Chapter 3
Insurance Contract Amendment Bill 2007 Draft regulation impact statement

EXPOSURE DRAFT

Background

Definition — Insurance

3.1 Insurance plays a vital role in Australia's economy. Individuals, groups, businesses and governments are able to participate in social and economic activities that they otherwise would not be able to engage in by using insurance as a means to price and transfer risks associated with those activities.

3.2 Insurance is created by an insurer and an insured entering into a contract. Under the contract of insurance, a person facing a risk of loss (the insured) from a possible occurrence pays a contribution known as a premium to an insurer who, in return, promises to compensate the insured in proportion to their loss should the occurrence eventuate.

3.3 There are four main classes of insurance:

- personal — provides benefits if the insured person dies or is disabled by accident or sickness;
- property — provides against loss of or damage to insured property such as buildings or their contents, motor vehicles, ships, cargoes or any other class of property;
- liability — provides against legal liability to pay compensation for injury or damage for which the relevant insured may be sued by some other person; and
- monetary loss — provides against monetary losses due to, for example, embezzlement by employees or failure of a debtor to repay a loan.

3.4 Personal insurance equates to life insurance. The remaining three classes of insurance are categorised as general insurance.

Profile of the Australian insurance market

General insurance

3.5 As at 30 June 2005, 112 direct insurers and 11 reinsurers operated in Australia's general insurance market. In the financial year ending June 2005, the total number of general insurance policies that were issued or renewed in Australia, according to statistics released by the Insurance Ombudsman Service, was 26,545,814. Of these, 10,301,950 were motor vehicle insurance policies and 5,558,842 were home building insurance policies.

Life insurance

3.6 In 2004–05, the net premium revenue for direct insurers was $19.6 billion. Net incurred claims totalled $12.2 billion. The total after tax profit for direct insurers was $4.5 billion. Direct insurers held $68.3 billion in assets. The five largest insurance groups underwrite 70 per cent of the net premium revenue and hold 63 per cent of the total industry assets.[1]

3.7 As at 31 December 2005 there were 37 life insurance companies operating in Australia. They managed around $226.5 billion in assets (backing both Australian and overseas policyholders) and received $34 billion in premium income for the year ended 31 December 2005. Single premium business (as opposed to annual regular annual premium business) accounted for 79 per cent of life insurance premiums. 97 per cent of single premium business relates to superannuation business.

3.8 The top ten life insurance groups represented 93 per cent of total assets backing Australian policyholders, 94 per cent of new premiums and 91 per cent of total premiums. Bank owned life insurance companies

EXPOSURE DRAFT

1 Axiss Australia 2006, Executive Briefing: Insurance in Australia.

account for 38 per cent of total assets backing Australian policyholders and 38 per cent of total Australian business premiums.[2]

Insurance Contracts Act 1984

3.9 The law governing contracts of insurance has a direct influence on the effectiveness and efficiency of the insurance market in Australia. For some time, the law concerning contracts of insurance was derived from a combination of common law principles and statutes issued by a variety of parliaments.

3.10 In 1982, the Australian Law Reform Commission (ALRC) released Report No 20, Insurance Contracts (ALRC 20), which made a number of detailed recommendations for reform of the law concerning contracts of insurance. That report led to the enactment by the Australian Parliament of the *Insurance Contracts Act 1984* (IC Act), which came into operation on 1 July 1986. The IC Act provisions were based largely on the ALRC's recommendations.

Problem identification

3.11 The ALRC identified a series of key principles in ALRC 20 which it considered should be the foundation of the law concerning contracts of insurance. Those principles, outlined below, addressed some issues and deficiencies that had affected the efficiency of the former law.

- Uniformity and modernisation — the law should, as far as possible, be uniform throughout Australia. The ALRC noted the law should remove uncertainties and specify acceptable rules for the modern relationship of the insurer and insured.

- Assurance of fair competition — the law should ensure that freedom of contract and promotion of competition, so far as compatible with principles of equity and fairness to the insuring public, are basic goals.

EXPOSURE DRAFT

---

2 Australian Prudential Regulation Authority, *Life Insurance Market Statistics* — December 2005.

- Promotion of informed choice of insurance — as far as practicable, insureds should receive sufficient information and be otherwise protected by the law so that they may choose the insurance policy best suited to their needs. The ALRC noted that a lack of information concerning contracts of insurance and the different types of cover available was a serious problem for consumers.

- Principle of utmost good faith — the principle of utmost good faith, which has traditionally underlined contracts of insurance, should remain the touchstone of contracts of insurance.

  – Need to avoid unfair burdens — the remedies available to insurers in respect of misrepresentation, non-disclosure and breach of contract should not place a burden on the insured that is vastly disproportionate to the loss the insured's actions caused to the insurer.

  – Need to avoid catastrophic losses — as far as practicable, insureds who might otherwise unintentionally be exposed to the risk of catastrophic losses should be protected against losing insurance cover through no fault of their own.[3]

3.12 The IC Act was designed to give effect to those principles. As mentioned above, it has been in operation since 1986. Since then, the market for insurance in Australia has evolved in terms of the type of insurance on offer and the participants in the market. Judicial interpretations of the IC Act have highlighted how it applies in a range of situations, some of which may not have been contemplated when the IC Act was designed. Also, more recent statutes, such as the *Corporations Act 2001* and *Electronic Transactions Act 1999*, have made changes to the surrounding regulatory environment.

3.13 Those developments, and experience of applying the IC Act since 1986, have led to a widely held view that, although the IC Act has generally operated effectively to the benefit of the insurance market, there

EXPOSURE DRAFT

---

3 Australian Law Reform Commission 1982, Insurance Contracts, ALRC 20, Canberra, pp xxi-xxii.

are aspects that would benefit from refinement to prevent inefficiencies and inappropriate outcomes.

Revision of the IC Act: Objectives

3.14 In 2003, the Australian Government commissioned a review panel (the Panel) to review the IC Act to ensure it 'continues to meet its original consumer protection objectives and does not discourage insurers from writing policies in Australia.'[4] The Panel was asked to report on whether provisions of the IC Act remained appropriate in light of developments in the insurance market and whether any amendments were necessary to clarify or remove ambiguity.

3.15 The Panel found that the IC Act was generally operating satisfactorily. However, some amendments were recommended to address insurance market developments and judicial interpretation during the period since its enactment. The Panel's recommendations were developed having regard to the need to preserve an appropriate balance between the rights and obligations of insurers and insureds.

Consultation

3.16 The options for reform, which are outlined in Part 5 below, are based on recommendations of the Panel, developed in the course of the review in response to issues raised by stakeholders in written submissions and in meetings with the Panel.

Section 54 of the IC Act

3.17 Insurers had particular concerns about the operation of section 54 of the IC Act and its impact on the cost and availability of liability insurance. The Panel began its review by releasing an issues paper that explained the operation of section 54 and its current judicial interpretation. In response, 32 written submissions were received from stakeholders including the insurance industry, consumer representatives,

EXPOSURE DRAFT

---

[4] Press release C087/03, 10 September 2003, issued by the then Minister for Revenue and the Assistant Treasurer.

the regulator, and dispute resolution bodies. The Panel also met with stakeholders.

3.18 The Panel concluded that legislative reform of section 54 was necessary, but only in respect of particular types of insurance policies. Draft amendments that gave effect to the Panel's initial recommendations were released for public consultation in 2004. An additional 16 submissions primarily from the insurance industry, the legal profession and the regulator were received on the draft amendments. The Panel made further recommendations to revise the draft amendments in response to these submissions and stakeholder consultations.

Provisions of the IC Act other than section 54

3.19 The Panel's review of provisions of the IC Act other than section 54 began in November 2003 with a request to stakeholders for written 'submissions at large' on issues that may be affecting the current operation of the IC Act and options to address those issues. This was followed by a series of stakeholder meetings in February 2004 to identify key matters for consideration from those issues raised in written submissions.

3.20 In March 2004, the Panel released an issues paper, which outlined the matters raised by stakeholders that the Panel intended exploring in the second phase of the Review. The Panel noted that it could only address issues that had an adverse impact on the operation of the IC Act and could not analyse some issues which may be of significance but fell outside the review's terms of reference.

3.21 The Panel received around 25 submissions from the insurance industry, consumer representatives, dispute resolution bodies and the legal profession in response to the issues paper and used them to develop a proposals paper, which was released in May 2004. The proposals paper included over 40 proposals to amend the IC Act. The Panel sought further comments on the contents of its proposals, particularly those that had not been raised in the issues paper but were developed subsequently.

3.22 The proposals paper generated further written submissions from the insurance industry, dispute resolution bodies, consumer representatives and the legal profession. Those were taken into account by the Panel in formulating its final recommendations and report, released in January 2005.

EXPOSURE DRAFT

Summary of key stakeholder views

3.23 Insurance brokers, legal specialists, life insurance industry representatives and the regulator expressed general support for the recommendations of the Panel, with some reservations on details.

3.24 Consumer representatives indicated that they would have preferred the Panel to propose more regulation concerning claims handling processes, and they also have some reservations about the detail of some recommendations. However, generally consumer representatives were satisfied with the review process and consider that the recommendations are well reasoned and balanced.

3.25 The industry body representing general insurers expressed some dissatisfaction with the time frame of the consultation process and opposed a number of the Panel's recommendations on the basis that they would impose additional costs for their insurers. Those comments have been noted where applicable in Part 5 below, headed 'Identification of Options'.

3.26 A key consideration for the Panel in developing its recommendations was the preservation of an appropriate balance between the rights and obligations of insurers and insureds.

Identification of options

3.27 The Insurance Contracts Amendment Bill 2007 (the Bill) is based on the Panel's recommendations. The proposed regulatory changes in the Bill that are not minor or machinery relate to the following matters:

1. Claims handling processes;
2. Direct offshore foreign insurers;
3. Electronic communication;
4. Objective component of insured's duty of disclosure;
5. Disclosure obligations on renewal of an eligible contract of insurance;
6. Notification of duty of disclosure;

EXPOSURE DRAFT

7. Non-disclosure rules and life insureds;

8. Life insurance remedies;

9. Third party beneficiaries; and

10. 'Claims made' and 'claims made and notified' policies.

3.28 The groups that will primarily be impacted by the proposals include:

- insurers;
- insureds (especially those that have claims);
- industry bodies involved in self regulation;
- complaints-handling bodies in the financial services industry; and
- government and regulators.

Most of the proposals affecting insurers or insureds would also affect insurance brokers, where a broker is involved in the negotiation and ongoing management of an insurance contract. However, for the sake of simplicity insurance brokers have not been identified as a separate impact group for the purposes of the regulation impact statement. It has been assumed that the costs and benefits accruing to insurance brokers as a result of the proposals would ultimately be passed on to insurers and insureds.

3.29 Options for responses to each of these matters are analysed below.

Note

The following analysis of costs and benefits in this draft regulation impact statement is based on a 5 point scale that endeavours to reflect the magnitude of the particular cost or benefit relative to other costs and benefits relating to the same issue, having regard to the impact on insurers, insureds and other affected stakeholders. The scale is:

[5] = Very high cost/benefit

EXPOSURE DRAFT

[4] = High cost/benefit

[3] = Medium cost/benefit

[2] = Low cost/benefit

[1] = Very low cost/benefit

In the tables below, each cost and benefit has been allocated a suggested rating based on the scale. The suggested ratings are preliminary and are intended to promote consideration and comments by stakeholders on the ratings and information that may be available to assist with quantification of costs and benefits. Quantified assessments of costs and benefits will be included in the final version of the regulation impact statement wherever possible.

Claims handling processes

Problem

3.30 If an insurer lacks adequate arrangements for claims handling, there is a potential failure to satisfy the purpose for which insurance is taken out. Persons entitled to recover compensation for a significant loss may require the insurance payout to sustain their daily lives or to operate their business. If the claim is unreasonably refused or delayed, the insured may have to expend further funds on unnecessary litigation to force an insurer to pay the claim. In cases of hardship there could be implications for governments if insureds require financial assistance.

3.31 There is no direct regulation in the IC Act of insurers' claims handling processes. Claims handling is affected by the duty of utmost good faith, which is implied into all contracts of insurance by section 13 of the IC Act, and other equitable principles at common law.

3.32 The regulator responsible for administration of the IC Act the Australian Securities and Investments Commission (ASIC) raised concerns with the Panel about regulation of claims handling processes by insurers. The regulator noted the existing arrangements provided no guarantee that:

EXPOSURE DRAFT

- insurers have adequate procedures in place to ensure claims handling is conducted in a fair, transparent and timely manner;

- insureds have the opportunity to respond to adverse findings by insurers and receive reasons for the denial of claims;

- employees and outsourced service providers involved in the claims handling process receive adequate training and supervision;

- insurers are liable for the conduct of outsourced providers involved in the claims handling process; and

- experts involved in the claims handling process are independent.

Objective

3.33 The objective is that all Australian insurers have systems in place so that, to the extent reasonably practicable, claims are dealt with in a fair, transparent and timely manner. This is in accordance with the principle of utmost good faith which, under the provisions of the IC Act, is a mandatory element of the insurer/insured relationship.

Options

Option A: Industry-regulation

3.34 Under this option, insurance industry bodies, who prepare standards guiding actions of their members, would issue and monitor best practice standards for claims handling processes.

Option B: Legislate for minimum claims handling standards

3.35 This option would involve an amendment to legislation to prescribe particular standards for claims handling in legislation, rather than leaving them to be set out in industry guidance. The minimum standards could be developed by the Government in consultation with relevant stakeholders.

EXPOSURE DRAFT

Option C: Legislate to make a breach of duty of utmost good faith a breach of the IC Act

3.36 The duty to act with fairness and honesty in all dealings with respect to the other party ('the duty of utmost good faith') is implied into all contracts of insurance. It is considered the sole obligation on insurers under the IC Act that governs the adequacy of claims handling processes.

3.37 However, the duty applies to individual contracts of insurance. There are few sanctions available to deal with an insurer that seriously or repeatedly acts without utmost good faith. Should the inadequacy of a particular insurer's claims handling practices affect multiple insureds, they would need to commence multiple actions (at considerable expense) to seek redress.

3.38 Under this option, a breach of the duty of utmost good faith would be deemed to be a breach of the IC Act. By making a breach of utmost good faith a breach of the Act, ASIC would be enabled to commence representative actions on behalf of one or a number of insureds under section 55A of the IC Act as that provision requires an actual or suspected breach of the Act to exist.

Option D: No specific action

3.39 Under this option, there would be no changes to regulation of claims handling processes. They would be governed by the duty of utmost good faith and principles of common law.

Impact analysis

Impact group identification

3.40 Groups that will be affected by the proposed amendments include:

- insurers;
- insureds (especially those that have claims);
- industry bodies involved in self regulation;

EXPOSURE DRAFT

- complaints-handling bodies in the financial services industry; and

- government and regulators.

EXPOSURE DRAFT

Assessment of costs and benefits

Option A: Industry regulation

Benefits	Costs
If standards are complied with then, depending on the nature of the standards, insureds will benefit from quality claims handling processes and will have avenues to pursue grievances when standards are not met [4, dependent on industry code terms] Codes developed by industry may receive wider industry endorsement, and may be more attuned to commercial standards, than legislation [4] There will be increased consumer confidence regarding insurance products if the incidence of poor claims handling diminishes [4, dependent on Code terms] An industry guide for claims handling which is administered by industry dispute resolution schemes lessens the risk of costly court processes as the only option to resolve disputes [5, dependent on industry code terms]	There will be costs to industry bodies of monitoring compliance with added industry standards and handling complaints regarding breaches [4] Some insurers may face compliance costs where they must update their processes to comply with new industry standards [3] Compliance costs of new standards for industry may lead to a consequential price rise for consumers [3] Government may face high-level costs monitoring general compliance with, and effectiveness of, the industry standard [3] Unlikely to add to the current limited range of remedies available against insurers who demonstrate poor claims handling processes on an ongoing scale [2]

Option B: Legislate for minimum claims handling standards

Benefits	Costs
There is a high level of certainty that insureds will benefit from legislative standards for claims handling and will have avenues to pursue grievances when standards are not met [4] There will be increased consumer confidence regarding insurance products if the incidence of poor claims handling diminishes [4]	Some insurers may face compliance costs if they must update their processes to comply with new industry standards [4] Compliance costs of new standards for industry may lead to a consequential price rise for consumers [4] Government will face regulatory costs monitoring and enforcing compliance with the minimum standards on an ongoing basis [4] Legislating a minimum standard may

EXPOSURE DRAFT

	lead to 'lowest common denominator' standards in the industry [3] Unlikely to add to the current limited range of actions that may be taken against insurers who demonstrate poor claims handling processes on an ongoing scale [2]

Option C: Legislate to make breach of the duty of utmost good faith a breach of the IC Act

Benefits	Costs
This option allows the regulator to act in response to systemic or repeated breaches of utmost good faith across multiple consumers, thereby reducing the risk of ongoing harm [4] This option will allow insurers that disregard their duty of utmost good faith to be barred from providing insurance [4] There will be increased consumer confidence regarding insurance products in the knowledge of a mechanism for regulatory action against repeat offenders [2]	There will be costs for government in taking action against serious/repeated breaches [3] In comparison to Option A, this option allows for potentially lengthy and costly court procedures to resolve disputes [3] Insurers that repeatedly/seriously breach their duty of utmost good faith may be subject to costs of responding to regulatory action [1]

Option D: No specific action

Benefits	Costs
This option would be of least cost to insurers and allow them the maximum flexibility for claims handling processes [3]	This option would not address the current costs borne by individual consumers that must pursue redress for ongoing breaches via courts and dispute resolution bodies [4] There is an ongoing lack of confidence amongst the general community in the goodwill of some insurers and the insurance industry more generally [4] Would not add to the current limited range of actions that may be taken against insurers who demonstrate poor claims handling processes on an ongoing scale [2]

EXPOSURE DRAFT

> **Request for comment**
>
> Are there additional costs and benefits for the above options, which are not listed?
>
> Are the suggested relative ratings appropriate?
>
> Information to assist with quantification of costs and benefits is sought for inclusion in the final regulation impact statement.

Consultation

3.41 Option A received support from the Insurance Council of Australia, which has recently implemented the General Insurance Code of Practice (see further details below). In a submission to the Panel, a consumer representative body argued that regulation was necessary in addition to an industry standard because best practice guidelines were voluntary and only effective if properly enforced.

Conclusion and recommended option

3.42 The problem is a risk of poor and inefficient claims handling practices by insurers which may result in considerable unnecessary expense and possibly hardship for individual insureds. This risk has been highlighted by the regulator and consumer representatives. Although insurers face reduced business if they develop a reputation as an insurer that does not handle claims appropriately, this discipline is not sufficient to prevent some insurers from having poor practices in that aspect of their business.

3.43 Option D proposes no specific action to address this risk. This option would impose no additional costs on the insurance industry. However, it is not preferred because the risk of unnecessary burdens and expenses for some individual insureds are significant.

3.44 Options A and B could be effective to ensure that claims are handled in a fair, transparent and timely manner. However, in the case of Option A, the insurance industry would develop the rules governing their practices. It may be expected that industry acceptance and compliance with the rules could be higher than for rules imposed by legislation and they could be more flexible and responsive to market developments. Also, the costs involved with designing and establishing industry codes is

EXPOSURE DRAFT

likely to be of a lesser degree than the costs for Government and stakeholders in designing and implementing a new legislative framework.

3.45 In its report, the ALRC indicated that the duty of utmost good faith should be a cornerstone of all contracts of insurance. Option C would allow the regulator to take action against an insurer who repeatedly breaches this fundamental duty, whether by repeated poor claims handling practices or otherwise. This would provide a 'reserve' regulatory tool to deal with the possibility that industry codes are not effective in respect of one or more insurers.

3.46 A combination of Option A and Option C is recommended. Option A provides a reasonable level of certainty that consumers will benefit from improved claims handling procedures and it is of lower cost than legislating minimum standards. However, in the event that self-regulation fails to improve claims handling processes by a particular insurer then Option C provides a means for external regulatory intervention to deal with the situation.

3.47 Since the Panel's report the Insurance Council of Australia has revised the General Insurance Code of Practice. The revised Code, released on 18 July 2005, deals with matters such as the time in which an insurer must notify the insured whether they accept their claim, periods in which an insured must be notified of the progress of their claim and information that must be provided to an insured. The Code is enforced by the Insurance Ombudsman Service. The Consumers' Federation of Australia expressed support for the revised Code but noted that consumer confidence in it may be increased if it were to be approved by ASIC under section 1101A of the *Corporations Act 2001*.[5]

3.48 There is no equivalent industry code of practice for life insurers.

EXPOSURE DRAFT

5 Consumers' Federation of Australia, *Media release*, 18 July 2005.

Request for comment

Is there any quantitative information about the incidence of poor claims handling practices?

Is the life insurance industry proposing to develop best practice guidelines for claims handling such as those promulgated by the general insurance industry?

Direct offshore foreign insurers

Problem

3.49 Direct offshore foreign insurers (DOFIs) are foreign insurers, who are based overseas. They sell insurance to Australians via the internet or through an insurance agent or broker licensed in Australia. They represent only a small part of the general insurance market (around 2.5 per cent) but provide additional capacity in specialised lines of insurance.

3.50 DOFIs typically offer insurance to niche and specialised markets within Australia, which are not serviced by domestic Australian insurers. They therefore play an important role in the Australian market.[6]

3.51 In the majority of cases, DOFIs operate from largely comparable regulatory jurisdictions, and much of the business written is for large corporate entities. However, domestic insurers have raised competitive neutrality concerns in respect of DOFIs that operate from regimes with lower capital and solvency requirements, so that they may undercut Australian insurers. There are also concerns that some Australian businesses and consumers, who acquire insurance from DOFIs, may be exposed to insurers that have no ability or inclination to pay claims and that come from home jurisdictions with poor prudential and/or consumer protection frameworks.

EXPOSURE DRAFT

[6] For further information on DOFIs in Australia, see Key Findings of the Review of Discretionary Mutual funds and DOFIs, 2004, available at http://dmfreview.treasury.gov.au/content/Report.asp?NavID=3.

3.52 As DOFIs are based overseas, the provisions of the IC Act may not always apply to policies that they issue. The jurisdictional reach of the IC Act is determined pursuant to section 8 of the IC Act by reference to the 'proper law' that would apply to the relevant contract of insurance, irrespective of any choice of law clause that it may contain. Determining what the 'proper law' is may require application of principles of private international law.

3.53 Should the provisions of the IC Act be deemed not to apply to a particular contract of insurance issued to an Australian insured or in respect of an Australian risk, then the relevant insurer and insured will be subject to the consumer protection laws of the jurisdiction in which the particular DOFI is located. As noted above, there have been concerns raised that these laws may not always be as rigorous as would apply in the IC Act and this could have adverse consequences for the insured.

3.54 If no action is taken, then some contracts of insurance which have been issued by DOFIs to Australian insureds and/or in respect of Australian risks would continue to fall outside the IC Act. This has implications for the protection of insureds and competitive neutralities between DOFIs and other locally-based insurers.

Objective

3.55 The objective is to ensure as much as possible that the rights and responsibilities, which are conferred on insureds and insurers under the IC Act, apply uniformly to all contracts of insurance issued to Australian insureds or in respect of Australian risks.

Options

Option A: Amend the IC Act to include an express provision that the Act applies to all DOFI contracts with Australian insureds and/or in respect of Australian risks

3.56 Under this option, the IC Act would be amended so that it was stated expressly to apply to all contracts issued by DOFIs in respect of Australian insurers or Australian risks or both.

Option B: No specific action

3.57 Under this option, the IC Act would apply to contracts of insurance that are issued by DOFIs only if the 'proper law' of the contract

EXPOSURE DRAFT

was the law of an Australian State or Territory (irrespective of any choice of law clause that may be contained in the contract).

Impact analysis

Impact group identification

3.58 Affected groups:

- insurers, especially DOFIs;
- insureds that enter contracts of insurance with DOFIs;
- courts (both local and international); and
- government and regulators (both local and international).

Assessment of costs and benefits

Option A: Amend the IC Act so it covers all DOFI contracts with Australian insureds and risks

Benefits	Costs
This option means that DOFIs dealing with Australian insureds and Australian risks will need to comply with similar requirements to their domestic counterparts so insureds will not be disadvantaged when dealing with DOFIs [5] This option removes potential competitive inequalities that may currently exist in respect of different legislative requirements applicable to insurers [5]	Compliance by DOFIs with IC Act requirements would impose costs for the DOFIs which would likely increase the price of insurance offered [2] The option may not be feasible in cases where the Australian risk/insured is a part of an international insurance arrangement [2] This option would involve costs to government of developing legislation and monitoring compliance with that legislation in respect of a relatively small proportion of the insurance market [2] This option will involve increased costs to dispute resolution bodies and courts, particularly foreign courts, which may be called upon to enforce DOFI compliance with IC Act requirements [2] There is a risk that the rule will not be observed in foreign courts [2]

EXPOSURE DRAFT

Option B: No specific action

Benefits	Costs
This option involves no cost to government of amending the law and monitoring/ enforcing compliance with the new rules [2] This option maintains the current position on the territorial scope of the IC Act which has been tested by courts [3] This option avoids the risk of potentially complex legal disputes, in local dispute resolution contexts or overseas, concerning DOFI compliance with IC Act requirements [3]	Under this option, some Australian insureds or risks will not be covered by the IC Act which is contrary to the original intentions of the IC Act [4] Some insurers and insureds will be subject to differing regulatory requirements despite offering insurance in respect of the same risk. This has negative consequences for competitive neutrality [4]

Request for comment

Are there additional costs and benefits for the above options, which are not listed?

Are the suggested ratings appropriate?

Information to assist with quantification of costs and benefits is sought for inclusion in the final regulation impact statement.

Are there practical difficulties with enforcing DOFI compliance with IC Act provisions?

Consultation

3.59 Representatives of domestic insurers expressed strong support for an amendment of the type proposed by Option A. However, representatives of insurance brokers argued that the current IC Act application provision worked effectively and that an amendment of the type proposed by Option A would not be enforced by foreign courts. A further submission argued that Option A would be inappropriate to global commercial arrangements covering Australian risks where the parties had agreed on another governing law.

EXPOSURE DRAFT

CONCLUSION AND RECOMMENDED OPTION

3.60 The problem is that some products issued by DOFIs to Australian insureds and/or over Australian risks are not covered by protections of the IC Act. This exposes the consumers to risk and may give DOFIs a competitive advantage over domestic insurers.

3.61 Option A proposes amending the IC Act to clearly specify that the Act applies to contracts of insurance issued by DOFIs to Australian insureds or in respect of Australian risks. Option B proposes no specific action.

3.62 On balance, the preferred option is Option A.

Electronic communication

Problem

3.63 Communications under the IC Act are currently exempt from the operation of the *Electronic Transactions Act 1989* (ET Act). The ET Act provides that if a Commonwealth law requires a notice to be provided in writing, it may also be given by means of electronic communication if the relevant recipient consents.

3.64 There are no equivalent facilities in the IC Act. Accordingly, the exemption for the IC Act limits the ability of insurers to utilise electronic communication with insureds. Use of electronic communication for various requirements under the IC Act has potential to lower costs and increase convenience for insurers and insureds.

Objective

3.65 The objective is to ensure that the IC Act permits a range of means of communication between insurers and insureds, including by electronic means, provided that the risks for the recipients in the use of electronic means are not unreasonable.

EXPOSURE DRAFT

Options

Option A: Make amendments so that electronic communication may be used for communications between insurers and insureds

3.66 This option would involve removing the exemption of the IC Act from the operation of the ET Act and amending the IC Act so that all communications currently required to be in writing for the purposes of the Act may be done by electronic means.

Option B: Make amendments to allow for communication electronically subject to some safeguards, including to avoid inadvertent loss of insurance cover

3.67 Option B is the same as Option A. However, the law would prescribe particular safeguards designed to ensure the communications were accessible for insurers and capable of being retained in traditional paper format. To increase flexibility and responsiveness to developments, the safeguards would be included in regulations made under the IC Act, rather than the IC Act itself.

3.68 The safeguards proposed to be included in the regulations include the following requirements for statutory notices and other documents under the IC Act sent by electronic means:

- documents/notices should not contain an image, message, advertisement or other feature that distracts or interferes with the recipient's ability to understand;
- the contents of a document/notice should be readily distinguishable from any image or like item that accompanies it;
- recipients must be readily able to scroll through the whole of the document/notice; and
- insurers must include in a notice/document a street address and telephone number where they may be contacted.

3.69 There would also be a facility for the regulations to specify particular types of notice to be communicated by traditional writing in addition to, or instead of, by electronic communication, in order to reduce

EXPOSURE DRAFT

the risk that insureds are exposed to an inadvertent loss of insurance cover.

Option C: No specific action

3.70 Under this option, the IC Act would remain exempt from the ET Act and a number of communications under the Act would still need to be made by traditional writing.

Impact analysis

Impact group identification

3.71 Affected groups:

- insurers;
- insureds; and
- government and regulators.

Assessment of costs and benefits

Option A: Electronic communication may be used for all IC Act purposes

Benefits	Costs
This option maximises opportunities for insurers to reduce costs by using electronic communication for all IC Act purposes and brings the IC Act into line with general rules under the ET Act [4] Some insureds may find electronic communication more convenient than traditional communication [2]	Electronic communication may represent an increased cost for consumers that do not have access to electronic communication facilities. However, under the ET Act, consumers must consent to electronic communication [1] This option may represent an increased risk that insureds will not receive insurance related communications over traditional methods such as via post [3] Insurance notices are important documents for insureds. It is reasonable to expect that many consumers will wish to store their insurance communications in paper format. Without some additional requirement, the ET Act could be interpreted as requiring only the ability to retain communications in electronic

EXPOSURE DRAFT

	format [2] The ET Act does not expressly prohibit ‘pop-ups’ or advertising material that may distract a consumer’s attention from the contents of a statutory notice [2] This option does not allow for the law to prescribe that some insurance-related communications should continue to be provided in traditional/ hard copy format [2]

EXPOSURE DRAFT

Option B: Electronic communication may be used for IC Act purposes, subject to some safeguards, including to avoid inadvertent loss of insurance cover

Benefits	Costs
This option provides opportunities for insurers to reduce costs by using electronic communication for all IC Act purposes and brings the IC Act into line with general rules under the ET Act [4] Some insureds may find electronic communication more convenient than traditional communication [2]	Electronic communication may represent an increased cost for consumers that do not have access to electronic communication facilities. However, under the ET Act, consumers must consent to electronic communication [1] This option may represent an increased risk that insureds will not receive insurance related communications over traditional methods, such as post. However, the risk would not be as great as under Option A because there would be a facility to require specified types of documents in hard copy [2] The additional safeguards, particularly any requirements for documents to be provided in hard copy, may result in costs for insurers that would not be present under Option A. [1] There could be added costs for insurers beyond those in Option A, as insurers will need to provide notices electronically in a way that allows for them to be retained in hard copy format [1]

Option C: No specific action

Benefits	Costs
This option does not expose recipients to any additional risks of non-receipt of communications [2]	This option prevent insurers from taking advantage of the efficiencies offered by use of electronic communication [4] This option leaves the IC Act at odds with current policy that encourages a transition to electronic communication in light of increasing use of electronic technologies [2]

EXPOSURE DRAFT

Request for comment

Are there additional costs and benefits for the above options, which are not listed?

Are the suggested ratings appropriate?

Information to assist with quantification of costs and benefits is sought for inclusion in the final regulation impact statement.

Consultation

3.72 Removal of the current IC Act exemption from the scope of the ET Act received wide support. There were no submissions opposed to allowing for electronic communications under the IC Act. However there were suggestions from representatives of consumers and the legal profession that allowing electronic communications should be subject to particular safeguards (Option B). These included those safeguards proposed by the Panel its final report.

3.73 Representatives of insurers submitted there should be no requirement to provide notices in hard copy if the relevant insured has consented to receive information electronically. This was supported by other submissions. However, a insurance dispute resolution body argued that no sanction should apply to an insured until they had been sent a hard copy of the relevant notice or acknowledged receipt of the notice through electronic means.

3.74 Life insurance industry representatives suggested that the annual review notice could still be required to be provided in hard copy.

Conclusion and recommended option

3.75 Option C is not preferred because:

- general government policy, as reflected in the *Electronic Transactions Act 1999*, is to facilitate electronic transactions; and
- the potential cost savings in permitting electronic communication to be used for IC Act purposes are significant.

EXPOSURE DRAFT

3.76 Although Option A would allow for electronic communications in accordance with the requirements of the ET Act, a number of submissions argued the nature of insurance warranted additional safeguards. For example, it was argued strongly by consumer representatives and some lawyers that communications required under the IC Act that are sent electronically should be capable of being printed and retained.

3.77 Therefore, it is proposed that Option B be adopted over Option A. Option B allows for electronic communications but subject to additional safeguards that a number of submissions argued were necessary in the context of insurance contracts. The nature of the safeguards, and the category of notices that must be sent in hard copy format, will be able to be varied time to time by regulation.

Objective component of insured's duty of disclosure

Problem

3.78 A number of submissions to the Panel, particularly those from advocates of insureds, argued that the current tests for the duty of disclosure (particularly those under subsections 21(1) and 21A(4) of the IC Act) imposed an unreasonable burden on insureds to know what an insurer regards as relevant to its decision whether to enter a contract of insurance.

3.79 Section 21, which applies to all contracts of insurance, requires an insured to disclose every matter that they know, or reasonably could be expected to know in the circumstances, would be relevant to the insurer's decision whether to accept the risk and enter the contract.

3.80 Section 21A, which applies in respect of eligible contracts of insurance,[7] precludes an insurer making open ended requests for an insured to disclose 'any other matter'. However, the insurer may still seek disclosure of 'exceptional circumstances' that the insured, or a reasonable person in the circumstances, would be expected to know are relevant to the insurer's decision whether to accept the risk (subsection 21A(4)).

[7] 'Eligible contracts of insurance' are defined in regulation 2B of the *Insurance Contracts Regulations 1985*.

EXPOSURE DRAFT

3.81 Disclosure is a significant issue in a number of insurance related disputes. In a submission responding to the Panel's issues paper, the Consumers' Federation of Australia (CFA) estimated that around 13 per cent of determinations made by the then Insurance Inquiries and Complaints Service Ltd involved disputes regarding disclosure.

3.82 Further, the CFA argued that no other consumer contract imposes a burden on the consumer to know what information the other party requires when deciding whether to enter the contract. The CFA noted that in the case of consumer credit, consumers must answer the credit provider's questions accurately but are not expected to know what other information the credit provider needs to assess the loan application.

3.83 The CFA also argued that the IC Act provisions concerning disclosure fail to take account of technological advances such as data processing and the internet, which place insurers in a better position to assess risk.

3.84 Requiring potential insureds to disclose all information relevant to an insurer's decision, when those persons are not necessarily in a position to assess what type of information may be relevant, can result in unfair outcomes for insureds if a claim is denied or reduced as a result of the failure to disclose.

Objective

3.85 The objective is to ensure that the duty of disclosure requirements in the IC Act strike an appropriate balance between, on one hand, ensuring insurers have reliable information to assess and price risk and, on the other hand, the need to avoid placing unfair burdens on insureds in respect of the remedies available against them for non disclosure.

Options

Option A: Replace the general duty to disclose in section 21 with a requirement to answer specific questions honestly and fully

3.86 Under this option, the general duty of disclosure in section 21 would be replaced with a duty on insureds to answer fully and honestly questions that are put to them by the insurer. If that were to happen,

EXPOSURE DRAFT

section 21A, which applies such a framework to eligible contracts of insurance, would no longer be necessary.

Option B: Clarify the operation of the mixed objective/subjective duty of disclosure test in section 21

3.87 Under this option, the current mixed objective/subjective duty of disclosure that applies to insureds under section 21 would be retained. However, the test would be elucidated by requiring reference to a non-exclusive list of factors in its application including the nature of the particular cover being provided, the class and type of persons who would ordinarily be expected to apply for that type of insurance, and the circumstances in which the contract is entered into.

Option C: Remove that part of section 21A that permits insurers to ask 'catch all' questions in relation to eligible contracts of insurance

3.88 This option would discourage insurers that offer eligible contracts of insurance from asking general 'catch all' questions concerning 'exceptional circumstances'. Insurers would no longer be able to rely on the duty of disclosure in relation to eligible contracts of insurance if they ask the insured to disclose 'exceptional circumstances' in circumstances such as described by the current paragraph 21A(4)(b).

Option D: No specific action

3.89 No changes would be made to the objective elements of the insured's duty of disclosure tests in sections 21 and 21A.

Impact analysis

Impact group identification

3.90 Affected groups:

- insurers;
- insureds;
- proposed insureds;
- life insureds (who are not the insured under a contract of life insurance); and

EXPOSURE DRAFT

- dispute resolution bodies and courts.

Assessment of costs and benefits

Option A: Replace the general duty to disclose with a requirement to answer specific questions honestly and fully

Benefits	Costs
This option would remove the current obligation on insureds to know matters that the insurer would regard as being relevant to their decision whether to accept the risk and enter the contract [4] There is a possibility that fewer disputes and legal actions by insureds concerning their obligation to disclose matters that were considered relevant by the insurer will arise [3]	Applying this option to large commercial risks, and in respect of some life insurance products, may not be practical as it would not be possible for insurers to produce 'pro-forma' specific questions in those circumstances [4] The difficulties of requiring insurers to ask specific questions may result in less availability of insurance and higher costs for insureds [4] In response to the lack of a 'catch all' question, insurers may produce lengthy and complex sets of questions which will increase complexity and costs for insureds [4]

Option B: Clarify the operation of the mixed objective/subjective duty of disclosure test in section 21

Benefits	Costs
This option may assist with interpretation and assist in resolving inconsistencies between courts in the factors that are taken into account in determining an insured's duty of disclosure [3]	This option may lead to some litigation about interpretation of the new objective factors [2]

Option C: Remove the part of section 21A that permits insurers to ask 'catch all' questions in relation to eligible contracts of insurance

Benefits	Costs
Under this option, insureds under eligible contracts will not be unfairly disadvantaged by being required to answer questions that require a knowledge of what factors may be relevant to an insurer's decision [4]	For some insurers under eligible contracts, being no longer able to rely on 'catch all' questions may encourage them to ask more specific questions, potentially adding to cost and complexity for

EXPOSURE DRAFT

The removal of the objective element to the duty of disclosure is likely to lead to less disputes about an alleged failure to disclose relevant matters [2]	insureds [4]

Option D: No specific action

Benefits	Costs
Insurers sometimes benefit from the objective elements of the existing duty of disclosure test to deny claims [2]	Leaving the current duty of disclosure test unchanged may continue to unfairly disadvantage some insureds if they fail to disclose a matter they do not realise is relevant to an insurer's decision whether to enter the contract of insurance. This may also lead to continued disputes [3] Courts may continue to have different interpretations about the factors to consider in relation to the objective element of the duty of disclosure, which leads to a lack of uniformity in application of the IC Act [2]

Request for comment

Are there additional costs and benefits for the above options, which are not listed?

Are the ratings appropriate?

Information to assist with the quantification of costs and benefits is sought for inclusion in the final regulation impact statement. Examples of prejudice to insureds arising from the objective elements of sections 21 and 21A would be helpful.

Consultation

3.91 Option A was supported by stakeholders including representatives of insurance brokers, and a legal aid commission. It was argued that insurers should be required to ask insureds specific questions that reflect their underwriting guidelines. Insurers that offered insurance over large commercial risks, however, disagreed. They provided examples suggesting that, in those cases, questions were formulated and asked in the course of negotiating the relevant contract of insurance. It was not possible to produce a 'pro forma' list of questions at the outset

capable of dealing with all relevant risk factors that may affect the policy proposal.

3.92 Option B was suggested to the Panel by a firm of commercial solicitors. They noted the existing test in section 21 had been applied inconsistently by various courts, which runs counter to the policy intention that the law concerning contracts of insurance should apply uniformly throughout Australia.

3.93 In respect of eligible contracts of insurance, one general insurer reported to the Panel that it asked potential insureds specific questions and did not have a 'catch all' question. That insurer argued the 'catch all' question was no longer relevant to eligible contracts. Insurers offering that type of contract had 'clear underwriting guidelines based on comprehensive historical data that effectively define what information a prospective customer needs to provide to enable a risk to be accepted'. This view was not shared by other general insurers and their representative body, who argued it would not be possible for many insurers to develop a list of relevant specific questions.

Conclusion and recommended options

3.94 Option A (replacing the general duty of disclosure with a duty to answer specific questions) is unlikely to be practicable to apply more widely than in relation to eligible contracts. In particular, it would not appear to be practical to apply Option A in the context of large commercial insurance and some types of individual life insurance. Accordingly, Option A is rejected.

3.95 Option B, under which the duty of disclosure would be clarified by setting out some non-exclusive factors in the Act to which regard should be had in applying the duty test, does not result in greater expenses for insurers. This option is designed to assist courts interpreting how the duty applies in difficult cases and should assist to remove current inconsistencies in the application of the test between courts and promote uniform application of the IC Act throughout Australia.

3.96 Option C would address concerns about the duty of disclosure rules incorporating an objective test that requires insureds to know what an insurer regards as relevant, at least in respect of personal lines insurance (eligible contracts). Although some insurers have strongly opposed Option C on the grounds that it would increase expenses, others

EXPOSURE DRAFT

have noted that in the case of personal lines insurance, insurers generally have a very strong understanding of what factors are relevant to risk, and ask specific questions accordingly. The likelihood of any other factors being relevant to risk is not high, and this risk should be borne by the insurer rather than the insured.

3.97 Option B is recommended, because further guidance in interpreting provisions in the IC Act dealing with disclosure is likely to be of benefit to insurers, insureds and courts. Further, the costs of applying this option are not great. Option C is also recommended, because it largely addresses concerns from the insureds' perspective regarding the objective component of the duty of disclosure in respect of eligible contracts, notwithstanding there are some costs associated with its implementation.

Disclosure obligations on renewal of an eligible contract of insurance

Problem

3.98 The then Insurance Enquiries and Complaints Service Ltd (IEC) (now the Insurance Ombudsman Service), in its first submission to the Panel, raised concerns at the current law surrounding notice of the duty of disclosure upon renewal of a contract of insurance. The IEC stated:

> '… the experience of (IEC) Panel members is that the great majority of people regard a renewal notice in the same way as they would a gas bill, that is an account to be paid at or about the due date, although unlike the gas bill, a reminder notice is usually not issued if the sum payable is not paid within the prescribed time. In other words, the general public do not understand the renewal process creates a new insurance contract, sometimes with new policy terms, with new disclosure obligations.'

3.99 If insureds do not realise that they are under a new set of disclosure obligations upon renewal of a contract of insurance, they risk failing to inform the insurer of matters that have occurred since the relevant contract was entered into that are relevant to the insurer's decision whether to accept the risk of the renewed contract. As a consequence, the insured may be denied the right to recover under the contract, to potentially great detriment to the insured and any other person with an interest in the particular insurance contract.

EXPOSURE DRAFT

3.100 In its submission, the IEC noted instances of insureds under motor vehicle policies being denied claims because they failed to update their driving history as required upon renewal. Apparently this was due to a lack of awareness of the disclosure requirement, rather than any deliberate concealment on their part.

3.101 Circumstances such as that continuing to arise are undesirable because the detriment to the persons concerned is potentially great.

Objective

3.102 The objective is to ensure that, as much as possible, insureds that renew an eligible contract of insurance understand their duty of disclosure obligations.

Options

Option A: Make the obligation to provide details regarding the duty of disclosure the same at both inception and renewal of an eligible contract of insurance

3.103 Under this option, renewal of an eligible contract of insurance would trigger similar duty of disclosure obligations for both insurers and insureds as the obligations that applied when the contract was first entered into.

3.104 For example, under this option, in the case of eligible contracts, an insurer wishing to rely on an insured's duty of disclosure at renewal would need to send the insured specific questions. In effect, insurers would need to seek an update to the answers the insured provided at the inception of the contract.

Option B: No specific action

3.105 The requirement on insurers under an eligible contract of insurance to ask specific questions of the insured, if they wish to rely on the insured's duty of disclosure, would not apply on renewal of the particular eligible insurance contract.

EXPOSURE DRAFT

Impact analysis

Impact group identification

3.106 Affected groups:

- insurers;
- insureds; and
- dispute resolution bodies and courts.

EXPOSURE DRAFT

Assessment of costs and benefits

Option A: Make the obligation to provide details regarding the duty of disclosure the same at both inception and renewal of an eligible contract of insurance

Benefits	Costs
This option would remove the risk faced by insureds because they did not realise that the duty of disclosure applies on renewal of an insurance contract [4] In some cases, insurers may be better informed about the risks associated with renewal of a particular eligible contract [2] This option may lead to a lesser need for dispute resolution between insurers and insureds regarding the disclosure requirements [1]	At each renewal, insurers who wished to rely on the insured's duty of disclosure would be required to ask and record answers to another round of specific questions, which may increase administrative expenses for insurers and potentially costs for insureds [4]

Option B: No specific action

Benefits	Costs
No need for any additional expenditures [3]	Continuing disadvantage for some insureds who may be denied claims because they did not realise their duty of disclosure obligations on renewal, and insurers will not necessarily be fully informed of the risk factors associated with the renewal of eligible insurance contracts [4]

EXPOSURE DRAFT

> **Request for comment**
>
> Are there additional costs and benefits for the above options, which are not listed?
>
> Are the ratings appropriate?
>
> Information to assist with the quantification of costs and benefits is sought for inclusion in the final regulation impact statement. In particular, are there any estimates regarding the number of complaints to external dispute resolution bodies annually that involve individuals whose claim has been rejected because they failed to comply with their duty of disclosure obligations following renewal?

Consultation

3.107 In submissions to the Panel, a consumer representative body and a legal aid commission expressed support for the amendment proposed in Option A. The legal aid commission noted that, in its experience, many insureds were unaware of their duty of disclosure obligations on renewal and assumed that it was an automatic process, subject to payment of the premium. Insurance broker representatives submitted the IC Act should be amended so that insurers must make clear in any renewals the consequences of non disclosure.

3.108 General insurer representatives submitted that requiring notification of the duty of disclosure on renewal would result in significant increases in the costs incurred by insurers. The additional costs would be passed on to insureds.

Conclusions and recommended options

3.109 Option A would result in the duty of disclosure obligations (such as the requirement to ask specific questions for eligible contracts) applying at renewal, as well as inception.

3.110 If Option A were adopted:

- insurers would be better advised of factors affecting the risk associated with a particular contract of insurance; and
- insureds would be less likely to be disadvantaged when making a claim because they failed to disclose adequately on renewal.

EXPOSURE DRAFT

3.111 However, the change may result in administrative costs for insurers because they would need to ask insureds to update answers provided at inception of the contract, or on last renewal, and record and assess the answers, rather than relying on the general duty of disclosure in section 21. Notwithstanding the prospect of increased administrative costs, Option A is recommended because the measure would avoid the possibility of significant detriment for insureds as a result of a failure to comply with the general duty of disclosure obligations applying on renewal due to ignorance about their existence.

Notification of duty of disclosure

Problem

3.112 Section 22 of the IC Act requires insurers to clearly inform prospective insureds of the general nature and effect of the duty of disclosure before the insured enters the relevant contract of insurance. However, as part of its review, the Panel was made aware that in some circumstances the time between providing the relevant disclosure and the commencement of the contract of insurance can be some months.

3.113 A legal aid commission noted in a submission to the Panel that, in its experience, many insureds assume they have complied with their duty of disclosure obligations when they disclose all facts known to the insured at the time of filling out a proposal form or answering an insurer's questions during a preliminary telephone application interview. Matters that are relevant to the insurer's decision to accept the risk and enter the contract may arise after the date of application for the policy and the date it comes into effect, but it is quite common for insureds to fail to disclose such matters because they mistakenly believe they are under no obligation to do so.

3.114 If no action is taken, some insureds that fail to provide requisite disclosures for events that took place between the date of their initial application and the time the contract was entered, will continue to have any claims jeopardised by the failure. The Panel noted that although some insurers ask the insured immediately prior to the policy coming into effect whether they have anything additional to disclose since filling out the original proposal form, this is not a universal practice.

EXPOSURE DRAFT

Objective

3.115 The objective is to ensure, so far as is reasonably possible, that insureds are not disadvantaged if a claim arises because they did not understand their duty of disclosure obligations where there is a delay between the date they initially applied for the contract of insurance and the date it was entered into.

Options

Option A: Require insurers to issue reminders concerning the duty of disclosure at the time the relevant contract is issued

3.116 Under this option, insurers would be required to provide to the insured, at the time the contract of insurance is issued, a reminder that the duty of disclosure continues until the time that the policy is entered into, unless the contract is entered a short time after the person initially applied for insurance.

Option B: Require insurers to use clearer language as to when the duty applies in the initial notification

3.117 Under this option, there would be no need for an additional reminder when the policy is issued as proposed by Option A. However, insurers would need to clearly state when explaining the insured's duty of disclosure that it extends until the time the contract is entered into.

Option C: No specific action

3.118 This option would retain the current rule that insurers must advise prospective insureds of their duty of disclosure at the time the insured submits an application for insurance. However, there is no further requirement for a reminder at the time the policy is issued.

Impact analysis

Impact group identification

3.119 Affected groups:

- insurers;
- insureds;

EXPOSURE DRAFT

- proposed insureds;
- life insureds (other than the insured under a contract of life insurance); and
- dispute resolution bodies and courts.

Assessment of costs and benefits

Option A: Require an additional reminder at the time the policy is issued

Benefits	Costs
Notification increases the likelihood that insurers will be properly advised of relevant factors necessary to assess risks [2] This option would prevent insureds, especially those under contracts of life insurance with large time periods between the time of policy application and policy issue, from having claims denied due to their failure to understand that the duty of disclosure extends until the policy is entered [4] This option may reduce the incidence of disputes going to court/ dispute resolution bodies as a consequence of insureds not being aware of their duty of disclosure obligations upon renewal [1]	Requiring insurers to issue reminders about the duty of disclosure at the time of policy issue imposes additional administrative costs which may be passed on to insureds [4]

Option B: Require insurers to use clearer language as to when the duty applies in the initial notification

Benefits	Costs
This option could prevent insureds in some cases from suffering disadvantage arising from failure to update information provided during application, although it is unlikely to be as effective in this regard as Option A [3]	Although not expected to be as large as those for Option A, there would still be some administrative expenses required for this option [2] Despite the additional explanation, there will still be some insureds who neglect to adequately disclose which affects the insurer's understanding of the risk and may jeopardise an insured who seeks to make a claim [2]

Option C: No specific action

Benefits	Costs
No additional compliance costs [4]	Claims by some insureds will continue to be jeopardised due to non-disclosure, leading to potentially significant detriment for the persons concerned and greater disputes [4]

Request for comment

Are there additional costs and benefits for the above options, which are not listed?

Are the ratings appropriate?

Information to assist with quantification of costs and benefits is sought for inclusion in the final regulation impact statement.

Consultation

3.120 General insurance industry representatives argued the benefits of a change such as proposed by Option A were not significant enough to justify the costs. Option A would require a change in the compliance requirements of insurers that was disproportionate to the benefits that may flow from such an amendment.

3.121 However other submissions, including from legal profession representatives and a dispute resolution body, supported reform of the type proposed in Option A. One submission noted that an amendment such as Option A could be expected to lead to a reduction in the number of disputes.

3.122 Life insurance industry representatives noted that the majority of life insurers already included advice to prospective applicants that their duty of disclosure continues until the date the contract is entered into, such as that proposed in Option B.

Conclusions and recommended options

3.123 Many insureds do not realise that their duty of disclosure extends until the contract is entered into so that, if the policy is issued some time after a proposal form is submitted, the insured may be exposed to the denial of a claim if they failed to disclose a relevant fact that arose

EXPOSURE DRAFT

(or which they became aware of) during the interim period. A failure to disclose could lead to a claim being denied.

3.124 Option A minimises this risk by requiring insurers to give insureds a reminder of the duty at the time the contract is issued (unless the contract is issued within a short time of receiving the proposal). This option would generate additional administrative expenses for insurers.

3.125 Option B goes some way toward addressing the problem by having the initial notice of the duty state more clearly that the duty extends until the time the contract is issued. Although the additional administrative expenses associated with Option B would be less than those associated with Option A, Option B is likely to be less effective than a reminder at the time the policy is issued, particularly when the contract is entered some time after the proposal form is submitted.

3.126 Typically, the insurer would communicate with the insured at the time the proposal is accepted to notify them of the acceptance and to request payment. At this time, the insurer could add an additional 'standard' element to that communication regarding the fact that the duty of disclosure extends until the relevant contract is entered. Therefore, the additional costs of complying with Option A (after a transitional phase) are not expected to be great.

3.127 On balance, Option A is favoured.

Non disclosure rules and life insureds

Problem

3.128 Misrepresentations by a 'life insured' (that is, a person other than the insured whose life is insured under the contract of life insurance) are treated as if they were made by the insured themselves pursuant to section 25 of the IC Act. As a consequence, if a life insured is found to have misrepresented, the insurer has the same remedies against the insured as if the misrepresentation had been made by the insured.

3.129 However, a life insured may also fail to disclose some matter that is relevant to an insurer's decision whether to enter the contract of life insurance. Should a life insured fail to disclose this matter then, under the current law, such a non-disclosure would not be impugned to the insured

EXPOSURE DRAFT

and the insurer would not be entitled to remedies against that insured for a breach of the duty of disclosure.

3.130 This seems anomalous given the terms of section 25 and may lead to unfair results for insurers. The reason is that insurers must satisfy a claim under a contract of life insurance notwithstanding that there has been a non disclosure by the life insured that, if made by the insured, would have allowed the insurer the right to avoid the contract or reduce their liability.

3.131 If no change is made, then the current disparity of remedies for insurers in respect of misrepresentations and non-disclosures by life insureds would continue, resulting in unfair outcomes for insurers.

Objective

3.132 The objective is to ensure that insurers receive reliable and adequate information to assess and price risk without placing an unfair burden on insureds in respect of the remedies available against them for non-disclosure.

Options

Option A: Expand the duty of disclosure under section 25 to cover non disclosure by a life insured

3.133 Under this option, the rule in section 25 of the IC Act that attributes a misrepresentation by a life insured to an insured would also apply to a non disclosure by the life insured. Further, the insurer would be required to give the life insured notice of the duty of disclosure before the relevant insured enters the contract of insurance.

Option B: No specific action

3.134 This option would leave section 25 of the IC Act unchanged so that it continues to apply only in respect of misrepresentations by life insureds. Also, there would be no obligation on insurers to give the life insured notice of the duty of disclosure.

EXPOSURE DRAFT

Impact analysis

Impact group identification

3.135 Affected groups:

- insurers;
- insureds;
- life insureds (who are not the insured under a contract of life insurance);
- prospective life insureds; and
- dispute resolution bodies and courts.

Assessment of costs and benefits

Option A: Expand the duty of disclosure under section 25 to cover non disclosure by a life insured

Benefits	Costs
Under this option, insurers would benefit by being able to rely on non-disclosures by life insureds as a defence to claims, as well as their current right to rely on misrepresentations. This may ultimately result in reduced risk premiums [4]	The proposed additional requirement that insureds notify life insureds of the duty of disclosure would result in additional administrative costs for insurers and life insureds [3]

Option B: No specific action

Benefits	Costs
No additional administrative costs [2]	Insurers would continue to be disadvantaged in some cases by non-disclosures of life insureds which could not be impugned to the insured [3]

EXPOSURE DRAFT

> **Request for comment**
>
> Are there additional costs and benefits for the above options, which are not listed?
>
> Are the ratings appropriate?
>
> Information to assist with quantification of costs and benefits is sought for inclusion in the final regulation impact statement. In particular, information on the financial cost to insurers of non-disclosures by life insureds would be helpful.
>
> Are there any benefits in maintaining a distinction between misrepresentations and non-disclosures by a life insured in relation to when they are imputed to an insured?

Consultation

3.136 In their submissions to the Panel, life insurance industry representatives strongly supported amending the IC Act in the manner proposed by Option A.

3.137 Representatives of the legal profession submitted that further evidence and consideration were necessary before Option A were considered. A consumer representative body argued there was no empirical evidence to suggest the current formulation of section 25 had caused problems for insurers, and a legal aid commission also opposed any reform of the type proposed in Option A.

Conclusions and recommended options

3.138 Non-disclosure by a life insured may adversely affect the reliability of information available to insurers so that they can more accurately price their risk. Indeed, in many instances non-disclosure may have a similar result in that regard to misrepresentation.

3.139 Option A ensures that non-disclosure by a life insured would have similar ramifications as a misrepresentation. This will help to ensure insurers are fully informed about the relevant risks so that they can price them accordingly. Further, failure to disclose would have the same impact for insureds as a misrepresentation by a life insured, and life insureds would therefore be subject to a broader duty of disclosure.

3.140 If a life insured's non-disclosure or misrepresentation is to be imputed to an insured then it follows that the life insured should receive

EXPOSURE DRAFT

some notice that this will occur. A key principle underlying the ALRC recommendations that gave rise to the IC Act was that consumers should receive all the information relevant to their contract of insurance and therefore the notice requirement in Option A appears appropriate. Insurers would usually communicate with life insureds about their disclosure obligations so it is reasonable that the insurer provide information about the duty directly as part of that process rather than relying on indirect channels through the insured.

3.141 Although Option A does impose some additional costs for life insurers (in relation to the notification obligation) and life insureds (in respect of the broader duty), it is preferred over Option B in order to ensure that non disclosure by a life insured is dealt with appropriately and insurers may deny or reduce claims in appropriate circumstances if non-disclosure by a life insured occurs.

Life insurance remedies

Problem

3.142 The current provisions in the IC Act that deal with the remedies available to a life insurer are of quite long standing. They derive from remedies formerly available under the *Life Insurance Act 1945* and are largely based on principles of proportionality.

3.143 Such remedies were appropriate for 'traditional' life insurance products that were available at the time the remedies were developed (that is, cover for death and/or investment-type products with a surrender value). However, the life insurance industry argues that the remedies are now inadequate and inappropriate for the range of products currently available.

3.144 In a submission to the Panel, life insurance industry representatives identified the following developments, in addition to judicial interpretations of provisions, which had taken place in the life insurance industry since the IC Act commenced operation:

- the increasing popularity of cover such as income protection and total and permanent disablement (TPD) insurance, as well as trauma/critical illness;

EXPOSURE DRAFT

- the practice by some life insurers of selling multiple types of cover within the one contract (for example, 'bundled' contracts);
- the incidence of life insurance products allowing for more than one life insured; and
- developments in underwriting practices to take account of the changing nature of life insurance products available.

3.145 The submission argued that the prescriptive nature of remedies in section 29 means that the current remedies in the IC Act no longer provide a fair balance between the interests of insurers and insureds. In particular, there is a concern that the remedies in respect of life insurance are designed primarily for policies that provide for cover on death and/or have a surrender value (which is an amount payable to an insured should their contract be terminated before the end of its term).

3.146 Life insurance industry representatives argued that the relative inflexibility of remedies in section 29 frequently leads to inequitable results. For example, if an insured failed to disclose that they are a smoker, an appropriate remedy could be the setting of a higher premium. However, under subsection 29(4), the remedy must be a reduction in the benefit amount, which may be a harsher penalty than is required or appropriate in the circumstances.

3.147 Further, if different types of life cover are bundled in the same contract, the IC Act does not allow avoidance or correction of one cover without affecting the other cover(s) bundled in the same contract.

3.148 If no action is taken, the inflexible nature of the remedies available in respect of life insurance will persist.

EXPOSURE DRAFT

Objective

3.149 The objective is to ensure that life insurance remedies in respect of misrepresentation and non disclosure provide adequate redress for insurers but do not result in penalties for insureds that are disproportionate to the loss suffered by the insurer.

Options

Option A: Make remedies for breach of the duty of disclosure for life insurance mirror the counterpart remedies for general insurance

3.150 Under this option, the remedies for non-disclosure or misrepresentation under a contract of life insurance would be similar to remedies for non disclosure and misrepresentation under a contract of general insurance. This would mean that, in the case of fraud, the insurer could avoid the contract. In the absence of fraud, the insurer may reduce its liability to an amount that would restore the insurer to the position had no breach of the duty of disclosure had occurred.

3.151 There would no longer be a distinct remedy in respect of fraud or non disclosure concerning age as currently applies under section 29. Further, the three year time limit for insurers to avoid a contract of life insurance on the basis of non-disclosure or misrepresentation would be removed.

Option B: As per Option A, but retain specialised life insurance remedies for policies that cover mortality risks and/or have a surrender value

3.152 This option is like Option A, but the current remedies for life insurance in section 29 would be retained for those types of life insurance policy for which they are suited — that is, policies covering mortality risks and policies that have a surrender value.

3.153 Further, if the policy contained cover for mortality risks and/or has a surrender value, and some other type of insurance cover, the policy would be 'unbundled' for the purposes of considering the application of remedies for breach of the duty of disclosure. By unbundling in that way, a misrepresentation or non-disclosure that is relevant to the risk for one type of cover (for example income protection) would not necessarily result in remedies applying to a different type of cover for which the non disclosure or misrepresentation was of no consequence or relevance (for example death cover).

Option C: No specific action

3.154 Under this option, the specialised life insurance remedies in section 29 continue to apply to all types of life insurance.

EXPOSURE DRAFT

Impact analysis

Impact group identification

3.155 Affected groups:

- life insurers;
- insureds;
- life insureds (that are not the insured under a contract of insurance); and
- dispute resolution bodies and courts.

Assessment of costs and benefits

Option A: Make remedies for breach of the duty of disclosure for life insurance mirror the counterpart remedies for general insurance

Benefits	Costs
This option would allow more flexibility in determining remedies for breach of duty of disclosure, to the benefit of both insurers and insureds [4] Increased flexibility of remedy may benefit insureds overall by allowing the use of less costly remedies [2]	Removal of the specialised remedies and the protection offered by the 'three year rule' in section 29 could produce inappropriate outcomes in some cases (particularly those 'traditional' life insurance policies) to the significant detriment of some insureds [5]

Option B: As per Option A, but retain specialised life insurance remedies for policies that cover mortality risks and/or have a surrender value

Benefits	Costs
This option would allow more flexibility in determining remedies for breach of duty of disclosure, to the benefit of both insurers and insureds [4] Increased flexibility of remedy may benefit insureds overall by allowing the use of less costly remedies [2]	Dividing different types of life insurance cover into categories increases complexity and administration of the legislation [3] There will be transitional administrative costs for insurers associated with adopting a new remedies framework [1] The claims of some insureds may be detrimentally affected by loss of

EXPOSURE DRAFT

	protections offered under the present remedies framework [1]

EXPOSURE DRAFT

Option C: No specific action

Benefits	Costs
No additional administrative expenses [3]	The lack of flexibility in remedies for life insurance can result in detriment to insureds who are subjected to a sanction more onerous than necessary [3] The price and availability of life insurance may continue to be adversely affected through lack of access to more appropriate remedies [2]

Request for comment

Are there additional costs and benefits for the above options, which are not listed?

Information to assist with quantification of costs and benefits is sought for inclusion in the final regulation impact statement.

Consultation

3.156 There has been no clear consensus regarding the need to reform the current remedies available to life insurers in respect of non-disclosure and misrepresentation. The life insurance industry strongly argues that there are significant deficiencies in the current remedy arrangements given the range and type of life insurance products currently on the market. In a submission to the Panel, one life insurer noted that difficulties with the current life insurance remedies may be affecting the cost and availability of insurance (with consequent negative effects for insureds).

3.157 However, consumer representatives opposed any change of the type proposed by Options A or B. A consumer representative body submitted that the distinction between remedies in respect of life insurance and general insurance had historical foundations in that it was an acknowledgement that the *Life Insurance Act 1945* already regulated life insurer conduct. Consumer representatives questioned whether the current remedies are as restrictive as claimed by members of the life insurance industry and expressed concern about the impact of changes on the protections for insureds.

EXPOSURE

3.158 It was argued that life insurance, even the types of life insurance that are akin to 'pure risk', involve more complex disclosures than an ordinary general insurance product. Therefore, insureds require greater protections than general insureds in relation to remedies for breaches of the duty of disclosure.

Conclusions and recommended options

3.159 The problem is that the remedies available to life insurers for non disclosure or misrepresentation may fail to take into account the changed nature of life insurance products and, as a result, unnecessarily limit the availability of life insurance or increase its cost.

3.160 Option C would involve no change to the current regime and, as a consequence, the concerns regarding the inflexible nature of life insurance remedies would continue. Option A would involve removing the current distinction between remedies for a breach of the duty of disclosure in life insurance and general insurance so that the remedies are the same. Option B is similar to Option A, although Option B would leave the existing life insurance remedies available for particular types of cover for which those remedies may have initially been developed.

3.161 It is accepted that the current remedies for breaches of the duty of disclosure in life insurance are restrictive and unnecessarily restrict the remedies available to insurers in the context of some types of cover. However, the specialised remedies offered in relation to traditional types of life insurance policies (death cover and/or surrender value) remain appropriate. The benefits of freeing up the remedies in other cases outweigh the costs of moving to a bifurcated system, with the complexity of unbundling the components of policies. The risks of unfairly disadvantaging insureds by removing some of the protections currently offered is not considered great in respect of non traditional types of policies.

Third party beneficiaries

Problem

3.162 Third party beneficiaries are not parties to a contract of insurance. Rather, they are specified in the contract as being persons to whom any insurance cover provided by the contract extends. They

EXPOSURE DRAFT

include, for example, persons who are covered by a personal accident policy taken out by their employer or persons that receive life insurance cover under a policy taken out by their superannuation fund.

3.163 Although the IC Act deals with the entitlement of such persons to make a claim notwithstanding that they are not parties to the contract (see section 48 as one example), there is little reference to third party beneficiaries elsewhere in the IC Act. Concerns have been raised that the IC Act should include more references to third party beneficiaries because their status as the primary object of insurance cover in many instances may mean that they should have the same rights and obligations as insureds.

3.164 For example, it is arguable that an insurer should have a duty to act in good faith towards the specified beneficiary, and vice-versa, at least after the contract has been entered into.

3.165 Inclusion of suitable contractual provisions to deal with third party beneficiaries may provide a partial solution to the limited application of the IC Act to their situation. However, as third party beneficiaries are not parties to the contract, this option cannot deal effectively with all of the relevant issues.

Objective

3.166 The objective is to ensure that, to the extent reasonably practical; third party beneficiaries under an insurance contract have rights and obligations that are in keeping with the context and intention of their relationships with both the insurer and the insured.

Options

Option A: Extend all rights and obligations of insureds under the IC Act to specified third party beneficiaries

3.167 Under this option, specified third party beneficiaries would have the same rights and obligations under the IC Act as if they were the insured. Consequently, the insurer would need to notify all third party beneficiaries of their duty of disclosure before the relevant contract is entered. Further, in relation to eligible contracts of insurance, all third party beneficiaries would need to be notified of unusual terms in the contract.

EXPOSURE DRAFT

Option B: Extend only certain rights and obligations under the IC Act to specified third party beneficiaries

3.168 This option would treat specified third party beneficiaries as insureds under the IC Act only for the purposes of:

- subrogation, in that the insurer would be able to substitute for the third party beneficiary in an action against a third party who is liable for a loss that has been paid by the insurer;
- the duty of utmost good faith (but not pre-contractually); and
- circumstances where the IC Act allows an insured to request the insurer provide them with particular information by way of written notice.

3.169 In those circumstances, it is practical to treat a third party beneficiary as an insured because the third party beneficiary is identifiable.

Option C: No specific action

3.170 This option would retain the current position under which specified third party beneficiaries are generally not covered by the IC Act.

Impact analysis

Impact group identification

3.171 Affected groups:

- insurers;
- specified third party beneficiaries; and
- government and the regulators.

EXPOSURE DRAFT

Assessment of costs and benefits

Option A: Extend all rights and obligations of insureds under the IC Act to specified third party beneficiaries

Benefits	Costs
This option would ensure that specified third party beneficiaries have access to all protections offered under the IC Act to insureds [4] Insurers would benefit from the obligations owed by third party beneficiaries such as the duty of disclosure [3]	This option would significantly increase costs for insurers in relation to, for example, providing required notices such as a notice of renewal [4] This option would present practical difficulties in respect of some obligations if applied pre-contractually, as some third party beneficiaries are described generally and are difficult to identify with precision until after the contract is entered into [4] This option could increase the cost and/or decrease the availability of particular types of insurance, especially types involving multiple specified third party beneficiaries [4]

Option B: Extend only certain rights and obligations under the IC Act to specified third party beneficiaries

Benefits	Costs
This option gives third party beneficiaries rights and remedies against insurers in some circumstances, for example an action for a breach of utmost good faith [3] Insurers would have some benefits in dealing with third party beneficiaries, such as the right to subrogate [2]	This option would involve costs for insurers where they must provide a notice in response to a request by a third party beneficiary [2] There may be some additional cases for courts and dispute resolution bodies as a result of vesting third party beneficiaries with rights and obligations [1]

Option C: No specific action

Benefits	Costs
No additional compliance costs [3]	Inappropriate outcomes for insurers and third party beneficiaries will continue to be generated due to a lack of recognition of third party beneficiaries under the IC Act [4]

Request for comment

Are there additional costs and benefits for the above options, which are not listed?

Are the ratings appropriate?

Information to assist with quantification of costs and benefits is sought for inclusion in the final regulation impact statement. In particular, is there information about the frequency with which insurers may wish to exercise subrogation rights over a third party beneficiary against another person? How does an insurer deal with this circumstance under the current regime where subrogation is not permitted?

Consultation

3.172 There was support from consumer and insurance industry representatives for extending the duty of utmost good faith to third party beneficiaries. However, concerns were expressed about the practicalities of extending all rights and obligations of an insured to third party beneficiaries. NIBA noted it would be impractical to extend the duty of utmost good faith to pre contractual matters such as the duty of disclosure.

Conclusions and recommended options

3.173 The problem is that the current limited application of the IC Act to third party beneficiaries has resulted in some anomalies and inconsistencies. Third party beneficiaries acquire cover under a contract of insurance comparable to insureds, but have few of the insured's rights and responsibilities.

3.174 The proposal in Option A would extend all rights and responsibilities conferred on insureds under the IC Act to third party beneficiaries. However this has significant practical difficulties because many third party beneficiaries will not be known with certainty until after the contract is entered into. Option B enables avoidance of some of those difficulties by only conferring on third party beneficiaries a limited range of rights and obligations which do not involve significant expense. Option C involves no change to the current situation.

3.175 The preferred option is Option B. Concerns raised during the initial consultation period regarding the expense and practical difficulties

EXPOSURE DRAFT

of bestowing third party beneficiaries with all of the rights and obligations held by insureds appear to be justified. Option B bestows rights and obligations only if it would address an anomaly or inconsistency, and would be practical to implement.

Claims made and claims notified policies

Background

Section 54

3.176 Section 54 of the IC Act prevents an insurer from relying on an act of the insured, or some other person, to refuse to pay an insurance claim, unless the particular act could reasonably be regarded as having caused or contributed to a loss for which the insured is now seeking reimbursement. However, by section 54, an insurer is entitled to reduce their liability in response to some act of the insured to the extent that the insurer's interests were adversely affected by the act of the insured (this is referred to as the 'prejudice test').

'Claims made and notified' insurance

3.177 A 'claims made and notified' policy covers an insured if a claim of liability is made against them during the policy period and the insured notifies this claim to their insurer, also during the policy period. In some cases, 'claims made and notified' policies may contain a provision that obliges the insurer to cover an insured in respect of a loss arising from facts that the insured notified to their insurer during the policy period, even if the claim is actually made outside the policy period.

3.178 These provisions are known as 'deeming provisions' and they achieve an outcome similar to subsection 40(3) of the IC Act. Subsection 40(3) stipulates that, for liability insurance, insurers must provide cover where an insured notifies them of facts that may give rise to a claim during the period of cover, regardless of whether such coverage is provided for in the contract.

Problem

3.179 Judicial interpretation of the operation of subsection 54(1) has altered the way in which the section operates in relation to 'claims made

EXPOSURE DRAFT

and claims notified' insurance. The effect has been to excuse holders of 'claims made and notified' policies from the need to:

- notify their insurer of a claim during the policy period; and
- if the policy has a 'deeming provision' — notify their insurer of facts that may give rise to a claim during the policy period.

3.180 Although late notification of facts that may give rise to a claim is a breach of the terms of a 'claims made and claims notified' policy, the courts' interpretation of subsection 54(1) has ensured that an insurer cannot refuse to cover the eventual claim.

3.181 This interpretation appears to have forced insurers to have higher ongoing claims reserves than they would otherwise have to allow for claims that may arise where relevant facts were known but not previously notified to the insurer. The interpretation is believed to have contributed to a reduction in the availability and affordability of liability insurance at particular times. For example, when last the Australian insurance market tightened, insurers were said to reduce the risk associated with providing indemnity insurance by:

- substantially increasing premiums for 'claims made and notified' policies to better account for 'incurred but not reported' claims;
- narrowing the breadth of 'claims made and notified' policies by introducing a variety of restrictions in the policies; and/or
- withdrawing (either in part or fully) from the liability market.

3.182 It is argued that, without reform, the current interpretation of section 54 may lead to similar problems in the future. Already, many insurers have responded to the current interpretation of section 54 by removing 'deeming provisions' from their contracts of insurance.

3.183 In the case of Gosford City Council v GIO General Limited[8] (Gosford), the New South Wales Court of Appeal held that section 54

8 [2002] NSW SC 511 and [2003] NSW CA 34.

EXPOSURE DRAFT

would not relieve an insured who failed to notify facts that may give rise to a claim during the policy period, where such a notification relied upon subsection 40(3) of the IC Act. The circumstances of the decision depended on the particular wording of the policy.

3.184 The basic effect of the Gosford decision is that:

- if a contract of liability insurance contains a ‘deeming provision’, then section 54 operates in relation to the late notification of facts; but
- if a virtually identical contract lacks a ‘deeming provision’ — and instead relies upon subsection 40(3) to allow insureds to notify facts — then section 54 does not operate in relation to the late notification of facts.

Objective

3.185 The objective is to ensure that section 54 of the IC Act operates in a consistent manner to all contracts of liability insurance such that the provision of this type of insurance within Australia remains attractive now and into the future.

Options

Option A: Ensure section 54 no longer excuses the late notification of facts that might give rise to a claim under a contract of liability insurance

3.186 This option would involve:

- amending the IC Act so that section 54 no longer excuses an insured from the obligation to notify their insurer of facts that might give rise to a claim during the period of cover;
- introducing new disclosure requirements for insurers so that they must notify potential insureds of the consequences of a late notification of facts that might give rise to a claim; and
- introducing a statutory ‘extended reporting period’, during which an insured could continue to notify their insurer of facts for 28 days after their policy expired, as long as such facts arose during the policy period.

EXPOSURE DRAFT

Option B: Ensure section 54 no longer excuses the late notification of a claim or the late notification of facts that might give rise to a claim under a contract of liability insurance

3.187 Option B is similar to Option A, but would also deal with the late notification of a claim. It involves:

- amending the IC Act so that section 54 no longer excuses an insured from the obligation to notify their insurer of a claim during the period of cover;
- amending the IC Act so that section 54 no longer excuses an insured from the obligation to notify their insurer of facts that might give rise to a claim during the period of cover;
- introducing new disclosure requirements for insurers so that they are required to notify potential insureds of the consequences of a late notification of a claim, or of facts that might give rise to a claim; and
- introducing a statutory 'extended reporting period', during which an insured could continue to notify their insurer of a claim, or of facts that might give rise to a claim, for 28 days after their policy expired, as long as the claim or facts arose during the policy period.

Option C: No specific action

3.188 This option would see section 54 retained in its current form, as interpreted by the courts.

Impact analysis

Impact group identification

3.189 Affected groups:

- insurers;
- insureds;
- third party beneficiaries; and

EXPOSURE DRAFT

- courts and dispute resolution bodies.

EXPOSURE DRAFT

Assessment of costs and benefits

Option A: Ensure section 54 no longer excuses the late notification of facts that might give rise to a claim under a contract of liability insurance

Benefits	Costs
Clarifying that section 54 does not excuse the late notification of facts provides certainty for the insurance industry. Insurers will be able to more appropriately produce enough reserves to meet 'incurred but not reported claims.' [3] Certainty will aid the insurance market when it next hardens. The effect of section 54 on the late notification of facts was said to encourage insurers to withdraw liability coverage in the last hard insurance market (the late 1990's/early 2000's) [3] This option would mean that section 54 applies uniformly to policies with deeming provisions and policies without deeming provisions [3] New disclosure requirements would improve the transparency of liability insurance policies [4]	There will be a one off cost associated with insurers updating existing disclosure documents to introduce the new requirements. However, ongoing disclosure costs would not increase substantially as the new requirements could be incorporated into existing documents [4] Insureds would no longer be covered if they made a late notification of facts, except as provided by the extended reporting period. However, such coverage only currently applies to policies that have deeming provisions. Evidence exists that there are not many policies in the market that still contain deeming provisions. As such, the cost to insureds is likely to be small [1]

EXPOSURE

Option B: Ensure section 54 no longer excuses the late notification of a claim or the late notification of facts that might give rise to a claim under a contract of liability insurance

Benefits	Costs
Clarifying that section 54 does not excuse the late notification of a claim or of facts provides certainty for the insurance industry. Insurers will be able to more appropriately produce enough reserves to meet 'incurred but not reported claims [3] Such certainty will aid the insurance market when it next hardens. The effect of section 54 on the late notification of claims and facts was said to encourage insurers to withdraw liability coverage in the last hard insurance market (the late 1990's/early 2000's). This option would provide more certainty for insurers then Option A [4] This option would mean that section 54 applies uniformly to policies with deeming provisions and policies without deeming provisions [3] New disclosure requirements under this option will improve the transparency of indemnity insurance policies [4]	There will be a one off cost associated with insurers updating existing disclosure documents to introduce the new requirements. However, ongoing disclosure costs would not increase substantially as the new requirements could be incorporated into existing documents [4] Insureds would no longer be covered if they made a late notification of a claim (except as provided by the extended reporting period) even where they can establish that the late notification did not prejudice the insurer. This would be a large cost to insureds, as it would lessen the coverage currently provided by all indemnity policies [4] Insureds would no longer be covered if they made a late notification of facts, except as provided by the extended reporting period. However, such coverage only currently applies to policies that have deeming provisions. Evidence is that there are not many policies in the market that still contain deeming provisions. As such, the cost to insureds is likely to be small [1]

EXPO

Option C: No specific action

Benefits	Costs
No specific action avoids any transitional compliance costs for insurers [3] Under this option, section 54 would continue to apply to the late notification of claims, the prejudice test would continue to provide a balance and allow insurers to reduce payment where a late notification is shown to cause detriment [2] Section 54 would continue to apply to the late notification of facts, where the insurance policy contains a 'deeming provision' [2]	Currently, the prejudice test does not operate in relation to the late notification of facts. As such, insurers have no way of reducing payment for a late notification, despite the difficulties a late notification causes in setting aside appropriate reserves [5] Under this option, section 54 would continue to have a different effect on virtually identical policies where one policy contains a deeming provision and the other relies on subsection 40(3) of the IC Act. Some insureds may not be aware of the different treatment of similar policies [3] Insurers will continue to experience difficulties in appropriately producing enough reserves to meet 'incurred but not reported claims.' [4] Under this option there is a risk that insurers may again leave the liability market next time the insurance market hardens. As the insurance industry goes through cycles, this could be an ongoing problem [3]

Request for comment

Are there additional costs and benefits for the above options, which are not listed?

Are the ratings appropriate?

Information to assist with quantification of costs and benefits is sought for inclusion in the final regulation impact statement.

Consultation

3.190 This issue was examined by the Panel first and became the subject of a separate report released by the then Minister for Revenue and Assistant Treasurer, Senator the Hon Helen Coonan and the then Parliamentary Secretary to the Treasurer, the Hon Ross Cameron.

3.191 Draft amendments were produced giving effect to the recommendations of the Panel, which is Option A above. The Australian Government considered that consultation on the actual wording of the proposed amendments was necessary to assist determinations as to whether Option A was appropriate or whether Options B or C may be better alternatives.

3.192 Consumer representatives were concerned that Option B would substantially reduce the coverage currently provided by indemnity policies if section 54 no longer applied to the late notification of claims. It was argued this reduction would adversely affect insureds and third party beneficiaries notwithstanding that they accepted section 54 did not operate in relation to the late notification of facts under most liability policies due to the removal of 'deeming provisions'.

3.193 Consumer representatives accepted that it would be useful to clarify that section 54 does not operate at all in relation to the late notification of facts, so long as an extended reporting period was provided and insurers were required to inform the insured of the effect of a late notification of facts.

3.194 Insurance industry representatives indicated a preference for Option B. They argued that the availability and affordability of liability insurance would only improve during a tight insurance market if section 54 no longer applied to both the late notification of claims and the late notification of facts. Insurance industry representatives expressed concern about the cost of proposed disclosure requirements in Options A and B, which would require insurers to explain the consequences of a late notification of a claim or fact.

3.195 The insurance broking industry representatives initially did not consider any changes were necessary. Later they indicated that the changes proposed in Option A were relatively minor and would provide clarity for insurers and insureds.

EXPOSURE DRAFT

Conclusion and recommended options

3.196 The preferred option is Option A. Although Options A and B share many characteristics, Option B would have a detrimental impact on insureds as it no longer allows section 54 to operate in relation to the late notification of claims.

3.197 Insurers argue that the operation of section 54 in relation to the late notification of claims discourages them from offering liability

insurance in a hard insurance market. However, section 54 appears to be operating as intended. The provision allows insurers to avoid payment under a contract of liability insurance if they can show that the late notification of facts prejudiced them. By contrast, the prejudice test does not appear to be operating in relation to the late notification of facts, which would justify an amendment.

3.198 Option C is not recommended as it fails to correct the current inconsistent operation of section 54 in relation to virtually identical contracts of liability insurance.

Implementation and review

3.199 The recommended actions all require legislative amendments to the IC Act, except the self regulation aspect of claims handling processes, which will be implemented through liaison with relevant industry bodies where it is still applicable.

3.200 No formal review has been scheduled. The operation of the IC Act will be under continuous monitoring and adjustments or refinements to the proposed amendments will be made as required.

EXPOSURE DRAFT