Attachment A

MYSUPER ROLLOVER RELIEF

INTRA-FUND TRANSFERS

1. Issue

The objective of the Government's MySuper reforms is to provide a low cost and simple superannuation product to replace existing "default" funds. From 1 January 2014, employers must make default contributions to a MySuper product. Further, any amounts in a "default" product as at 31 December 2013 (an "accrued default amount") must be transferred to a MySuper product no later than 1 July 2017 (a "mandatory transfer").

It was recognised that a mandatory transfer may have adverse financial consequences for members due to the incurrence of capital gains tax (CGT) or the loss of the benefit of the unused revenue and capital losses. Accordingly, Division 311 of the Income Tax Assessment Act 1997 ("ITAA") was introduced to allow for CGT rollover relief and for the transfer of losses on the transfer of accrued default amounts (ADA's) to a MySuper product. However, Division 311 only operates when there is a transfer of an ADA from an original fund to another complying superannuation fund (sub-section 311-10(3) of the ITAA).

We submit that a "mandatory transfer" involving the transfer of a member from a default product to a MySuper compliant product **within the same superannuation fund** may result in the derivation of capital gains, the result of which is to detrimentally affect the account balances of members so transferred. In order to obviate this unintended detrimental impact, the rollover relief currently provided under Division 311 of the ITAA should be extended to also encompass all "mandatory transfers", and specifically mandatory transfers to a MySuper compliant product within the same superannuation fund.

2. "Mandatory Transfers"

2.1 Legislative Framework

Schedule 6 of the *Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Act 2012* (the "Act") contains provisions relating to the movement of ADAs to a complying MySuper product. These are the requirements under which ADAs for members who have not given a direction with respect to their superannuation fund and investment option must be transferred to MySuper (providing the members do not 'opt-out' during the notice period). These transfers are due to occur by 2017.

The Act contains provisions for the Trustee of a fund that intends to obtain a licence from APRA and offer a MySuper product, to make an election to transfer members to that MySuper product, hence recognising that in many cases a transfer to MySuper will involve a move between products within the same fund.

The wording of the section clearly refers to 'product' rather than 'fund'. The relevant section (with emphasis added) reads as follows:

29SAA Election to transfer accrued default amounts

(1) An RSE licensee that applies for authority to offer a class of beneficial interest in a regulated superannuation fund as a MySuper product makes an election in accordance with this section if:

(a) the RSE licensee elects that, if authority to offer the class of beneficial interest in the fund as a MySuper product is given, the RSE licensee will:

> (i) attribute to the MySuper **product** each amount that is an accrued default amount for a member of the fund who is eligible to hold the MySuper **product**, unless the member directs the RSE licensee in writing to attribute the amount to another MySuper **product or an investment option within a choice product in the fund; and**
>
> (ii) do so before the end of a period of 30 days beginning on the day on which notice of authority to offer the class of beneficial interest in the fund as a MySuper product is given to the RSE licensee under section 29TD;

2.2 Regulatory Framework

The majority of the requirements with respect to the transfer of ADAs are dealt with in APRA's Superannuation Prudential Standard SPS 410 - MySuper Transition ("SPS 410"). This also uses the phrase 'product' throughout and does not differentiate between transitions that involve a move between products within a single fund, and those that require a transfer between funds (because the fund currently holding the ADAs will not offer a MySuper product).

The core definition within SPS 410 of a suitable MySuper product to which ADAs can be transferred recognises that the product could be an existing product, a different product within the same fund, or a product in a different fund.

Paragraph 11 of SPS 410 defines a suitable MySuper product as:

11. A MySuper product will be suitable for the purposes of paragraph 10 if it is a MySuper product:

(a) that:

> (i) the RSE licensee is authorised to offer in the RSE in which the accrued default amount is held; or
> (ii) the RSE licensee is authorised to offer in another RSE within its business operations; or
> (iii) is in any other RSE; and

(b) into which the member or class of members is eligible under the governing rules to make contributions; and

(c) to which the RSE licensee is legally able to attribute the member's accrued default amount

and the RSE licensee has formed the view that attribution of the member's accrued default amount to that MySuper product promotes the financial interests of the member or class of members.

2.3 Intention to treat product and fund transfers equally

It is clear from both legislative drafting and the drafting of APRA prudential standards that the policy parameters for the transfer of ADAs to the MySuper regime treats transfers between products, and transfers between funds equally; no distinction or differentiation is made in this regard.

A superannuation Trustee that holds ADAs on behalf of a member is required to transfer those amounts to a suitable MySuper product. This is a mandatory transfer.

The MySuper regime does not, however mandate that the member's ADAs must be transferred between funds, it clearly recognises that the MySuper product may be the same product in which the member's monies reside, a different product within the same fund, or a product within a different fund. If the Trustee selects a suitable MySuper product within the same fund as the appropriate MySuper product, the transfer to this product is 'mandatory' in the same way as a transfer to a product in a different fund would be, had that been the appropriate product selected by the Trustee.

We therefore submit that the structure of the CGT relief being provided to facilitate the transition to MySuper should equally support transfers between products within a single superannuation entity.

3. Capital Gains Tax Implications

3.1 Typical Life Backed Superannuation Model

Division 311 of the ITAA was introduced to ensure that members were not detrimentally affected through the crystallisation of capital gains on the transfer of assets pursuant to a mandatory transfer. However, the relief as currently written does not apply in relation to capital gains crystallised as a result of the transfer of members from a default option to a MySuper compliant option within a single superannuation entity. In particular, this is so in the case of "life-backed" superannuation products (i.e. products where investments are made via an investment policy in a life insurance company).Such an outcome is inconsistent with the purpose of Division 311. We note that paragraph 1.22 of the Explanatory Memorandum to Superannuation Laws Amendment (MySuper Capital Gains Tax and Other Measures) Bill 2013 (which introduced Division 311) specifically acknowledges the commercial reality that a significant amount of superannuation is invested through life insurance companies.

Typically, a life-backed superannuation arrangement (prior to MySuper) would be structured as follows:

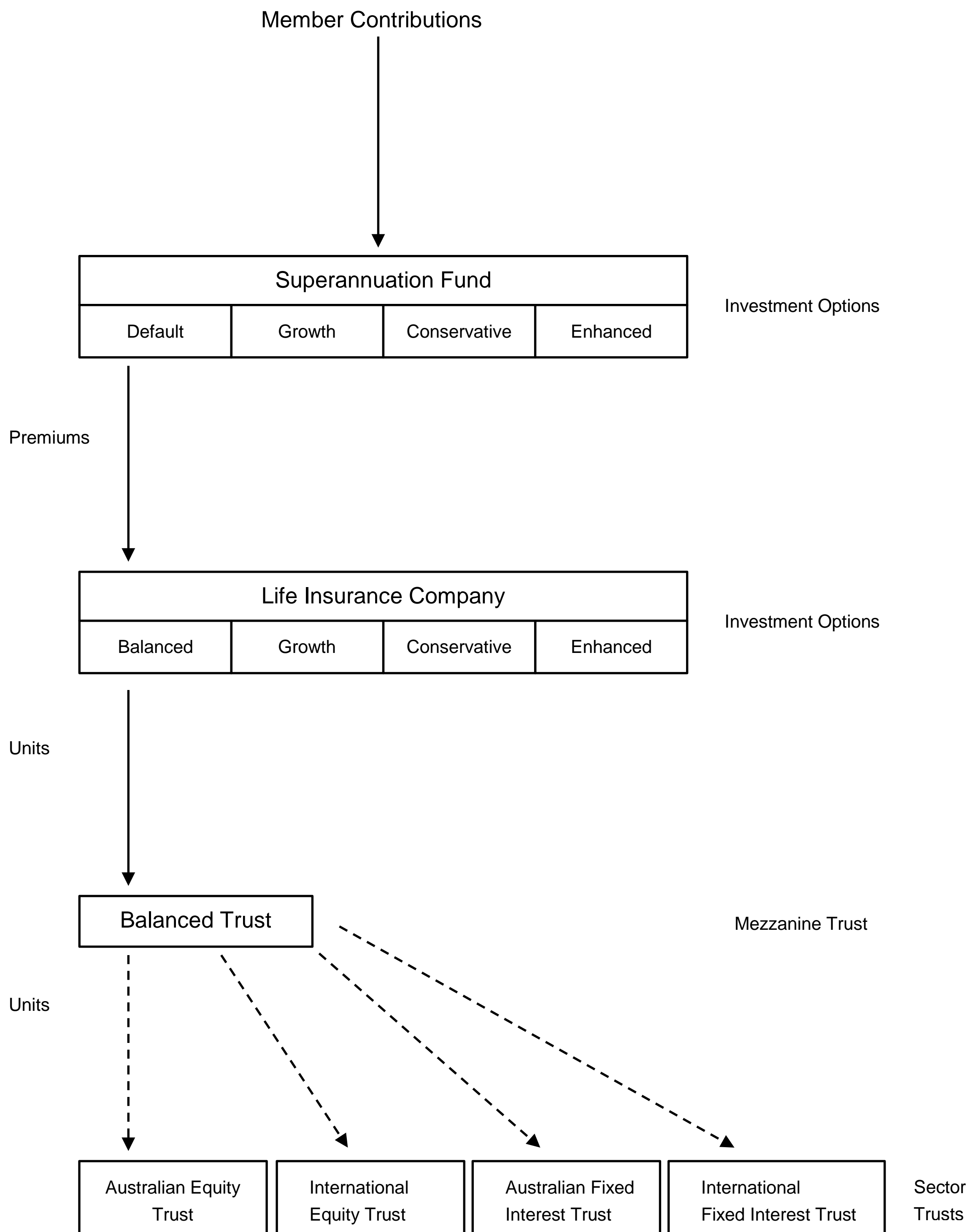
- The superannuation fund offers investment options. If a member does not choose an investment option, that member will be attributed to the "default" option.

- The superannuation fund will "acquire" an investment policy from a life insurance company. The life insurance company will offer investment options similar to those offered by the superannuation fund. The life insurance company will invest the

moneys "assigned" to those options under a mandate which supports the investment aims of that option (e.g. growth option, conservative option etc). Default funds of a superannuation fund would normally be invested in a balanced investment option.

- Normally, the life insurance company will invest their balanced option in a Balanced Trust. The life company will own units in that Balance Trust and the Balanced Trust will in turn invest in specific investment sectors in accordance with the trust's "balanced" mandate.

This typical structure is shown in the following diagram:



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3.2 Mandatory Transfers Pursuant to a Life Backed Superannuation Model

A MySuper product can either have a single diversified investment strategy (similar to the balanced option above) or can adopt a lifecycle strategy. Given the variances in appropriate investment strategies across an individual's working life, we understand that the vast majority of funds are providing their MySuper compliant products with a lifecycle strategy. Accordingly, in the case of typical life-backed superannuation arrangements:

- MySuper products offered by the superannuation fund would be based on the respective age cohort of members (e.g. someone born in the 1960's would be a member of the "1960's Cohort" MySuper product).

- The life insurance company will offer an investment option that corresponds to the respective age cohort product in the superannuation fund (i.e. the moneys referable to the 1960's age cohort product in the superannuation fund will be invested in the "1960's Option")

- The respective age cohort investment option of the life company will invest in a cohort-specific trust (e.g. the "1960's Cohort" MySuper product will invest in the "1960's Trust" which in turn would invest in relevant investment sectors dependant on the mandate of that age cohort.

- Under MySuper arrangements, members in current default options (the Balanced Option in the diagram above) would be required to be mandatorily transferred to the new MySuper compliant age cohort product. This will ordinarily involve the following steps:

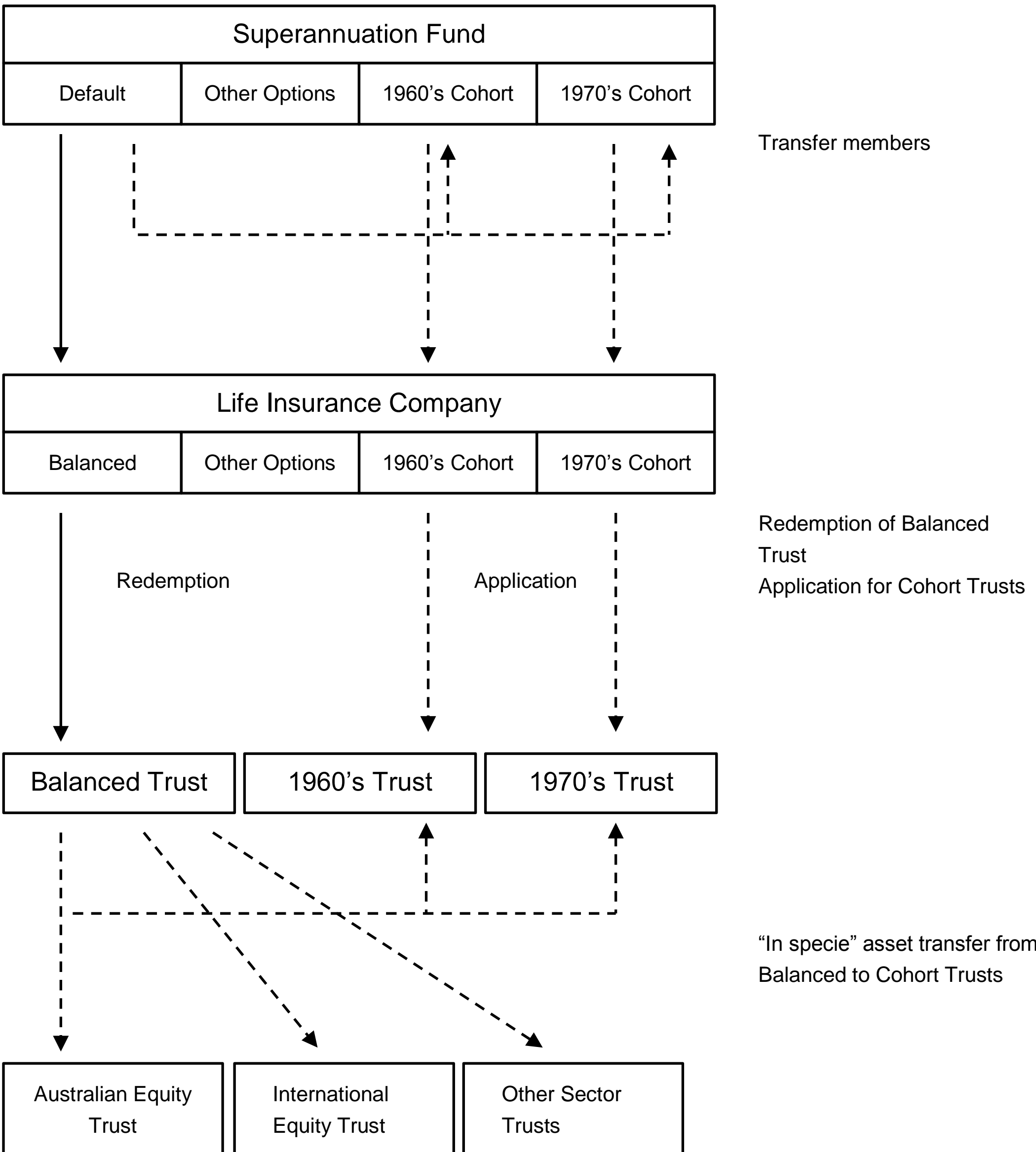
    - Members will be switched from the Balanced Option to their respective Age Cohort Product. This will simply be transferring between products offered by the same superannuation fund.

    - The life company will redeem units in the Balanced Trust;

    - The life company will apply for units in the Age Cohort Trusts (corresponding to the value of member balances attributable to each cohort option)

    - As consideration for redemption of units in the Balanced Trust, assets of the Balanced Trust will be transferred "in-specie" to the Age Cohort Trusts (ordinarily, this will be a pro-rata transfer of each asset held by the balanced trust referable to the value of member balances in each age cohort).

These mandatory transfer steps are shown in the diagram below (note that for simplicity, only the Default product and Balanced Option from Diagram 1 is included, as it is that option that will be impacted by the MySuper mandatory transfer, and only 2 age cohorts are shown):


Superannuation Fund
Default
Other Options
1960's Cohort
1970's Cohort
Transfer members
Life Insurance Company
Balanced
Other Options
1960's Cohort
1970's Cohort
Redemption
Application
Redemption of Balanced Trust
Application for Cohort Trusts
Balanced Trust
1960's Trust
1970's Trust
"In specie" asset transfer from Balanced to Cohort Trusts
Australian Equity Trust
International Equity Trust
Other Sector Trusts

3.3 CGT Events and Rollover Extension

The following CGT events occur as a result of the above steps:

- The redemption by the life company of its units in the Balanced Fund is a CGT event to the life company, potentially giving rise to realisation of capital gains; and

- The transfer of assets from the Balanced Trust to the Age Cohort Trusts is a CGT event, potentially giving rise to a capital gain that will be "distributed" to the life company.

In the event that a capital gain is realised as above, crystallisation of this liability will detrimentally impact member account balances. **We contend that such detriment to members is unintended and that therefore the CGT rollover relief currently provided in Division 311 of the ITAA be extended to provide relief in such circumstances.** Such relief could take the following form:

1. Roll over by the life insurance company of the cost base of units in the Balanced Trust to units in the respective age cohort trusts. This can be simply achieved by extending the second condition contained in sub-section 311-10(3) of the ITAA to include the circumstances whereby member 'accrued default amounts' are mandatorily transferred to a MySuper product offered by the original fund. If the "original fund" were then defined to be both the "transferring entity" and the "receiving entity" for the purposes of the Division, then the operative provisions of Subdivision 311-D of the ITAA should provide the requisite rollover without the need for additional amendments.

2. Roll over by the Balanced Trust of the cost base of the units it holds in the sector trusts to the age cohort trusts.

3.4 Mandatory Transfers Pursuant to Other Superannuation Investment Models

Notably the diagram above only depicts a life-backed investment model. However some of our members may also have their Super Funds directly invested in other flow through and taxed vehicles. Some of these include Unit Trusts and Pooled Superannuation Trusts (PST) instead of an investment policy with the life insurance company. Furthermore with the use of Unit Trusts, our members vary in terms of the number of layers of these interposed entities required to construct their MySuper/cohort options.

Alternatively, their Super Funds could invest directly in the underlying asset classes, instead of holding them through any investment vehicles.

Regardless of the investment structure adopted, each equally need to be afforded the option and flexibility of CGT rollover relief when it comes to an Intra Fund Transfer.

PRODUCT RATIONALISATION WORKING GROUP PROPOSAL
PROPOSED PRODUCT RATIONALISATION MECHANISM

1. FINANCIAL PRODUCT RATIONALISATION SCENARIOS

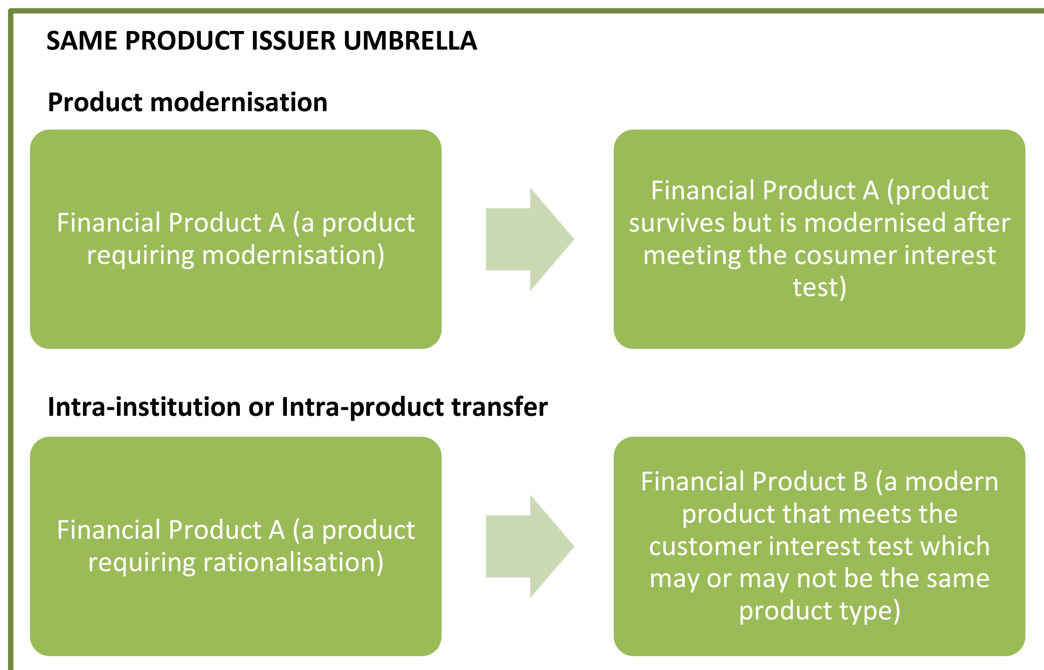
Under Part 9 of the Life Insurance Act 1995 (Cth) and the Financial Sector (Business Transfer and Group Restructure) Act 1999 (Cth), there is a process for the merger of the statutory funds of two life companies or the transfer of part of the life insurance business between them however this is too complex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

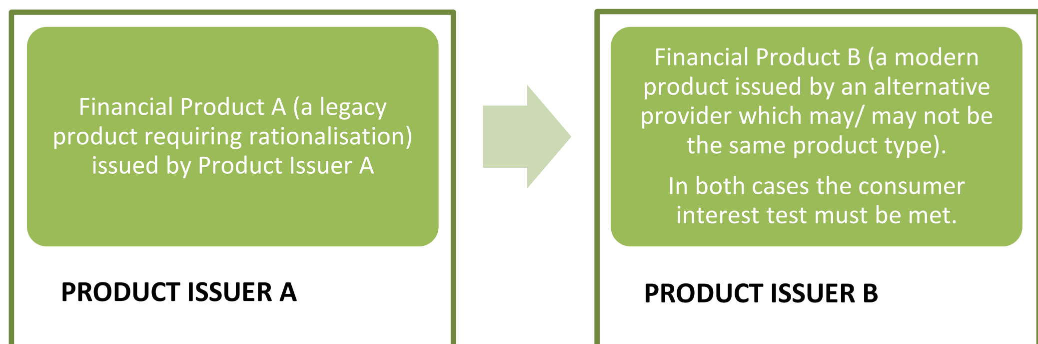


b. External simplification

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:

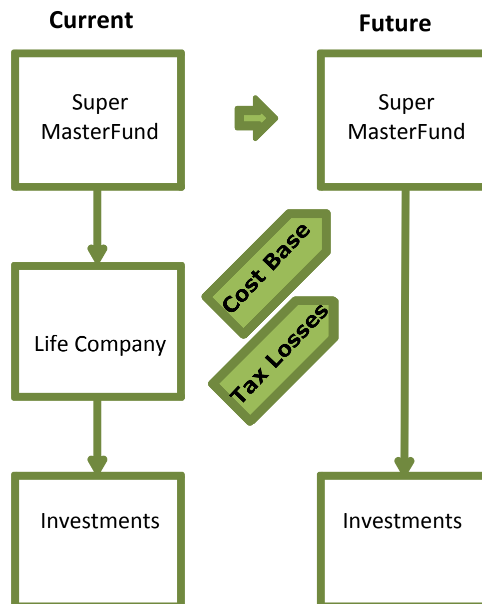
3. Permit the transfer of all the members from a legacy scheme (e.g. a scheme that is economically inefficient or out-dated) to another fund where the responsible entity or trustee considers on reasonable grounds that those transfers are in the interests of those members as a whole.
4. Introduce a more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