

3 May 2019

Financial Services Reform Taskforce
The Treasury
Langton Crescent
PARKES ACT 2600

FOFAGrandfathering@treasury.gov.au

Dear Taskforce

Re: Ending Grandfathered Commissions - Regulations

Thank you for the opportunity to comment on the regulations to remove grandfathering arrangements for conflicted remuneration and other banned remuneration from 1 January 2021.

Challenger Limited ("Challenger") is an ASX-listed investment management firm managing \$78 billion in assets under management (as at 31 December 2018). We are the leading provider of annuities in Australia, delivering on our vision to provide our customers with financial security for retirement. We provide more than 60,000 Australians with a secure and reliable income in their retirement. We are also one of Australia's top ten largest investment fund managers, offering institutional and boutique funds management solutions.

Challenger is committed to ensuring the best outcome for our customers and we support the proposal for customers to receive the benefit of previously grandfathered commission payments.

The existing regulatory regime governing superannuation trustees, responsible entities of managed funds, and annuity providers (life insurers) needs to be carefully considered so that potential legal conflicts can be addressed. We are concerned that these conflicts may result in unintended customer detriment and we recommend that a cross-agency working party be formed to identify and resolve these issues. Further detail is provided in Appendix A.

Please do not hesitate to contact me should you wish to discuss our submission further. I can be best reached on (02) 9994 7288 or choorweg@challenger.com.au.

Yours sincerely



Carla Hoorweg
Head of Government & Industry Relations

Melbourne Level 19, 31 Queen Street PO Box 297, Flinders Lane, Melbourne VIC 3000 Telephone 02 9994 7000 Facsimile 02 9994 7777
Brisbane Level 9, 241 Adelaide Street GPO Box 3234, Brisbane QLD 4001 Telephone 07 3136 5400 Facsimile 07 3136 5407
Perth Level 26, 140 St Georges Terrace, Perth WA 6000 Telephone 08 6466 9613
Adelaide Level 7, Suite 714, 147 Pirie Street, Adelaide SA 5000 Telephone 08 8427 9511

Challenger Limited ABN 85 106 842 371 Challenger Group Services Pty Limited ABN 91 085 657 307
Challenger Life Company Limited ABN 44 072 486 938 AFSL 234670
Challenger Investment Partners Limited ABN 29 092 382 842 AFSL 234 678
Challenger Retirement and Investment Services Limited ABN 80 115 534 453 AFSL295642 RSE Licence No. L0001304
Challenger Mortgage Management Pty Ltd ABN 72 087 271 109 Challenger Securitisation Management Pty Ltd ABN 56 100 346 898 AFSL 244593
Challenger Investment Solutions Management Pty Ltd ABN 63 130 035 353 AFSL 487354

APPENDIX A

About Challenger's business

Challenger has three business areas which will be impacted by the changes to grandfathered commission payments. These are:

- A life insurance business, which is an APRA registered life company;
- A superannuation business for which we hold a Registrable Superannuation Entity (RSE) licence, also issued by APRA; and
- A funds management operation for which we are Responsible Entity (RE) and hold relevant Australian Financial Services Licenses (AFSL) issued by ASIC.

Challenger does not have a financial advice business. Instead we utilise third party networks of financial advisers by contracting with the dealer group licensees who run these businesses. The majority of our products are distributed through these advice channels, with a small proportion of products being directly acquired by consumers.

While a proportion of our business is subject to grandfathered commission payments, the majority of our advised business does not pay commissions.

Annuities

An annuity is a financial product which allows a customer to purchase an income stream (the annuity) in exchange for an amount of capital. Payments made by the annuity provider are set up front and comprise either a fixed dollar amount, or an amount indexed to increase over time, for instance in line with the consumer price index (CPI).

Some annuities are offered as a superannuation product 'within' the superannuation system', and others fall outside the superannuation system. For business outside the system, superannuation rules may still be relevant as tax and social security treatment often leverages superannuation definitions.

The *Superannuation Industry (Supervision) Act 1993* ("SIS Act")¹ defines an annuity as including a benefit which complies with the rules set out in the *Superannuation Industry (Supervision) Regulations 1994* ("SIS Regulations"). The SIS Regulations in turn provide for a variety of different annuity types which are considered to comply with the superannuation rules. These rules have evolved over time to cater for changes in the regulation of annuities and there is considerable complexity. Likewise, the definitions of pensions under both the SIS Act and SIS Regulations are broad and cater for a variety of scenarios; further some offerings that meet the 'pension' criteria may also involve annuity-like products.

The concept of an annuity also exists at common law and applies in cases where the annuity product does not meet the specific eligibility requirements of the superannuation system. The taxation and social security rules for annuities also contemplate the common law concept of an annuity.

¹ s10 Definitions "annuity includes a benefit provided by a life insurance company or a registered organisation, if the benefit is taken, under the regulations, to be an annuity for the purposes of this Act."

The redirection of commission payments to customers has the potential to intersect unfavourably with the fundamental concept of an annuity expressed at common law, and under the SIS Act and SIS Regulations (i.e. 'known payment amounts agreed upfront') and we believe that significant consumer detriment could occur if further consultation is not undertaken.

Consumers of annuity products could face unintended outcomes if their annuity product ceases to comply with the relevant taxation, social security or superannuation provisions; or if existing grandfathering² of certain taxation, social security, or superannuation treatment is not maintained.

We believe these hurdles can be overcome through careful consideration of the issues by the relevant agencies and industry participants. We propose that Treasury work closely with the Department of Social Services, Australian Taxation Office, and the Australian Prudential Regulation Authority, at a minimum, to form a working party responsible for identifying issues and proposing legislative solutions. Without the involvement of all relevant agencies any legislative solution has the potential to create unintended consequences for consumers in other parts of the law.

Specific limitations on superannuation annuities and pensions

Annuities and pensions that comply with the superannuation rules have limitations on the payments which can be made by providers to recipients. To qualify as 'complying' these limitations must be adhered to. Consideration of the superannuation rules will be required for annuity and pension providers to be able to redirect commission payments.

These specific limitations on payments made by providers to customers exist in the SIS Regulations and apply in relation to annuities and pensions, under *Part 1A – Annuities and pensions*. Broadly Part 1A sets out the meaning of annuities and pensions and certain standards and rules that must be met for these products. The relevant parts of the SIS Regulations are subsections *1.05 Meaning of annuity* and *1.06 Meaning of pension*.

The vast majority of Challenger's current annuity portfolio falls under subsection 1.05(11A)(b)(ii)(E) of the SIS Regulations which applies to annuities offered post-2007.³ This section, and the equivalent pension section, include prohibitions on varying annuity and pension payments other than for indexation arrangements or transfers, specifically:

- 1.05(11A)(b)(ii)(E) the total of payments from the annuity in a subsequent year cannot vary from the total of payments in the previous year unless the variation is as a result of an indexation arrangement or the transfer of the annuity to another person; and
- 1.06(9A)(b)(ii)(D) the total of payments from the pension in a subsequent year cannot vary from the total of payments in the previous year unless the variation is as a result of an indexation arrangement or the transfer of the pension to another person.

An exception to the annuity and pension rules in the *SIS Regulations* is needed to enable Challenger to redirect previously grandfathered commission payments to customers, or the redirection payment would need to be considered as an ex-gratia payment separate from the underlying annuity contract.

² Grandfathering has been provided over many years in a variety of circumstances unrelated to the grandfathering of commission payments under FOFA.

³ Subsections 1.05(11A)(b)(ii)(E) and 1.06(9A)(b)(ii)(D) *SIS Regulations*.

Challenger also has legacy annuity products which do not fall under the definition of 1.05(11A)(b)(ii)(E) or 1.06(9A)(b)(ii)(D). Given that similar limitations on varying annuity and pension payments exist regardless of the specific clause that applies, we expect that similar problems will arise for most if not all of our other annuity products where grandfathered commissions are currently being paid. We anticipate broad relief from SIS Regulations 1.05 and 1.06 will be required however we note that separate relief will be required for common law annuities.

In terms of timing, our view is that consequential amendments to the *SIS Regulations* should be made in conjunction with any legislative changes to grandfathered commissions. We also believe it would be prudent for any exceptions to be drafted broadly, to cater for the variety of products regulated under the *SIS Regulations* and the short implementation timeframes involved. Broad relief would provide product providers with clarity and certainty that all redirections could occur under the law and without the need to seek specific, individual relief from APRA, the ATO, the DSS and potentially other government agencies.

Facilitating redirection of commission payments to customers

Annuity contracts can be for a fixed term (say 1, 3 or 5 years) or for the life of the customer. Where the annuity contract is for a fixed period of time, the contract must be renewed for the product to continue past the initial term.

There are set terms for the provision of commission payments to advisers, via agreements with advice "dealer groups" or "hubs" (i.e. the financial advice licensee businesses). These agreements usually set out the specific amount of commission to be paid in relation to each customer's contract. This amount is based on the term of the annuity and the dollar amount agreed between the customer and their adviser.

Unlike investments in managed funds, fixed term annuity policies have a specified end date which means that it is possible to calculate the present value of all future commission payments owing to an adviser related to a specific policy.

In some cases, the best outcome for annuity customers could be for them to receive a single commission redirection payment which represents the present value of all future commissions owing to the adviser under the annuity contract. We believe this option could be preferable for customers because it would provide the customer with a potentially meaningful amount and allow them to receive the money earlier. It is also likely to significantly simplify the administration of the redirection and therefore minimise the risk of errors arising

We believe it will be important that annuity product providers are given flexibility in how commission redirections are facilitated for customers. In cases where customers would receive a small amount of redirected commissions it may be more appropriate for a lump sum amount to be paid.

A one-off payment would crystallise the taxation and social security implications of redirecting commission payments to customers. These issues will exist whether payments are made over time or as a one-off however the larger amounts involved will highlight the need for suitable treatment so that customers do not suffer unintended detriment as a result of redirected payments.

Social Security implications for consumers

The intention of the policy proposal is for customers to receive the benefit of previously grandfathered commission payments. We support this proposal and want to ensure that customers do not suffer unintended detriment when the proposal is implemented.

It will be important for consumers that treatment of any redirected commission payments does not alter, or adversely impact their eligibility for existing benefits. Many of our annuity customers are retirees who may be eligible for certain social security benefits, such as a part pension, health care card or other assistance.

The issues include, for example the following:

- Certain annuities are Asset and Income Test Exempt for the purposes of social security means testing rules. We believe it is important for current treatment of these to continue to be grandfathered (i.e. the existing grandfathering of these products from the asset test should continue).
- Redirected commission payments will constitute income for social security income test purposes. This may impact customers adversely, resulting in customers unexpectedly moving above income test thresholds.

We suggest that the Department of Social Services be engaged via this consultation process so that discussions can commence regarding consequential legislative amendments to the social security legislation.

Clarity regarding the social security implications of redirected commission payments will be important for customers and also for product providers, who will need to be able to answer customer queries about the consequences of redirected payments.

Further, certain products have been afforded grandfathering from social security rule changes which have occurred over time. In some cases, we anticipate product modifications may be necessary to facilitate the redirection of commission payments to customers in a timely and effective manner. It will be important for customers that the benefits of any such grandfathering are not lost as a result of necessary product modifications.

Managed Funds

There is a requirement for the RE of a managed fund to ensure investors within a fund are treated equally and fairly.⁴ We are concerned that this may be at odds with the redirection of commission payments to individual investors, where those commission payments have been funded via the management fee charged by the fund manager. This management fee has been charged to all investors in the fund. From this management fee, the RE has then made commission payments to advisors relating to specific investors, not necessarily all investors.

These commissions could be redirected to these specific investors; however we are concerned about whether an RE can redirect commission amounts to certain individuals and still be considered to be treating members of the same class equally.

Another method would be to cease the commission payments and for the RE to reduce the management fee by the amount of commission payments, to the benefit of all unitholders (and not seek to deal with each unitholder in isolation). We believe this method would be highly efficient and that the RE could easily and effectively implement such as solution, however the approach would need to be mandated so as to provide

⁴ s601FC *Corporations Act 2001 (Cth)*

REs with the necessary legal protection. Without protection REs could be vulnerable to a claim based on unequal treatment of unitholders.

Taxation issues

Challenger will need to provide taxation information to all customers who receive redirected commission payments (i.e. annuitants, managed fund investors, super fund members) so that they can complete their annual tax returns accurately.

The tax characteristics of payments will need to be determined before the payments are made, via consultation with the ATO. For example, providers will need certainty as to whether redirected amounts are income or capital for tax purposes and also any GST consequences (e.g. GST liability of financial advisers with respect to redirected commission payments).

We expect treatment might need to be different for different product types – for example in managed funds a reduction in management fee would be considered an expense reduction but for annuities redirected commission payments may be a return of capital.

We understand that some work has already been completed in relation to remediation payments made by banks to customers for previously overcharged amounts. That previous work should inform the conclusions drawn in relation to the tax treatment of redirected commission payments, to ensure that inconsistent outcomes do not arise.

Legacy product rationalisation

Allowing product providers greater scope to smoothly transition customers out of high-fee legacy products into modern, lower fee options would have considerable benefits for consumers.

An effective product rationalisation mechanism would include:

- relief from legal requirements not to close funds;
- capital gains tax rollover relief for funds; and
- state stamp duty relief for funds.

We believe there is merit in considering whether a discrete legacy product rationalisation regime could form part of the legislative solution for redirecting commission payments.