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The Principles and Practice of Product Rationalisation

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Principles and Practice of Product Rationalisation

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Abstract

The financial services industry incurs significant costs maintaining closed, legacy products for investors, even where these investors may be better placed in a more modern open product. The mechanisms that exist to rationalise products are not equally successful and are not consistent in their effects. The result is that whilst significant progress can be made in some sectors of the financial services industry, it is almost impossible to rationalise products in other sectors. Late in 2007, Treasury received submissions regarding establishing a uniform product rationalisation mechanism for all financial services products.

This paper explores the characteristics of a product rationalisation mechanism that might be suitable across a wider range of financial services products and the key elements of implementing a successful product rationalisation program.

The paper:

- Compares the existing product rationalisation opportunities available to specific product providers,
- Examines the key characteristics of a uniform product rationalisation framework. The paper contends that a robust, principles based framework could be successfully and equally applied to managed investment schemes, life insurance investment, traditional life and risk products, friendly society products, superannuation funds and divisions within superannuation funds,
- Examines the key elements of implementing successful product rationalisation initiatives, and
- Concludes by calling on the Treasury and the new Australian Government to continue to progress the work commenced in 2007 towards developing a uniform and effective product rationalisation mechanism.

Keywords: Product rationalisation, successor fund transfer, legacy, transition, migration

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1. Introduction

1.1 Context

The financial services industry incurs significant costs maintaining closed, legacy products for investors. These costs arise as companies must maintain business and IT staff with appropriate expertise across legacy products, operate legacy systems and implement compliance changes across multiple systems.

To the observer, organisations should be able to administer legacy contracts quite simply and economically, given they have been doing so for many years. The reality can be quite different:

- A large product range can rob an entity of economies of scale. For example, organisations often administer older products on older IT systems, incurring the additional operational costs of multiple systems.
- A large product range increases business risks as it becomes more difficult to ensure all contractual obligations to investors are being met.
- Increased risk can also manifest itself in operational areas. For example, staff turnover results in further hidden risks for legacy product providers. IT staff may not wish to develop a career specialising in aging technology. As a result, turnover on legacy systems can rob an organisation of corporate knowledge. When confronting essential compliance changes on a legacy system, product providers face a steep learning curve simply retraining staff in particular systems so that necessary amendments can be considered. This increases business risk associated with any change as those tasked with implementing a change may be doing so for the first time with minimal experience.

Not only are there costs in maintaining a legacy product. There may be benefits for investors in being placed in a more modern open product. The financial services industry is a competitive industry. Over time, in my observation, the outcome of most product rationalisations is that fees have generally reduced and the benefits provided to investors have improved. An effective product rationalisation mechanism should generate economic benefits for both product providers and investors.

There are existing mechanisms to rationalise products, however these are not equally successful and are not consistent. The result is that whilst significant progress can be made rationalising legacy products in some sectors of the financial services industry, it is almost impossible to rationalise products in other sectors.

In 2007, Treasury called for submissions regarding establishing a uniform product rationalisation mechanism for all financial services products. This officially reopened the debate on the characteristics of an appropriate mechanism to enable product providers to rationalise the legacy products that they are required to administer whilst balancing the need to ensure investor interests are protected.

In this paper I have used the terms “member”, “investor” and “policyholder” interchangeably.

1.2 What is Product Rationalisation?

In this paper, a product rationalisation mechanism is taken to involve the transfer of all members' interests from an existing financial services product to a suitable replacement product, so that the original product can be closed. In the context of a superannuation fund, this would result in the termination of a superannuation fund, or a division thereof. In the case of a life insurance company it would result in the elimination of all in force policies of the

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original type, but not necessarily the termination of a statutory fund. In the case of a Friendly Society, it is likely to result in the closure of the benefit fund. In the case of a managed investment scheme it would result in the termination of the originating scheme.

1.3 Objective

The objectives of this paper are to explore:

- The characteristics of a product rationalisation mechanism that might be suitable across a range of financial services products, and
- The key elements of implementing a successful product rationalisation program.

It is hoped that this paper will help facilitate a constructive discussion on this important area at the 2008 Financial Service Forum and more widely.

This paper:

- Compares the existing product rationalisation opportunities available to specific product providers,
- Examines the key characteristics of a uniform product rationalisation framework. The paper contends that a robust, principles based framework could be successfully and equally applied to managed investment schemes, life insurance investment, traditional life and risk products, friendly society products, superannuation funds and divisions within superannuation funds,
- Examines the key elements of implementing successful product rationalisation initiatives, and
- Concludes by calling on the Treasury and the new Australian Government to continue to progress the work commenced in 2007 towards developing a uniform and effective product rationalisation mechanism.

2. What Are Legacy Products?

The public debate has canvassed developing a product rationalisation mechanism that can be applied to “legacy products”. It is therefore important to consider what a legacy product is. It is also valid to question whether restricting a product rationalisation mechanism to a set of pre defined legacy products has merit, however I will consider this point later in this paper.

Legacy products can be deceptively difficult to define. They are commonly defined as closed products. Some also advocate that the product needs to have been closed for some time. Legacy products may also be defined by their administration on legacy systems or by their lack of scale.

These views of legacy products may be quite suitable for some products, for example personal life insurance products, however completely inappropriate for other products.

A legacy product need not be closed to new investors. Restricting the mechanism to closed products is not suitable for corporate superannuation products, where the decision to become a member is generally based on a decision to commence work with a specific employer. To demand that a corporate superannuation product be closed to new investors for any period of time prior to being considered for a rationalisation proposal would unnecessarily disrupt employers’ superannuation arrangements for new employees. At best, a superannuation fund will need to be closed to new members at some point as a consequence of a rationalisation decision. A requirement for a qualifying time period would seem to be an artificial and unnecessary constraint.

Defining a legacy product by scale is also problematic. In my experience, products that are suitable for rationalisation may vary in scale considerably. Any mechanism needs to be effective for products with both small and large membership. The mechanism will not be

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effective if it requires product providers to follow a process that is not economic for smaller product groups. It also introduces an unnecessary bias between providers in their ability to access such a scheme.

Attempting to define a legacy product is likely to bring practical difficulties that may render the process ineffective in some circumstances. I would question whether attempting to create such a definition is likely to be productive, relative to ensuring that any rationalisation mechanism protects, or ideally improves, the position of members or investors.

The difficulties that an attempt to define legacy products will create may be avoided by focussing on a product rationalisation mechanism that protects, and ideally enhances, the position of investors. Where this overall goal is able to be achieved the need to restrict the application of the mechanism to specific products in certain situations is less critical.

3. Why Rationalise?

Whilst definitions of legacy products can set the scope of what can be rationalised, the drivers for a product provider to rationalise help to indicate the scope of what rationalisation initiatives might be sponsored.

Any rationalisation proposal must firmly start with consideration of the impact on the investor. However, from a commercial perspective such an initiative will necessarily involve the investment of time and money. The stakeholder with the highest motivation to fund such an initiative is likely to be the product provider.

The financial incentive for a product provider to rationalise a product can stem from a number of issues.

- Businesses become more complex the larger the variety of investor contracts that need to be administered. This complexity increases direct costs and increases the probability and costs of potential error.
- Staff with skills required to support legacy computer systems built on older technology may resign and it is costly to train new staff in legacy programming languages.
- Computer hardware may no longer be able to be maintained and the cost of replacement brings forward a case for rationalisation.
- Governments may bring in new regulatory requirements that would impose a significant implementation spend across multiple systems, making some products uneconomic. Product rationalisation is then an attractive alternative to continuing to administer unprofitable products or to increasing fees to investors.
- A major factor that has led to product rationalisations to date has been mergers of financial institutions and/or superannuation funds.
- Product providers may offer a new product and it can clearly be demonstrated that it is in the members' interest to be transferred to that product. Innovation may provide product features in new products that reduce the attractiveness of an older product. This may motivate a product provider to seek to upgrade their existing customers in order to protect their market share or avoid the administrative consequences of distributor driven case by case transfers.
- Product providers may also seek to rationalise products (and the consequent multiple processes) in order to improve service levels, improve economies of scale, reduce the risk of error and reduce the consequent reputational and legal risks.

The Treasury discussion paper raised the question of whether there should be a "one-off" window during which product providers could rationalise products under a new mechanism, or whether such a mechanism should be available on an ongoing basis. As many of these

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issues arise continually in the market, and at different times for different providers, it is recommended that any mechanism should be available to providers on a continuous basis.

In many cases the drivers to rationalise products will be such that the full range of benefits will only be realised if rationalisation can be applied to a full group of products. A narrow definition of legacy products may negate the ability of the product provider to realise benefits in these circumstances and therefore reduce the effectiveness of, and access to, the mechanism artificially. This may occur, for example, where the driver to rationalise is the elimination of an administration system.

As noted above, this paper focuses on a product rationalisation mechanism that protects, and ideally enhances, the position of investors. Given the potential motivations of product providers to sponsor a product rationalisation initiative a narrow definition that limited the application of the mechanism to a specific selection of products or a specific timeframe could render the process ineffective in some circumstances by eliminating an otherwise willing sponsor.

4. Available Product Rationalisation Mechanisms

4.1 Successor Fund Transfer (Superannuation funds)

The successor fund transfer mechanism is available to trustees of superannuation funds, enabling the compulsory exit of members from their current superannuation fund and transfer of benefits to a receiving superannuation fund. Exiting all members from a fund would lead to closure of the original fund, resulting in an effective means of rationalising an existing product.

Broadly, successor fund transfer provisions allow trustees to transfer members' interests in a superannuation fund where the trustee is satisfied that the members will receive equivalent rights in the receiving fund. I will not explore all existing mechanisms quite as fully. However as many of the published submissions made to the Treasury advocate principles that are similar to this mechanism it is worth considering it in some detail early on in this paper.

When trustees consider exercising the power to make such a transfer they need to consider Superannuation Industry (Supervision) (SIS) regulation 6.29, which provides that:

...a member's benefits in a fund must not be transferred from the fund unless the member has given to the trustee the member's consent to the transfer or ... the transfer is to successor fund.

SIS regulation 1.03(1) defines a successor fund, as follows:

"Successor fund" in relation to a transfer of benefits of a member from a fund (called "the original fund"), means a fund which satisfies the following conditions:

- (a) the fund confers on the member equivalent rights to the rights that the member had under the original fund in respect of the benefits;*
- (b) before the transfer, the trustee of the fund has agreed with the trustee of the original fund that the fund will confer on the member equivalent rights to the rights that the member had under the original fund in respect of the benefits.*

In this instance there are two broad considerations for the Trustee.

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The first is whether the receiving fund qualifies as a successor fund by conferring equivalent rights in respect of the transferred benefits, relative to the rights they have in the original fund. This concept is not taken to mean that either benefits, or rights to benefits, cannot be improved in the successor fund.

The second issue that must concern the trustee is whether it is satisfied that the transfer is otherwise in the members' interests (or at least not adverse to them). A trustee needs to be satisfied of this in order to satisfy its fiduciary duties, as well as its obligation under section 52(2)(c) of the SIS Act to ensure that its duties and powers are performed and exercised in the best interests of the beneficiaries.

Important characteristics of this mechanism include the concept of equivalent rights and a trustee board exercising its legal obligations to act in the interests of members. There are also consequential requirements to communicate to members, an industry complaints mechanism and the guiding presence of industry regulators.

4.2 Benefit Fund Restructure (Friendly Societies)

Friendly societies operate benefit funds. If I align these terms to the more familiar life company language, each benefit fund provides a segregated fund (or a group of funds) for each product. Each benefit fund has a set of rules that govern the nature of the benefits, types of investments, fees, etc and these rules set out the common contractual terms and conditions of each policy that relate to a benefit fund. The rules perform a similar function to an individual policy document issued by a life insurance company to its policyholders.

Due to their structure, friendly societies will tend to have more benefit funds than a life company will have statutory funds, or divisions within statutory funds, because each benefit fund represents a policy group that would, in the life company context, exist within a statutory fund with other policy groups. This tends to result in numerous smaller funds where issues relating to adverse economies of scale occur more obviously. As each benefit fund may exist for a single product, or small number of products, where a friendly society product is closed the associated benefit fund also tends to close. The issues associated with mature funds running off are therefore more likely to occur. This heightens the importance of an effective product rationalisation mechanism for this sector.

A friendly society can call a meeting of members (policyholders) to approve a change to the benefit fund rules. This could include approving a product rationalisation proposal which would be achieved by the consolidation of benefit funds and modification of the policy owners' terms.

Members' interests are intended to be protected through the member vote and examination of the proposal by the Society's appointed actuary. To satisfy Prudential Rule No 41 before the friendly society applies to APRA for amendment of approved benefit fund rules under section 16Q of the Life Insurance Act 1995 (Life Act) the Society's appointed actuary must report on the proposed amendment to the approved benefit fund rules. In that report the actuary must state whether the proposed amendment will result in unfairness to the members of the approved benefit fund. This is required where the proposed amendment is beyond the scope of any previous actuarial advice.

Typically, these procedures will result in rule changes which seek to ensure no individual suffers a reduction in benefits as a result of the rationalisation.

There are some important distinctions between this mechanism and the successor fund transfer mechanism. These are noted below:

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- There is a prescribed requirement for a relevant expert (the appointed actuary) to advise the provider on the impact on members' benefits.
- Members are required to accept the change through a vote, although there are provisions for the regulator to permit a change by board resolution from the product provider.
- Communication to members occurs by way of pre-notification for the voting process; the member meeting and voting process also provides an opportunity for member involvement and feedback. This differs to the communication process followed through a successor fund transfer.
- APRA, as regulator, effectively approves the proposed change by registering the change.

In its submission to the Treasury the Australian Friendly Societies Association (AFSA) noted some of the issues associated with this approach, from which we might learn.

- Obtaining a suitable quorum of members to vote on a special resolution can be costly and may not result in meeting threshold voting requirements.
- In many cases benefit funds associated with legacy products have a relatively low asset value. This means that it is important to ensure that the cost associated with product rationalisation is not disproportionate to the legacy product being rationalised.

In its submission to the Treasury AFSA makes the following comment: "*AFSA points out, however, that the process is by no means a perfect process and could be improved, but it is a workable mechanism that AFSA members believe should be retained in principle for friendly societies and not be affected by any product rationalisation processes for life companies generally (where changing the policy contract unilaterally is an issue)*". I would speculate that this comment, at least in part, recognises the value the industry places in having a workable mechanism in place that is not too onerous for smaller product groups.

4.3 Termination of Statutory Funds (Life Companies)

There are limited effective provisions for life companies to rationalise products.

There are provisions within the Life Act that envisage the potential rationalisation of statutory funds. Section 35 (1) states that *a policy document must specify the statutory fund or statutory funds to which the policy is referable*. Section 35(4) then states that *subsection (1) does not prevent a policy document being endorsed so as to change the statutory fund or funds to which the policy is referable*. Transfer of individual policies between statutory funds does not result in product rationalisation in the manner envisaged in this paper. It may simplify some aspects of the operation of a life company. It may be the precursor to the termination of a statutory fund. However, after the restructure, the original policy contracts will continue to be administered and policyholders' terms will not have improved.

Having said that, there are features of the section 35(1) approach that are relevant when considering the features of a product rationalisation mechanism. Regulatory approval by APRA and disclosure requirements to notify interested parties are envisaged within the Life Act.

In limited cases, the occasion of a Part 9 transfer (i.e. a transfer made in the context of the merger of life companies) has been used to gain court approval for minor modifications to existing policy contracts. As I understand that these policy variations have generally been quite minor, the experience suggests that Part 9 only provides a workable approach to merge life companies with substantially unchanged benefits. It does not provide a robust framework for product rationalisation. Nevertheless, the concept of court approval is notable and the

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experience it provides may provide some lessons for a product rationalisation process should the debate proceed down that path.

Whilst there are actions a life company can undertake to reduce complexity and risk associated with legacy products, this paper focuses on product rationalisation mechanisms. These other actions are therefore not considered within the scope of this paper.

4.4 Managed Investment Schemes

In the case of managed investment schemes the only mechanism that can be used to facilitate the product rationalisation is use of the wind-up powers which generally involves member consent. The Treasury discussion paper notes that, *“under the present legislation, the majority of proposals to terminate a managed investment scheme and transfer members to another scheme are therefore unlikely to succeed, even if termination may be warranted in economic terms”*.

5. Characteristics of an Effective Product Rationalisation Mechanism

The Treasury discussion paper raised a number of insightful questions regarding the desirable characteristics of a rationalisation mechanism. Given the relevance of the issues raised, a number of these are also considered here. Where practical I have also commented on the flavour of the submissions made to Treasury to provide readers with a feel for the range of public opinion submitted.

5.1 What is the objective of product rationalisation?

The objective of a product rationalisation mechanism should be to protect the interests of investors (when transferring them from outdated products to more modern products) whilst providing an effective means for product providers to reduce the number of products that they are required to administer.

To be effective, a uniform process will need to:

- Incorporate elements that protect investors,
- Be cost effective for product providers across products and organisations of vastly different scale, and
- Provide a path for the body that makes the decisions to implement a proposal, to address the key issues of members’ interests that inevitably arise.

An effective and uniform process with appropriate investor safeguards should result in benefits to both the investors and product providers.

5.2 Should the process apply to specific products, or be available to specific product providers?

As noted earlier, I have avoided attempting to create a definition of a legacy product. Rather I am focussing on a process which will protect investors’ interests. Where the provider has a legal obligation to protect the interests of investors then I would contend that this obligation can be leveraged and relied upon.

Trustees of superannuation funds, responsible entities of managed investment schemes and boards of life insurance companies have such an obligation.

Trustee/responsible entity obligations are generally well understood. Both the SIS Act (in the case of superannuation fund trustees) and the Corporations Act (in the case of responsible entities of managed investment schemes) impose an express obligation to act in the best interests of investors.

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Section 48 of the Life Act imposes duties on directors in respect of statutory funds. This requires the director to give preference to the interest of policyholders over those of shareholders. Sub sections 1, 2 and 3 of section 48 are set out below.

- (1) *A director of a life company has a duty to the owners of policies referable to a statutory fund of the company.*
- (2) *The director's duty is a duty to take reasonable care, and use due diligence, to see that, in the investment, administration and management of the assets of the fund, the life company:*
 - (a) *complies with this Part; and*
 - (b) *gives priority to the interests of owners and prospective owners of policies referable to the fund.*
- (3) *In order to avoid doubt, it is declared that, in the event of conflict between the interests of owners and prospective owners of policies referable to a statutory fund and the interests of shareholders of a life company, a director's duty is to take reasonable care, and use due diligence, to see that the company gives priority to the interests of owners and prospective owners of those policies over the interests of shareholders.*
- (4) *A reference in subsection (2) or (3) to the interests of owners of policies referable to a statutory fund is a reference to the interests of such persons viewed as a group.*

There is potential to debate the meaning of “giving priority to policyholders” relative to a trustee’s fiduciary obligations. However, I consider this could easily be clarified in legislative amendments passed to support new product rationalisation initiatives by requiring expressly that a product provider considering a rationalisation proposal would have to be satisfied that the proposal would be in investors’ best interests. The content of “the best interests” principle is discussed in section 5.6 below.

Where an objective of a product rationalisation mechanism is to protect and ideally enhance the position of investors, it seems a worthwhile and prudent starting point to make that process available only to those organisations with a responsibility to protect the interests of investors.

5.3 Who should initiate the proposal?

Although a number of different groups may wish to initiate a product rationalisation proposal the most likely groups are the product providers or, perhaps, the regulator.

It is also conceivable that a cohort of investors might initiate a rationalisation proposal. It is however difficult to see how this could work in practice. Such a group is unlikely to be in possession of all relevant facts to fully develop a proposal, to fund a proposal, to gather the necessary collective action, or to determine that it should be implemented. The input of the product provider would ultimately be required. In practice, a cohort of members could probably only request a product provider to examine a proposal and fully develop it. Even then this would seem unlikely in the extreme. In practical terms, the product provider would need to formally develop the proposal.

It could be prudent to permit regulators to direct a product provider to initiate a proposal. Such intervention would only be expected to occur in more extreme circumstances where specific concerns exist regarding the operation of a provider. These circumstances would arise

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infrequently and many legitimate product rationalisation proposals could be developed by the provider without such intervention.

5.4 Should a uniform process apply across all sectors?

There should be benefits to consumers, at least in their understanding of the process, if the same process can be applied consistently across all applicable products.

I would not propose to launch an argument against consistency in the financial services marketplace in this paper. However, I note that not all the submissions to Treasury felt that consistency was an essential outcome.

A uniform process will result in a mechanism that is applied across a wide range of financial products. However, if the core principle of protecting the interests of investors is common to all it seems to be a worthy objective to determine a common process for all financial services products that fall within this scope.

It also needs to be noted that the more prescriptive a process (and less “principles-based”) the more that there may be difficulties in implementing an identical process in all sectors. Forms of prescription that may create difficulties could include: the definition of legacy products, prescribed requirements that don’t apply across all product sectors, a prescribed process that may be too expensive for smaller product groups and so on.

Where a new process replaces a process that is already effective for one category of provider, care needs to be taken to ensure this does not replace effective processes in some sectors with a less effective mechanism.

If the process is to apply to managed investment schemes, life insurance investment, traditional and risk products, friendly society products, superannuation funds and divisions within superannuation funds, a robust, principles-based framework is likely to offer the most viable approach to support successful and consistent outcomes.

5.5 Should the process be restricted to “Legacy Products” Only?

Whilst this paper focuses on the need for a process that protects the interests of investors, it needs to be acknowledged that a range of views have been expressed that restrict the application of the process to certain “legacy products”

The Institute of Actuaries submitted that “*We believe that to ensure a fair outcome for the consumer the most effective solution is to require that all proposals meet a set of legislated principles for consumer protection. However, a reasonable limitation to the scope would be to restrict the application of the mechanism to legacy products (defined as no longer being open to new applicants)*”. Other views included:

- That products must be closed, or will be closed as a consequence of the rationalisation, or
- That products must be closed for a specified minimum number of years, or
- That products sold recently to consumers would be specifically excluded.

Noting that corporate superannuation arrangements, by necessity, may sometimes need to accommodate ongoing new members, if a restriction is felt to be necessary, that proposed by IFSA, being “*the class of product is closed, or intended to be closed before the rationalisation, to new customers*” could be most practical.

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5.6 What principle should apply?

The principal test is that the transfer of members from their current product to a receiving product should result in “no material disadvantage” to members taken as a whole. The “no disadvantage” principle is recognised in the Treasury discussion paper as a key consideration. It is not surprising that this is the case as it also aligns with the core fiduciary duty to act in the best interests of beneficiaries. This duty applies expressly to superannuation fund trustees and responsible entities of managed investment schemes. In substance, it also rests on the same core principles as the duty of utmost good faith owed by life companies to policy holders in the Insurance Contract Act 1984.

This strikes at the question of product providers honouring the core “contract” made with the investor and meeting their reasonable expectations. A robust rationalisation framework that focussed on ensuring transfers were in the best interests of investors in the sense that there is, at least, no material disadvantage to them would ensure that the core “contract” with investors would be honoured or enhanced as a result of a transfer to a newer product.

Supportive tests could apply to demonstrate that the principle has been achieved. These are discussed in section 5.8 below.

Further, as it is envisaged that the principle outlined in this section will be applied to the members as a whole, it is also important to acknowledge that there may be adverse impacts in respect of some aspects of a transfer to a minority or members, or even individual members. These should not be overlooked by the product provider. It would be reasonable to expect that these would be considered by the product provider as part of the decision making process and mitigated, where practical.

5.7 Who should approve the proposal?

A number of parties exist that could potentially take the decision to approve a rationalisation proposal. These include regulators, courts, arbitrators, boards of product providers and the investors themselves.

This question is one where a wide range of views have been advocated to Treasury. The favoured options by those making the submissions appear to be either the establishment of an arbitrator, or that the board of the product provider approve the product rationalisation proposal without any external involvement or approval. It is interesting to note that, presumably for reasons of difficulty noted by AFSA in achieving a representative vote, the body of investors was not advocated as a suitable group to approve rationalisation proposals.

If a rationalisation framework is limited to those product providers with a legal responsibility to act in the interests of their investors then investors have legal recourse to these boards in the event that they fail to uphold this responsibility. This responsibility needs to be upheld in all the product providers’ dealings with their investors. This group is therefore the logical starting point for considering a body that can approve such a proposal.

In fact, given that boards of product providers are already subject to extensive regulation and supervision, the onus is arguably on those who suggest that some other entity should approve product rationalisation proposals to demonstrate why a responsible board would be unable to make this decision. If the legal framework for the operation of managed investment schemes, superannuation funds and life insurers takes the position that the boards of these providers are responsible bodies to act in the investors’ interests for all other matters then what is it that makes them less than fully responsible in the case of a product rationalisation decision? This is the approach that has been adopted in the successor fund context to date. What is it about a product rationalisation decision that means a board, with suitable expert advice, is suddenly unable to fulfil its legal responsibilities?

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The potential concern is presumably that the rationalisation decision could change the essence of the contract that the policyholder has with the product provider. A well designed rationalisation process, where the principal test ensures that the core contract with the investor is honoured as a result of the transfer, would provide some protection against this concern. A board should not be expected to make a rationalisation decision lightly. The basis of the decision should be documented, should be able stand up to scrutiny (both through an effective disclosure mechanism and regulatory enquiry) and should be supported by appropriate independent advice to the board by relevant experts. Relevant experts could include legal, actuarial and investment experts, as appropriate to the current and the receiving product.

The introduction of an arbitrator to the process has also been advocated and needs specific consideration.

Arbitrators bring a new party to the table. What legal responsibility would the arbitrator have to act in the interests of investors? What recourse does the investor have to an arbitrator if their decision is defective? Would the current law, which places responsibility to the investor with the board of the product provider, require the product provider to formally approve or reject the proposal prior to the arbitrator? Any proposed new process should not remove a board's responsibility to its customers in respect of a specific decision or dilute it by the addition of a third party to the decision making process.

Arbitration also brings additional costs to the process. Would the costs of the arbitration process be disproportionate to the rationalisation, rendering the process ineffective for smaller older products?

The use of an arbitrator may be considered because it is felt the board will not uphold its legal responsibilities. This seems to raise a broader question of board competency to balance the interests of multiple stakeholders at all other times. Whether this question is appropriately raised in respect of all boards is perhaps doubtful. However, as boards make similar decisions routinely in relation to the design, pricing, issue and variation of financial products it is not apparent why boards should not be adequately equipped to make such decisions in the context of a product rationalisation.

As a more practical alternative, regulators can, and should, play a very useful role in ensuring boards uphold their responsibility. In practice, in my experience, significant players (such as those in the institutional sector or large industry funds) will keep regulators informed of product rationalisation proposals as a matter of course. Regulators should be equipped to ensure boards of product providers continue to uphold their legal responsibilities to their investors. Ultimately, it is always open to the regulator to make inquiries and/or conduct a review of the process to satisfy itself that the product provider has acted consistently with its obligations. Regulators may:

- Establish a framework for boards to approve transfer proposals,
- Monitor compliance of those effecting proposals with their obligation to act in the interests of the investors,
- Document good practice and monitor performance of boards against this standard,
- Establish guidance for a complaints body should individual investors feel their circumstances have not been fully addressed in the transfer. This is discussed further in section 5.11.

There are circumstances where a product rationalisation involves a change of product issuer as well as a change of product. This may commonly occur in the case of superannuation. In this instance I envisage that the primary test should be applied by the provider that is deciding

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to exit the investors from the product they currently hold. In the case of a transfer into an established product, there is also a decision to accept the investors on certain terms into the receiving product. The board responsible for the receiving product (which may be, but will not necessarily be, a different board) needs to satisfy itself that it is reasonable to accept the members on the proposed terms, both with respect to their impending obligation to the new members as well as with respect to their responsibility to their current membership. The process needs to recognise both of these decisions. However I do not believe that the responsibilities of the receiving entity need to be the subject of special regulation. Organisations with open products accept new members on a daily basis. In doing so they must act within the constraints of their “best interests” obligations as well as their own commercial interests. These types of consideration are also relevant when accepting members following a product rationalisation.

5.8 What tests would be applied to ensure the principle is satisfied?

It should be possible to break down the general “no disadvantage” test into a number of practical considerations in respect of a specific transfer. These are likely to include:

- Equivalence of rights in respect of benefits before and after the transfer,
- The dollar value of the investor’s entitlement calculated immediately before and after the proposed transfer,
- The suitability of replacement investments (e.g. investment risks, market exposure and investment guarantees),
- The method of valuing the investor’s interest,
- The circumstances in which the investor’s can redeem their investment,
- The treatment of the investor’s interest on death (e.g. superannuation or life products may provide for benefits to be paid to beneficiaries other than the investor’s estate) and other insured events,
- Fees and charges,
- The level of security of the benefits,
- Other benefits and services.

The principle and supporting considerations could readily be expanded upon in a “Good Practice Guide” similar to that developed by ASIC and APRA for unit pricing.

Applying these considerations to investors on a collective basis is consistent with the general approach that is taken under trust law with regard to a trustee’s obligation to act in the beneficiary’s best interests. This recognises that if a trustee were precluded from taking actions that might cause some minor detriment to a small minority of beneficiaries this may produce a less than optimal result for the beneficiaries as a whole.

This is not to say that the consideration of some aspects of a rationalisation proposal would not be done at an individual level. For example examination of fees and premiums is likely to require individual consideration. Part of the proposal could also consider actions by the product provider in respect of whom increases in fees and premiums are expected to occur.

Having said that, quantitative analysis provides one part of the picture. There are legal and qualitative factors that also must be considered and weighed in respect of the whole group. The approving entity could be expected to demonstrate that:

- consideration has been given to the impact of the proposal on members,
- appropriate professional advice has been sought to consider the impact,
- consideration has been given to adverse impacts and that these have been appropriately weighed against the advantages to members, quantitatively where possible,

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- consideration has been given to member communication,
- appropriate steps have been taken to reduce adverse impacts to members.

5.9 Must all investors transfer?

5.9.1 Compulsory Transfer of all Investors

A rationalisation process where members may opt out or remain behind is likely to result in the benefits to the sponsoring party not being realised. Such a mechanism would be ineffective as it would significantly discourage product providers from sponsoring such an initiative. As product rationalisation arrangements are generally expected to be of net benefit to investors, this outcome would ultimately disadvantage investors.

To remove disincentives to providers for incurring the costs of developing and implementing a proposal, any rationalisation framework will need to enable the compulsory transfer of members and no members should need to remain.

There is additional operational risk and inconvenience if a product or fund must be maintained for a small number of members. This can involve the maintenance of investment & unit pricing processes and can also create regulatory inconvenience where a “remnant” product continues into a new financial year.

Given the issues noted above, lost members should also transfer. All products are likely to have some investors with whom the provider has lost contact at the time of the transfer despite their best efforts. If these members are treated in the same manner as all other members and the transfer satisfies the “no disadvantage” test then there is no reason why the members would not be transferred, so long as the product issuer maintains a suitable record of where the investors’ funds have been transferred to. Existing arrangements for treatment of lost and unclaimed moneys could continue to apply.

Providers are subject to legal requirements to maintain historical data for a minimum period. In a product rationalisation context compliance with this requirement is usually effected either by maintaining the member’s closed account or policy details on the administration system or archiving the data in an accessible format so that customer enquiries regarding historical accounts or policies can be answered. These requirements also provide protection for lost members

5.9.2 Family Law Cases and Deceased Members in Successor Fund Transfer

In designing a process, some thought should also be given to issues arising in relation to superannuation products with regard to:

- Family law “splitting orders”, and
- Benefits in respect of deceased members.

With regard to family law, the Family Law Act provides that a member’s superannuation benefit may be the subject of a court order or an agreement that has the effect of “splitting” the benefit or “flagging” the benefit. The effect of a flag is simply that the benefit cannot be dealt with until the flag is lifted. The legislation provides for a “flag” to be transferred to another fund in the context of a successor fund transfer. It does not provide for a splitting order or agreement to be transferred to the new fund. As I understand it, this simply reflects a drafting oversight, rather than considered policy.

In the case of death benefits, the general view appears to be that they do not fall within the scope of the current successor fund provisions since they are not benefits relating to current “members”. However, it is common practice for such entitlements to be transferred at the

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same time as members' entitlements are transferred in a successor fund transfer, provided that the fund's governing rules permit such an approach. (This is on the basis that compulsory transfers of deceased members' entitlements do not offend any restriction under the legislation). Consideration could be given to addressing this issue more directly as part of any review.

The issue of death benefits should also be considered in the context of managed investment schemes and life products. However, the family law splitting and flagging arrangements reflect legislation unique to superannuation products.

Whilst the process should permit the compulsory transfer of members, prior disclosure should provide time for some members to elect to transfer their investment to another product after considering the relevant communication material, should that be their preferred option.

5.10 Disclosure

5.10.1 Pre Transfer Communications

Disclosure is an important part of any process and investors must be informed of the impending transfer so that they can understand the implications of the change on their own circumstances.

Providers implementing a rationalisation proposal would expect to provide reasonable notice of the event to investors, including information about:

- the process and timing,
- the main features of the new product to which the investor is to be transferred,
- any material changes to the investor's account or policy, and
- rights of investors and actions the investor may wish to consider prior to the transfer, including the right to complain.

In the case of friendly societies, it is not uncommon for the communication material to quote the appointed actuary's opinion, in the role of the independent expert. Summarising the range of views expressed in any independent assessment can be a constructive part of the disclosure process. However if this occurs then the relevant experts should be required to approve the content of any summary appearing in the communication material, and the process of quoting experts should not be used to diffuse the board's responsibility for ensuring that the principle of protecting members has been achieved.

Early communication also provides the opportunity for investors to review the transfer and complain or object prior to the transfer. Providers could be expected to monitor investors concerns and the manner in which they were addressed throughout the process.

Under existing legislation most or all relevant product providers would be obliged to provide existing investors with notice of any compulsory transfer and/or closure of the existing product in accordance with the "significant event" reporting requirements under the Corporations legislation. It would also be reasonable to expect that investors would receive a Product Disclosure Statement (PDS) for the receiving product before or as soon as practicable after, any transfer. This is the approach that has been taken in the successor fund context where a PDS may be given up to three months after the transfer, and I suggest that it is a useful and workable model.

5.10.2 Post Transfer Communications

Existing disclosure requirements under the Corporations Act that apply in relation to exit from one product and issue of an interest in a new financial product can be applied to a

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compulsory transfer in the context of a product rationalisation with relatively little modification. That is:

- the “transferring/closing” product will issue the investor with an exit statement,
- the receiving product provider will issue the investor with new investor information.

In some cases, rationalisation will involve two separate product providers, although they may be related entities. Where this occurs it is reasonable to expect that an exit statement from the existing provider would be warranted. This could also be a requirement for product rationalisations involving only one company (i.e. where the same organisation is the entity responsible for both the closing product and the receiving product); however, where a single entity is involved it might be possible in principle for the entity to provide a statement for the full statement year spanning periods in both products. In practice it may be cleanest to require that under all product rationalisations investors must be provided with an exit statement and notification of new allocations (and / or insurance cover where relevant).

Where two entities are involved it is also possible that the exit communication is issued separately from the entry communication. This should not prevent a rationalisation proposal from being implemented.

5.10.3 Responsibility for Communications

The broad thrust of this paper is to suggest that the party that is currently responsible to act in the interests of investors takes full responsibility for any proposed product rationalisation proposal. This would suggest that they also take full responsibility for communications with investors. Other parties could however have a role in approving communications to investors.

5.11 Complaints

5.11.1 Who does the investor complain to?

In most cases there are existing complaints mechanisms that provide accessible and established avenues for investors. There is no reason why these complaints mechanisms should not address complaints regarding rationalisation activity provided, in the case of an external complaints mechanism, they are within the proper jurisdiction of the relevant body. Investors should be required to bring any complaint to the product provider’s internal complaints mechanism before being able to make a complaint to the external body. Where necessary, as part of the current review, it may be useful to clarify that all of the relevant schemes are able to accept and consider complaints relating to product rationalisation.

As I envisage a single rationalisation mechanism for all providers, ideally the complaints mechanisms should also act in a consistent manner. Guidance from the regulator may be required in the operation of the rationalisation process to ensure consistency in the treatment of complaints across all complaints bodies.

5.11.2 Is there a time limit?

There is merit in considering a time limit in which complaints can be brought forward.

In other contexts – including in the court system – there are limitation periods. The application of these periods recognises that it becomes increasingly difficult to accurately determine material facts the greater the lapse of time. This may be more rather than less of an issue for the various complaint handling bodies as they are generally less strictly bound by strict evidentiary rules.

Further, any complaint can be more fairly assessed for all parties against the overall rationalisation proposal when the terms of the rationalisation scheme are fresh in the minds of

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all parties. It would not be unreasonable to require persons to bring a complaint within, say, 24 months of the transfer date. Generally it is better to have clear rules but it would also be possible to have a facility for this requirement to be waived in exceptional cases where imposition of the limit would lead to harsh and unreasonable results.

5.11.3 What can an investor complain about?

Many financial products have fees, premiums and investment returns that are variable over time. Any complaint made by an investor that concerns what may have happened in the original product and what did happen in the new product some years after a transfer quickly becomes a fairly hypothetical argument that cannot be resolved. This itself provides a practical limit to the scope upon which complaints can be made. For example, it is very difficult to determine whether investment performance, some years after a transfer, in a product that no longer exists would have been materially better or worse.

The purpose of the complaints mechanism should not be to provide an avenue for members to challenge the basis or merits of a product rationalisation as a whole. I believe that it is the role of the regulator to monitor the activities of organisations conducting product rationalisations and to determine if they have complied with their statutory obligations to act in members' best interests. The purpose of a complaints mechanism should be to give an avenue to an individual member to argue that the impact of the product rationalisation on himself or herself has been unfair and unreasonable. A single member may argue that, due to the special circumstances of that particular member, there was an unusual negative impact in his or her case. In such a case the member might claim that it would be unfair and unreasonable not to redress that impact or that any compensation that has been provided to date is insufficient.

The complaints scheme should make it clear that its focus is on this "special" or "unusual" type of impact. Any compensation should be limited to any direct financial loss that the member could demonstrate as a result of the product rationalisation. If a member is able to demonstrate a loss – i.e. that their financial position in the product on an ongoing basis is inferior to the position that would have applied had their existing arrangements continued – I suggest that to provide greater certainty any compensation should be limited in time, to take into consideration where a member is generally not obliged to remain in a particular product or that the fees and premiums under the original product may have been able to have been increased.

In general the scope for a member to complain about a product rationalisation and the remedies available to them should be aligned with those that apply to other matters pertaining to the management and administration of investors' interests. So for example the type of rights that a member should have to complain about a product rationalisation should be similar to the type of rights that a member would already have to complain about such matters as a material change to the product features or services, a change to fees and charges, closure of the product etc.

5.12 Specific Issues

There are a number of considerations that arise with specific product types that need to be addressed. Four issues raised in the debate so far are those of high exit fees, participating policies, taxation and social security.

5.12.1 Exit Fees

Exit fees present a difficulty for product providers when approving rationalisation proposals.

One of the tests of a rationalisation proposal would be the equivalence in the dollar value of a member's entitlement before and after a proposed transfer. In general I believe that it would

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be very difficult for a product provider to determine that the “no disadvantage” test had been satisfied when a significant fee is incurred by the investors at the transfer date that directly benefits the product provider. In practice, the starting position for a rationalisation proposal would therefore be that a member’s exit fee liability would either be transferred to the receiving product to a fee with similar effect (i.e. so it would only be charged at the point that the member exited the new product) or that the transferring entity could waive the fee or make appropriate compensation arrangements.

5.12.2 Participating Policies

Participating policies present additional considerations for transferring members. Generally participating policies share in a mutual pool of assets, where emerging surplus is distributed to investors and also to shareholders of the life company. Therefore at any time there is likely to be a surplus in the pool that has not been allocated to members and may be meeting prudential capital requirements under the Life Act. Two issues that must be addressed are:

- The treatment of unallocated surplus within the pool at the time of transfer. The regulations should not prescribe that this be distributed to members. It may be appropriate to do this, however it may also be appropriate to transfer an equitable portion of the surplus to a new participating arrangement in the receiving product.
- The transfer of any share of distributed profits to life company’s shareholders and potential changes to these arrangements as a result of the transfer will need to be considered at the time of the rationalisation decision. Historically, transfers of distributed profits could be viewed as analogous to fees born by the members and should be compared to fees in the new product and potential transfers to shareholders in a participating arrangement in a new product.

The additional issues associated with participating policies would be considered as part of the rationalisation proposal.

5.12.3 Taxation

Taxation issues are complex, but particularly important as the issue of realisation of capital gains has been a particular impediment to an effective rationalisation mechanism for managed investment schemes.

Taxation issues can potentially arise for both the product provider (in transferring assets and liabilities and issuing new contracts) and also for the member.

Ideally the transaction should be tax neutral to all parties. It should not unnecessarily bring forward taxation revenue or defer it. Ideally this will consider the tax position of both the entity and the individual. The transfer should not incur state duties that would not have been born had the transaction not taken place.

If neutrality cannot be achieved, then where capital gains tax creates an adverse impact within a taxed vehicle, such as a superannuation fund, the effect of the impact is able to be quantified given the amount of gains and tax rate are known. The provider can then weigh this up as part of the overall transfer decision. This cannot be done in the case of a managed investment scheme, where the tax position of each individual is not known.

5.12.4 Social Security

Social security implications can also arise in respect of product rationalisation proposals. This currently occurs, for example, in the successor fund transfer of pensions between superannuation funds. Whilst these issues can be addressed, for completeness it is important to note that the objective of “neutrality” sought for taxation applies equally in respect of Social Security.

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6. Implementation

6.1 Initial planning

With any successful product rationalisation project, the devil is in the detail. The foundations for a successful project lie in thorough and careful analysis of the existing situation of investors and comparing that to the proposed new product into which they are proposed to be transferred.

Before I can delve into the detail, the products that are candidates for rationalisation need to be identified. This will vary with the circumstances of the product provider and the nature and operational environment of their product range.

Having identified the product that is to be a candidate for rationalisation, careful analysis of all aspects of the product must follow. This must include an assessment of the legal rights, financial position, investments, tax and administrative position of investors. This will provide the basis of documenting how the proposed transfer satisfies the “no disadvantage” principle.

The early detailed analysis and planning process sets the stage for mitigating risks associated with the transfer. The detailed planning will not only set the terms of the transfer in a manner that ensures the core principle has been achieved. It should provide the detailed documentation to demonstrate how this has been achieved through appropriate supportive tests. At a more practical level, it will also have analysed the available investor data to identify potential issues that may arise on implementing the transfer. These can include:

- Asset transfer risks,
- Risks arising from the final valuation of investors’ entitlements, including those associated with unit pricing and crediting rate mechanisms,
- Insurance risks, associated with changes to any insurance cover available through the product on transfer,
- Risks associated with the cost impact on transferring members,
- Communication risks,
- Risks arising from existing data that may not reconcile perfectly between systems;
- The failure to identify and properly address surplus assets,
- The scope of limited data in respect of existing members, for example tax file numbers in respect of superannuation members and more generally, contact details,
- Risks arising from the failure to properly address non member cash flows arising at the point of rationalisation: for example this may affect the preparation of the final tax return relating to the product.

Throughout this analysis the product provider, as sponsor, will also develop and review the business case for undertaking the rationalisation. Product rationalisation initiatives can vary in scale enormously and proper project governance, both at the early business case stage and throughout the project, will help protect the product provider from risks that arise across all stages of project design and implementation.

6.2 Independent Advice

Following the initial analysis, independent advice should be sought to verify the critical aspects of the rationalisation proposal. This could include advice from legal, actuarial and investment specialists and would be directed to the board of the decision making entity.

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6.3 Pre Transfer

Prior to any transfer, the product provider will need to:

- Formally approve the rationalisation proposal,
- Ensure suitable project governance to monitor the implementation and mitigate risks arising during the course of the project,
- Prepare and reconcile investor data,
- Establish and test the mechanical processes to exit members from the original product,
- Manage assets in preparation for the transfer, and
- Communicate to members.

6.4 Post Transfer

After any transfer, the product provider will need to:

- Reconcile transferred investor data,
- Provide post transfer communications,
- Ensure investors are established and able to transact in the replacement product
- Archive data to meet regulatory obligations and provide the required post transfer servicing,
- Wind up the originating product.

7. Conclusion

Whilst many models could be advanced for product rationalisation, an effective mechanism for product rationalisation would:

- Rely on the established legal responsibility of product providers to act in the interest of investors,
- Be based on the “no disadvantage” principle. Providers would be expected to conduct rigorous analysis to demonstrate that the principle had been achieved. A range of supportive tests designed to assess whether that the principle had been achieved could be outlined in a “Good Practice Guide”. Independent expert advice could be sought to comment on whether or not the proposal satisfied the relevant tests,
- Be considered by the board of the product provider, which would need to satisfy itself that the principle had been achieved on the basis of evidence presented, including appropriate independent expert advice,
- Be funded by product providers,
- Transfer all investors, and
- Be accompanied by effective disclosure and complaints mechanisms.

Actions of individual product providers would be reviewed by regulators in the ordinary course of the regulators’ activities to ensure that they have met their legal obligations.

The foundations to the successful execution of a product rationalisation project lie in the careful and thorough analysis of the detailed position of investors compared to the proposed position in the replacement product. Failure to get this right is likely to result in key aspects being overlooked and guarantee the eventual failure of the project.

The financial services industry incurs significant costs maintaining closed, legacy products for investors. These costs include maintaining business and IT staff with appropriate expertise across legacy products, maintaining legacy systems and implementing compliance changes across multiple systems. These costs occur, even where these investors may be better placed in a more modern open product. The introduction of an effective product rationalisation

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mechanism should generate economic benefits for both product providers and investors. To help realise these benefits I encourage Treasury to continue the work it has started in developing an effective uniform product rationalisation mechanism for managed investment schemes, life insurance and superannuation.

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