Board of Taxation Review of CGT rollover relief

FSC Submission on product modernisation

June 2020

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1. About the Financial Services Council

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advice licensees and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing $3 trillion on behalf of more than 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

2. Product modernisation

The FSC welcomes the opportunity to provide a submission to the Board of Taxation on Capital Gains Tax (**CGT**) rollover relief. This submission focuses on the issue of product modernisation (or product rationalisation) in financial services, in response to a specific request at a Board of Taxation consultation meeting for the FSC to provide details of the issue and the FSC's proposal.

Numerous Australians have significant amounts of money trapped in obsolete financial products that can have poor customer outcomes. These legacy products lack the higher returns, better features and easier access of more modern products. Financial services businesses are unable to move customers into more modern products for various reasons, including the imposition of large CGT liabilities on the transfer of customers to a more modern product. As a result, CGT rollover relief forms a central part of any product rationalisation scheme.

Acknowledging this problem, the Government some time ago (2015) announced it would implement a comprehensive product modernisation (or product rationalisation) scheme for obsolete products in financial services. The FSC is urging the Government to implement this already existing commitment, which is now clearly overdue.

2.1. Obsolete products are an extensive (and expensive) problem

The Productivity Commission in its 2019 report into the superannuation industry[1] highlighted the extent of the problems caused by obsolete/legacy products in superannuation alone. It found in 2017:[2]

- there was $162 billion invested in legacy superannuation products, which is 10% of the total assets held in APRA-regulated funds.
- there were 3.2 million legacy member accounts, which is 12% of the total number of accounts held at large super funds.[3]
    - This implies around 2 million individuals were trapped in legacy superannuation products with poor returns, based on the number of duplicate accounts in 2017.[4]
- Legacy products made up 46% of the assets in the high fee tail of products, with about 2 million member accounts; and almost all legacy products have high fees. The average fee in this tail was 2.2%, which is more than three times the most prevalent (i.e. modal) fee of 0.7% (page 180).
- The number of products in the high fee tail has remained steady over time (page 180). This implies that it cannot just be assumed that the issue of legacy products will gradually disappear over time (see further discussion in Section 2.5 below).

The figures above are large, but do not include obsolete products outside of superannuation such as life insurance and managed funds, which are likely to be substantial if the superannuation figures are anything to go by. Earlier estimates of the extent of the issues are contained in previous FSC submissions[5] and the FSC is planning to conduct a survey of our members to update these figures.

2.2. Adverse impacts of obsolete products

Obsolete financial products may have numerous detrimental effects on consumers, when compared to modern products:

- lower net returns, in many cases resulting in lower retirement incomes.
- higher fees – often significantly higher. The Productivity Commission evidence referred to in Section 2.1 above shows obsolete products in superannuation have fees that are more than three times the most prevalent fee rate.

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[1] Productivity Commission (2018) *Superannuation: Assessing Efficiency and Competitiveness*, Report no. 91
[2] Productivity Commission (2018), Page 115 except where stated.
[3] Technically, APRA-regulated funds.
[4] There were about 1.6 accounts per person in 2017, see: https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/Super-accounts-data/Multiple-super-accounts-data/
[5] For example see FSC Pre-Budget submission for 2018–19, available from: https://consult.treasury.gov.au/budget-policy-division/2018-19-pre-budget-submissions/consultation/download_public_attachment?sqId=question.2017-09-12.3768452384-publishablefilesubquestion&uuId=596571344

- poorer consumer disclosure and reporting.
- increased likelihood of errors, as many processes have to be completed manually.
- potentially reduced consumer targeting for suitability, as obsolete products were sold before the introduction of the Design and Distribution Obligations regime.
- poorer use of technology and reduced accessibility, for example they are not accessible through the internet or via apps.
- reduced resilience, as systems are out of date and expensive to maintain.

At an economy wide level, the trapping of consumers in these obsolete products:

- adds to product proliferation – this undesirable proliferation is not by consumer choice.
- increases financial system risks.
- reduces competition in financial services, as consumers trapped in obsolete products cannot move to competing products.
- inhibit Financial Technology (**FinTech**) innovation for two main reasons:
  - customers usually are unable to exit from obsolete products and move into modern products, including FinTech products; and
  - financial service providers are reluctant to innovate in case they create products that end up having low take-up and in future become out of date (obsolete) products.
    - this is especially a problem for long-dated products such as innovative retirement income products which can easily become obsolete products if take-up is low (see also the discussion in Section 2.5 below).
- reduces scale economies, increasing industry costs.
- reduces the productivity of financial services, dragging down economy-wide productivity.
- reduces savings and wealth.

2.3. Impact on Government Budget

The main budget cost of a rationalisation scheme is from individuals who were planning on exiting from an obsolete product despite tax or social security penalties, and now are able to exit without these penalties. Offsetting this cost is the benefit from the budget from taxpayers moving from products with low taxable returns into products with higher (taxable) returns; and the reduction in Government spending on income support, particularly the Age Pension, because of improved savings.

Therefore, while a product modernisation scheme may have a Budget cost in the short term, in the longer term a modernisation scheme may be a net benefit to the Budget as it will boost tax revenue, reduce Age Pension spending, and boost economy-wide growth due to the increased productivity and competition in financial services.

2.4. Barriers to product modernisation

It might be thought that financial services businesses could just transfer customers out of inferior obsolete products. However, there are various taxes, rules and regulations that prevent this occurring, including:

- Legal requirements that stop providers from changing consumer rights without explicit consumer consent. Broadly, superannuation deals with this issue in some circumstances (see section 2.7 below), but this issue is not addressed outside of super.[6]
    - There are often significant legal barriers to product modernisation in managed funds and life insurance. For example, the provisions in individual fund constitutions within an investment product may not allow for transferring holdings/rights to another trust.
- Consent may be required from individual members including those that are uncontactable.
- Transferring only some members to modern products might make those members better off but might make the remaining members worse off (because high costs are spread over fewer remaining members), making the transfer calculations more problematic.
- The imposition of CGT on unrealised gains. This tax can be imposed on the consumers holding the relevant obsolete investment product, and also on the vehicle making the investments.
    - CGT relief is available for merging superannuation funds, but only for transfers that are executed as a 'single arrangement' that occurs within a single tax year. This means relief is not available where there are too many members to transfer in one tranche for operational reasons.
    - The CGT issue remains unaddressed for the modernisation of products within a super fund, for life-backed superannuation products, for life insurance products, and for non-superannuation investments.
    - There is also generally an inability to transfer capital losses to new products.
- State stamp duty on investments that back a product (whether super or non-super). Stamp duty typically applies to land held through unit trusts and companies. The CGT rollover relief for merging super funds noted above does not deal with the stamp duty issue.
- For life insurance bonds, potential for re-starting of the 10 year rule.
- Legal barriers that restrict the ability for product providers to communicate with members of obsolete products about contemporary products.
- Possible loss of legislated member elections/decisions, for example binding death benefit nominations and elections as a result of the Protecting Your Super **(PYS)** and Putting Members Interests First **(PMIF)** legislation.

[6] See FSC submission to 2019–20 Budget.

- In some cases, any customer transition to a modern product must be done with client consent, generally based on financial advice. Given the cost of personal advice, this may act as a significant barrier to modernisation.
- Loss of grandfathered social security treatment. For example (highlighting added):
    - *a person who is an owner of an account-based pension purchased before 1 January 2015 and the holder of a CSHC [Commonwealth seniors health card] on 31 December 2014, will not have their account-based pension included in the income test for as long as they: continue to hold a CSHC, **and retain the same account-based pension**.*[7]
    - A 100% asset test exemption for complying income streams commenced between 20 September 1996 and 19 September 2004;
    - A 50% asset test exemption for complying income streams (including Market Linked Income Streams) commenced between 20 September 2004 and 19 September 2007;
    - A 'non-assessable portion' income test for account based income streams commenced before 1 January 2015, provided other conditions were also met; and
    - A 'non-assessable portion' income test and 'declining asset test' for lifetime income streams commenced before 1 July 2019.

To emphasise the points above, product modernisation relating to superannuation still faces numerous barriers even though some components have been addressed.

Obsolete products have caused some absurd problems for FSC members, including:[8]

- 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.
- A super fund had to buy a spare part on eBay for one of its obsolete systems because the manufacturer does not make or supply it anymore.

Continuing to manage outdated financial products that are highly aged and predate most employees is a significant challenge for most financial services companies. This causes many problems including:

- increased risk of failure, with consequent major costs to consumers — failures of aged systems are more likely because they are less resilient and harder to restore.
- reduced resources for activities that add customer value.
- 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.

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[7] See: https://guides.dss.gov.au/guide-social-security-law/3/9/3/31
[8] Sourced from a survey of FSC members, see FSC submission on 2019-20 Budget.

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2.5. The problems of obsolete products are unlikely to disappear

There is a perception that the existence of obsolete products is a 'one off' problem that will gradually solve itself over time, for example as customers of obsolete products withdraw remaining balances. As a result, it might be thought that inaction on this issue is less of a concern. However, this view does not fit with the data outlined in Section 2.1 above showing the number of obsolete products has not declined over time.

The Productivity Commission has also stated there is "strong risk that the incidence of obsolete retirement products will rise".[9] They reached this conclusion because:

- product innovation and policy developments suggest annuities and pooled investments will grow in prominence;
- products will reflect tax and social security policy settings at the time of issuance; and
- as these settings change, or if innovative products fail to gain sufficient interest, some products may become obsolete.

2.6. History of product modernisation

As mentioned in Section 4.5, product modernisation has been affirmed in a number of parliamentary reports, government background papers and public inquiries:

The Productivity Commission recommended product modernisation (or rationalisation) in its report 'Rethinking Regulation' stating

> *"The Taskforce considers that implementing a simplified product rationalisation mechanism that could be applied to the full spectrum of financial products would significantly improve operational efficiency and reduce the operational risks carried by financial entities."*[10]

The Super System Review **(the Cooper Review)** argued in June 2010:[11]

> *The consolidation and rationalisation of legacy products can provide benefits to members, including:*
>
> - *better product disclosure and clearer reporting to members;*
> - *lower costs — as cost savings will be passed on to members;*
> - *enhanced and newer features, for example, BPay, internet/online transactions, investment choice, unbundled offerings, more transparent and easier to understand products; and*
> - *improved service standards through better administration, greater flexibility, fewer systems and processes.*

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[9] See Productivity Commission (2018), page 216.
[10] Rethinking Regulation: Report on the Taskforce on Reducing the Regulatory Burden on Business (January 2006) See: https://www.pc.gov.au/research/supporting/regulation-taskforce/report/regulation-taskforce2.pdf
[11] See: https://treasury.gov.au/review/super-system-review

Such benefits result principally from greater economies of scale and transfers to more modern and flexible products and systems.

ASIC made the following submission to the interim report of the Financial System Inquiry **(FSI)** in August 2014:[12]

> *ASIC supports renewed consideration of the 2009 proposals on product rationalisation of legacy products by Government.*
>
> *…*
>
> *We support an approach developed from the 2009 proposals that provides a streamlined process for product rationalisation involving adequate disclosure and safeguards, without requirements of individual holder assent.*

ASIC report 466 *ASIC's work to reduce red tape* stated in January 2016:[13]

> ***Legacy product rationalisation***
>
> *Submissions suggested that a process be developed to rationalise legacy products. We agree that this would enable more efficient and up-to-date financial products and services to be provided to consumers, and avoid ongoing operational risk and cost associated with maintaining legacy products and systems. We have suggested implementing a process for legacy product rationalisation that balances the interests of consumers and product and service providers.*

An APRA submission to an Inquiry by the Senate Economics Committee into the *Scrutiny of Financial Advice – Life Insurance* of April 2016 stated:[14]

> *One area of potential change identified by APRA relevant to this Inquiry is the introduction of a mechanism to allow the rationalisation of legacy products to occur more easily*
>
> *…*
>
> *Over time, legacy products become more complex and expensive to administer and may no longer meet the requirements of the beneficiaries.*
>
> *…*
>
> *There is a range of very complex legal, consumer and tax issues that arise if a life insurer seeks to move policyholders from a legacy product to a new product, restricting the ability of insurers to close legacy products. The benefits of a simpler, though still*

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[12] See: https://download.asic.gov.au/media/2613736/asic-submission-to-the-financial-system-inquiry-interim-report-published-26-august-2014.pdf

[13] See: https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-466-asic-s-work-to-reduce-red-tape/

[14] See: https://www.aph.gov.au/DocumentStore.ashx?id=790eec66-f56a-4f2f-96d3-8eb6a8f65114&subId=412976

robust, mechanism to rationalise legacy financial products has been recognised for some time.

…

APRA continues to strongly support the need to comprehensively address this issue. From the perspective of the product provider, it would help mitigate the increasing operational risk that such products create, as well as improve the industry's operational efficiency. From the consumer perspective, it has the potential to improving consumer outcomes by updating definitions, improving efficiency and administration, and lowering costs.

The final report of an Inquiry by the Parliamentary Joint Committee on Corporations and Financial Services into the Life Insurance Industry stated the following in March 2018:[15]

Recommendation 10.13

The committee recommends that the Australian Government introduce legislation to facilitate the rationalisation of legacy products

The Productivity Commission inquiry into superannuation said the following in 2018:

[APRA should] undertake a systematic assessment of the costs to funds of the thousands of legacy products in the superannuation system. If the evidence demonstrates that they represent a significant cost in accumulation, APRA should further refine trustees' obligations for member transfers so these products can be rationalised.[16]

The Treasury stated the following in a background paper on the life insurance industry, written for the Royal Commission into Financial Services in August 2018:[17]

The products that the life insurance industry offers are continually revised and updated. Products are often deemed uneconomic or dated as a result of changes in market structure, government policy or legislation. These legacy products increase costs to insurers, which may be passed on to consumers. They may also increase operational risks in the management of products, which can lead to administrative errors that affect consumers. In rationalising these outdated products consumers and the industry can benefit from new, more efficient products.

There are challenges to achieving this rationalisation of legacy products fairly and effectively. For example, a capital gains taxation (CGT) taxing point may arise if life

[15] See: https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/LifeInsurance/Report
[16] Recommendation 23.
[17] See: https://financialservices.royalcommission.gov.au/publications/Documents/reforms-to-general-and-life-insurance-background-paper-27.PDF

company assets are transferred to another life company or a custodial arrangement as part of the rationalisation.

Despite these observations, no noticeable progress has been made on a comprehensive regime for product modernisation.

2.7. Existing relief for product modernisation

There is currently CGT rollover relief for merging superannuation funds (through successor fund transfers or **SFTs**) which has recently been made permanent. However, product rationalisation is also important for rationalisation *within* existing funds (intrafund transfers or **IFTs**). CGT relief is often not available for rationalisation within funds – so a financial services business that runs only one super fund (generally) does not have tax relief options to deal with obsolete products.

- The FSC has previously raised this issue in the context of rollover from legacy default super products into MySuper products (see submission at **Attachment A**), and in response the Government allowed tax rollover relief for IFTs into MySuper products;[18] however rollover relief is not available for IFTs relating to legacy products today.

In addition, relief from State stamp duty may not be available for product modernisation, either SFTs or IFTs. These tax issues are potentially why there exists a large volume of obsolete products in superannuation, even though some of the barriers to superannuation modernisation have been addressed.

2.8. FSC's recommended product modernisation solution

The FSC's recommended approach for the modernisation of obsolete financial products is:

- a consumer interest test applied at a collective level;
- transfer of non-tax attributes (for example, the grandfathering of social security benefits such as account-based pension 1 January 2015 grandfathering);
- roll over of all tax attributes to the new vehicle; and
- no tax implications of the rollover itself.

The consumer interest test involves an independent determination that modernisation is in the interests of consumers collectively. The FSC proposes 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.

To expedite the modernisation of a large number of obsolete products, a worthwhile approach is an institutional mechanism (e.g. tribunal) that would allow for expert independent decision-makers to approve modernisation of products. This would help address the concerns of both consumers and industry by providing greater certainty,

[18] See: http://jaf.ministers.treasury.gov.au/media-release/035-2015/

transparency and timeliness around a process that has historically proved difficult to negotiate.

The FSC proposes a modernisation regime that can be applied to any financial product including 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
- Superannuation products

FSC Recommendation: Introduce a comprehensive product modernisation (or product rationalisation) scheme for obsolete products in financial services. The Government has a long-standing commitment (made in 2015 in the Government's response to the FSI)[19] to implement such a scheme for life insurance and funds management, and the FSC argues this commitment should extend to superannuation.

FSC Recommendation: To expedite the modernisation of a large number of obsolete products, the Government should explore the appropriateness of an institutional mechanism (e.g. tribunal) that would allow for expert independent decision-makers to approve modernisation of products. This would help address the concerns of both consumers and industry by providing greater certainty, transparency and timeliness around a process that has historically proved difficult to negotiate.

[19] See inquiry recommendation 43 – legacy products, and the Government's response outlined here - https://www.treasury.gov.au/publication/government-response-to-the-financial-system-inquiry/attachment-government-response-to-financial-system-inquiry-recommendations