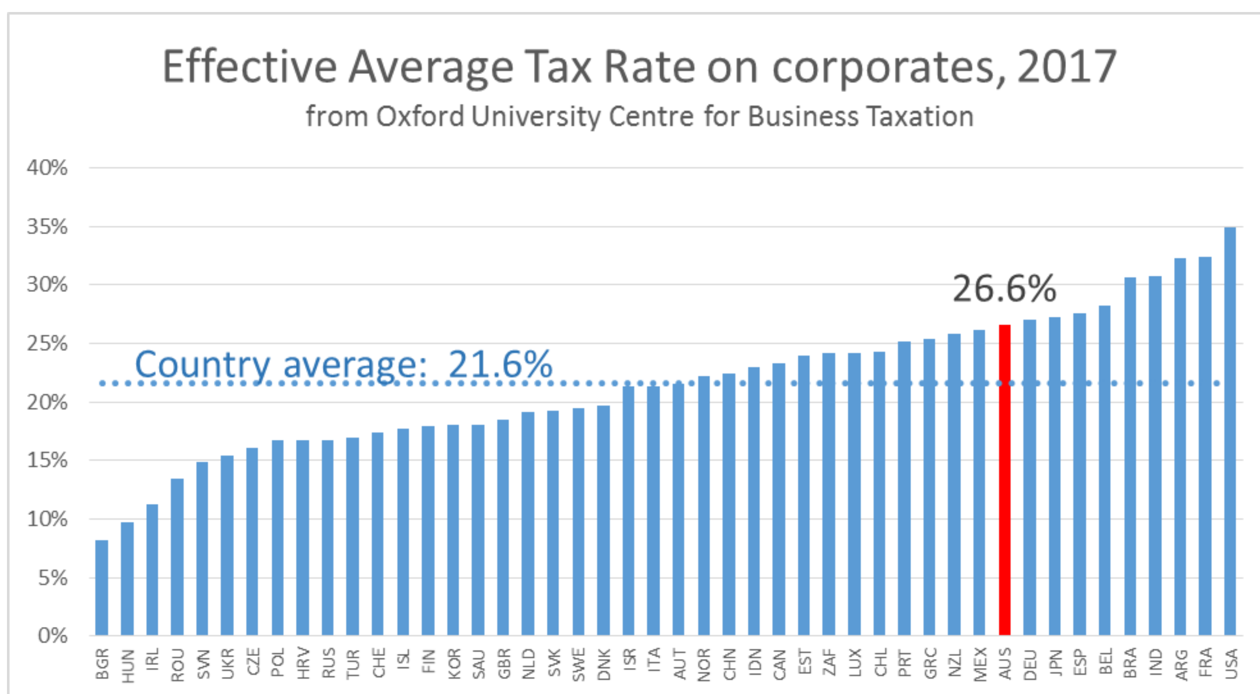
A report from the Tax Foundation finds Australia's effective corporate tax rate is at the high end compared to other developed countries, as shown in the graph below.

[37] Including the argument that x% of businesses paid no tax in a particular year.
[38] In 2015, imputation credits were worth about 1.2% of GDP based on the Tax White Paper (page 83); taking this off Australia's corporate tax to GDP ratio makes our ratio 3.1% of GDP, still above the average of 2.8%.
[39] See: https://data.oecd.org/tax/tax-on-corporate-profits.htm



Source: Mintz & Chen (2015) U.S. Corporate Taxation: Prime for Reform, Tax Foundation Special Report 228. Note again this does not include the impact of US tax reforms which will make Australia much less competitive.

Similar results from the Oxford Centre for Business Taxation finds the effective corporate tax rate for Australia is at the high end compared to many other countries:



Source: Oxford University Centre for Business Taxation, CBT Tax database.[40]

[40] See: https://www.sbs.ox.ac.uk/faculty-research/tax/publications/data

The report Paying Taxes 2018 by the World Bank, as part the Doing Business series, and PricewaterhousCoopers finds the tax on profits in Australia is 26%, well above the averages for every region of the world, including Europe (12.4%), Asia (17.5%) and the whole world (16.3%).[41]

Finally, a report prepared for the Minerals Council of Australia found the effective tax rate on profits was seventh highest out of 43 countries surveyed, above the G20 average of 27.4% and well above the OECD average of 19.2%.[42]

Critics of corporate tax cuts sometimes cite a report by the US Congressional Budget Office[43] that purports to show the effective tax rate on companies is low in Australia. However, this report is somewhat out of date, using data from 2012 and covers only the taxation of investments into Australia by US companies.[44] It therefore doesn't measure the tax on investment into Australia by US pension funds, US individuals, and any investors from outside the US. It therefore represents a quite unrepresentative view of the effective tax rates facing foreign investors or Australian business.

[41] World Bank & PricewaterhousCoopers *Paying Taxes 2018*
[42] Jack Mintz, Philip Bazel, Duanjie Chen and Daria Crisan (2017) *With global company tax reform in the air, will Australia finally respond?* Policy paper commissioned by Minerals Council of Australia.
[43] Congressional Budget Office (2017) *International Comparisons of Corporate Income Tax Rates*, Table 1.
[44] Ibid, Appendix A.

PRODUCT RATIONALISATION WORKING GROUP PROPOSAL

APPENDIX – PROPOSED PRODUCT RATIONALISATION MECHANISM

1. FINANCIAL PRODUCT RATIONALISATION SCENARIOS

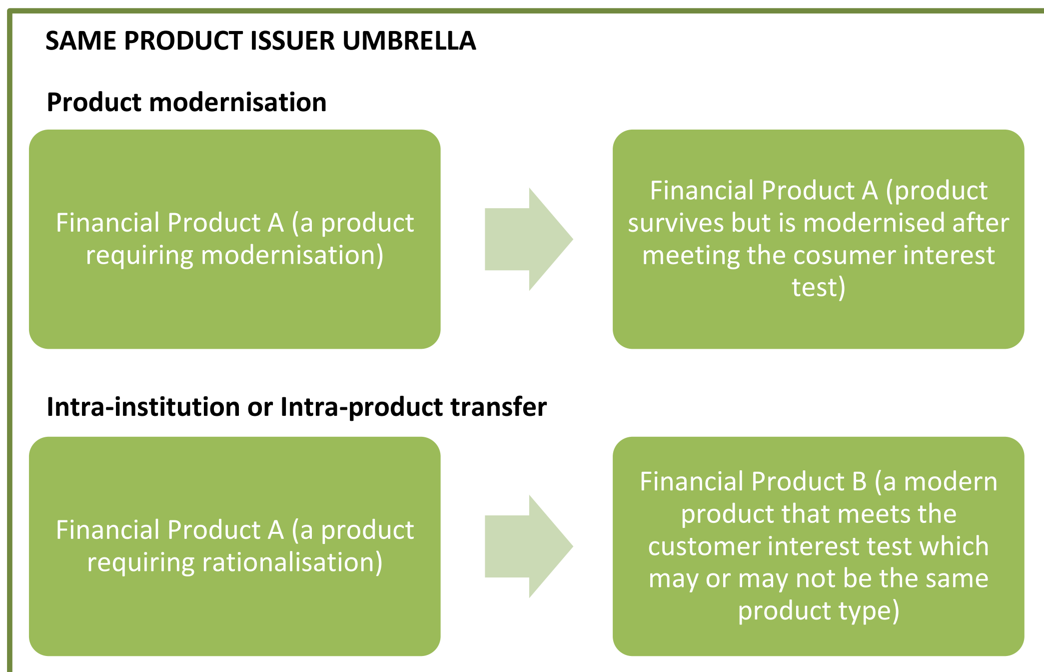
Under Part 9 of the Life Insurance Act 1995 (Cth) and the Financial Sector (Business Transfer and Group Restructure) Act 1999 (Cth), there is a process for the merger of the statutory funds of two life companies or the transfer of part of the life insurance business between them however this is too complex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

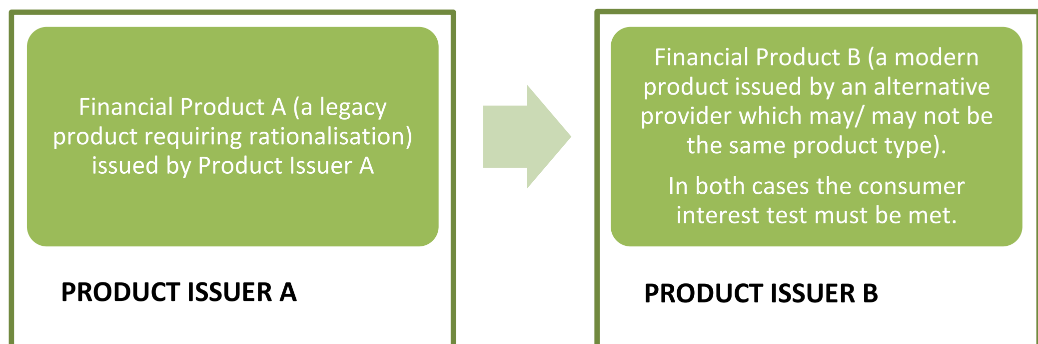


b. External simplification

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:

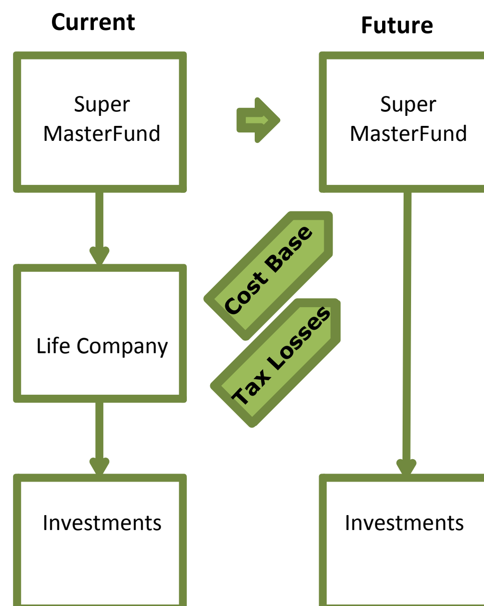
3. Permit the transfer of all the members from a legacy scheme (e.g. a scheme that is economically inefficient or out-dated) to another fund where the responsible entity or trustee considers on reasonable grounds that those transfers are in the interests of those members as a whole.
4. Introduce a more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