Treasury Laws Amendment (Unfair Terms in Insurance Contracts) Bill 2019

Submission to Senate Economics Legislation Committee

Response to: Treasury Laws Amendment (Unfair Terms in Insurance Contracts) Bill 2019
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Issue date: 29 August 2019
AIA AUSTRALIA LIMITED

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Introduction

Thank you for the opportunity to provide feedback on the Treasury Laws Amendment (Unfair Terms in Insurance Contracts) Bill 2019.

AIA Australia (AIAA) is pleased to provide information regarding the likely impact of the Bill on life insurance contracts. We have noted below our suggestions for amendments that could be made in order to more appropriately capture life insurance contracts while still meeting the fundamental principle underlying the Bill, that insurers should not include terms in their standard form contracts that are unfair to the consumer.

While we support this objective in principle, we are concerned that the implications of the Bill as drafted on long-term life insurance contracts will create uncertainty and undermine the ability for insurers to manage risk. The potential for terms to be found to be void will create significant prudential issues, with a resulting impact on pricing and reinsurance.

Life insurance contracts are designed to manage risk, not to create an unfair imbalance

Life insurance enables Australians to pool their risks of unforeseen events impacting their health and wellbeing. Life insurance contracts are designed to be held long-term, and are automatically renewable annually. Since the terms entered into at the contract's outset are locked in for the length of the contract, a prudent life insurer must carefully manage its risk exposure, and ensure it has in place the right controls for the long-term wellbeing of the pool of insureds as a whole, particularly given the strong likelihood that an insured's personal circumstances will change throughout the lifetime of the policy.

This is in contrast to a general insurance contract, whereby a customer needs to renew the contract each year in order to retain their insurance coverage, and provide any updated disclosures at the time of renewal.

Due to the long-term nature of life insurance contracts, an insurer has limited opportunities to manage risk: for example, an insurer is unable to cancel a life insurance contract except in specific circumstances, ordinarily involving fraud on the part of the consumer. Product design is carefully considered, and a relatively conservative approach is taken to what is necessary to protect a life insurer's legitimate interests over the substantial lifetime of the contract.

This is why life insurance contracts are intentionally designed to have benefit structures that change with age, or sums insured that reduce with age. What seems fair to a customer when they take out a policy at the age of 40 may later seem to them to be unfair when cover is removed at age 65, and for that reason clear and ongoing disclosure and customer engagement are essential for the consumer to understand the wider context in which they hold their product. Life insurers cannot operate with the uncertainty that a customer could at a future time believe that their long-term, automatically renewable contract is no longer fair to them.

The nature of life insurance involves sharing risk across a pool of customers. Even with an individually underwritten product, the determination of terms to be applied for an individual risk is based on the assessment of the broader pooling of risk, in order to ensure the products remain affordable and sustainable. Life insurers design products that include terms that are necessary to share risk amongst the pool of customers who take out that product.

There are protections against unfairness already built into the regulatory regime

The proposed unfair contract terms (UCT) regime will add to a larger regulatory context already in movement for the industry. Whilst the UCT provisions propose to have oversight of the terms of insurance contracts and create boundaries as to what constitutes fairness, Treasury ought to consider whether this additional layer of legislation will effectively achieve its proposed goals. In addition to

regulatory change, the enhancement of self-regulation in relation to unfair terms with oversight by independent bodies should be supported.

At the root of this legislation is the desire to bolster consumers' confidence in the insurance industry and ensure that consumers are not subject to unfair contract terms when they take out an insurance product. The desirability of these outcomes is supported throughout reviews undertaken over the last 10 years in relation to consumers' experiences:

a. The Productivity Commission (2008), Review of Australia's Consumer Policy Framework;
b. Australian Government (2011), Natural Disaster Insurance Review, Final Report;
c. Australian Securities and Investments Commission (2014), Report 416, Insuring your home: Consumers' experiences buying home insurance;
d. Insurance Council of Australia (2015), Too Long; Didn't Read: Enhancing General Insurance Disclosure;
e. Consumer Affairs Australia (2017), Australian Consumer Law Review;
f. Senate Economics Committee Inquiry into the General Insurance Industry (2017);
g. Parliamentary Joint Committee on Corporations and Financial Services, Life Insurance Industry (2018); and
h. Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (2019).

We support an appropriate framework being put in place for the purpose of building consumer trust in the insurance industry, and we strongly encourage Treasury to view legislative change holistically, with due consideration of how proposed changes will interact with the other changes impacting the industry.

The following regulatory frameworks similarly seek to build consumer trust and ensure their fair treatment in the insurance context:

a. The recently legislated Design and Distribution Obligations and the proposal to classify claims handling as a financial service will both play an important role in ensuring fairness for life insurance customers. By explicitly outlining a target market, and by being unable to distribute products to unsuitable markets, as both product designers and product distributors we are required to ensure that consumers are not getting a product that is not fit for purpose, and therefore reducing the potential that a consumer is locked into an agreement plainly unsuitable for their needs and unfair to hold them to. Similarly, claims handling becoming a financial service will ensure that our consumers have additional legislative requirements in place at their most vulnerable time with the direct oversight of ASIC as a Financial Services Licence regulator, significantly reducing the potential for unfair conduct to impact those in a difficult position.

b. The Life Insurance Code of Practice (Code) contains a number of consumer protections aimed at fairness and transparency, which are two of the principles that apply to a life insurer's products and services under the Code. Clause 1.6 states "*We acknowledge that a contract of insurance is based on the principle of utmost good faith which requires both us and you to act honestly and fairly towards each other, and for us to have due regard for your interests*."

   Product design under the Code requires insurers to "*include benefits intended to cover genuine risks that generally affect the relevant customers*".

c. Key information is required to be provided clearly and in plain language – such as exclusions and waiting periods – so that an applicant can decide whether they wish to enter into a contract on those terms. Any pre-existing condition exclusions are explained in detail, before the contract is entered into.

d. The Code also requires an insurer to explain any non-standard terms that are offered to an applicant, based on their personal circumstances; for example, an exclusion of specific events, activities or medical conditions, alteration of a benefit period, or alteration of a waiting period. Applicants can discuss this with the insurer prior to taking out the policy, and the insurer can review their decision.

e. The insurance industry has in place a strong dispute resolution framework: internal dispute resolution, external dispute resolution through AFCA, and monitoring of possible Code breaches by the Life Code Compliance Committee. AFCA is a free service available to customers with a complaint. Under AFCA's Rules, a decision-maker must do what they consider is fair in all the circumstances.

f. More broadly, ASIC and APRA serve to regulate the conduct of financial services organisations such as the insurance industry. ASIC can accept complaints directly from the public and can call on an insurer to address such complaints and require the insurer to co-operate with changing terms which are considered to be unfair.

The industry is working through the Financial Services Council to strengthen the existing Code to provide fair and balanced outcomes for consumers. We believe the self-regulation model is the best option for consumers: there is greater flexibility for change and accessibility to remedies for the average consumer, as opposed to what will become highly technical legal tests for UCT, which could only be interpreted by lawyers. Consumers can play a more active role in self-regulation and they can access redress more readily and cost-effectively.

The Bill as drafted creates extreme uncertainty and unintended consequences

Taking a narrow view of the "main subject matter" exclusion means that every term (if not, most) in an insurance contract could be reviewable and potentially be found to be voidable. To illustrate this, in relation to disability-based insurance cover, the following terms could be subject to being void if such a narrow view is taken:

- eligibility criteria
- pre-existing condition exclusions
- waiting periods
- provisions setting out when a benefit may be paid (i.e. defining the insured event)
- benefit limits
- age-based access to policies and benefit periods
- occupation or employment-based restrictions on definitions or capping of sums insured
- capability requirements

The possible consequence of a narrowly defined "main subject matter" exemption will be that insurers would be unable to rely on terms which form the basis of their management and cover of risk (which is the heart of insurance). Contractual terms including exclusions (which arise from actuarial assessments of risk) are important when it comes to pricing, reserving and reinsurance support, and the decision to accept a risk. The result of this could be withdrawal of products from the market and reduced competition, products with fewer beneficial design features (such as reduced scope of cover) and higher premiums. As raised above, the prudential impact would be significant. This is likely to jeopardise insurance affordability and accessibility. It is evident these issues go beyond the individual risk concerned but extend to the assessment of risk on a wider scale.

Further clarity is required regarding the definition of an unfair term

Under section 12BG of the ASIC Act a contractual term is unfair if:

a. It would cause a significant imbalance in the parties' rights and obligations arising under the contract; and
b. It is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term; and
c. It would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

The interpretation of the key terms used above in the context of insurance contracts needs to be determined so that insurance risk can continue to be assessed and designed. The approach to determining what is "unfair" is more important when insurance products are designed to manage risk

over the long-term. It is therefore our view that further guidance should be developed to establish the fairness test, and specifically what terms would be deemed to be "*reasonably necessary in order to protect the legitimate interests*" of a life insurer. This is particularly important in the case of the Bill as currently drafted, where every term in a contract is exposed to a determination of unfairness.

The Explanatory Memorandum gives as an example that a term allowing for the unilateral increase of premiums would not be considered unfair if that term was used "*to protect the legitimate interests of the insurer in response to a change in the actuarial pricing of risk required to underwrite the policy*."

As raised above, it needs to be made clear that this is broader than just considering an individual's risk; premium increases may be increased for an entire pool of customers for a product, and the increase may not be directly linked to an individual's increased risk.

Policy terms may be included in a contract in order to reduce premiums. For example, in the absence of an exclusion that is included within a contract, the premium charged by the insurer may be higher. Terms that can be shown to influence the premium that is charged by the insurer (which may also include waiting periods, claim exclusion periods, and benefit periods) should be viewed as terms which are reasonably necessary to protect the legitimate interests of the insurer.

The definition of "main subject matter" for life insurance needs to be broadened

It is acknowledged in the Explanatory Memorandum for the Bill at para 1.30 that a party cannot challenge a term concerning the basis for the existence of the contract, in recognition of the fact that the party had a choice whether or not to enter into the contract on the basis of what was offered.

It is clear that the current definition of the "main subject matter", being the life insured, is so narrow as to render the exclusion nugatory. A more appropriate and realistic definition would capture terms which define what the life insured is being insured for (such as the disability definitions that are relevant to the cover sought). This is what is offered to an applicant for insurance, who then determines whether to accept the terms of that cover.

This is in line with the European Union and UK approach, which exempts from the UCT regime terms which "clearly define or circumscribe the insured risk and the insurer's liability".

Provided that provisions which set the parameters of the cover provided by the insurance contract are transparently disclosed prior to entering into the contract, they should not be capable of being rendered void by a court declaration. The pre-contractual disclosure of terms pertaining to the contract are already overseen by (for example):

a. the Product Disclosure Statement (PDS) requirements under the Corporations Act (for retail clients);
b. the requirements set out under sections 35 and 37 of the Insurance Contracts Act in respect of notification of unusual terms.
c. the duty of utmost good faith as set out under section 14 of the Insurance Contracts Act (which also applies to pre-contractual disclosure noting the wording of section 14(3)).

An alternative to broadening the "main subject matter" definition as described above would be to amend the Bill to provide a specific exemption for terms that describe the cover provided by the contract, as follows:

"3 At the end of subsection 12BI(1)

Add:

; or (d) if the contract is an Insurance Contracts Act insurance contract—is a transparent term that:

(i) is disclosed at or before the time the contract is entered into; and

(ii) sets an amount of excess or deductible under the contract *or describes the contingencies covered by the contract*."

If this approach were adopted, guidance regarding what is required in order for a term to constitute a "transparent term" should be provided.

The "upfront price payable" exemption should extend to future premiums

The Bill makes clear that terms that define the upfront price payable, including deductibles, are excluded from the UCT regime, provided the term is transparent and disclosed at or before the time the contract is entered into.

The current construction of "upfront price payable" in the Bill would exclude terms defining how premiums for renewal periods (i.e. outside the first 12 months of the contract) will be calculated, such that these could be found to be unfair. Unlike other insurance contracts, the period for which a life insurance contract will run is uncertain, and the contract therefore needs to include provisions setting out how future premiums will be calculated.

The policy rationale for exempting the upfront price from the regime but not also exempting provisions dealing with the price to be paid for future period is not clear, particularly when these terms are transparently disclosed prior to entering into the contract.

APRA already has standards for pricing and valuation and therefore, the determination of appropriate premiums should continue to be left to the regulator, with the Bill amended to protect the pricing requirements for life policies.

The Bill should include a clear exemption for group insurance contracts

The Bill as drafted does not set out a clear exemption for group life insurance policies. While we acknowledge the guidance provided in the Explanatory Memorandum in relation to group insurance, it is our view that further clarity is required, in order to avoid any unintended negative consequences that could seriously jeopardise the affordability and availability of efficient group life cover.

We suggest that the Bill is amended to set out a clear exemption for group life insurance policies.

The Explanatory Memorandum provides at para 1.41 that a contract for insurance purchased on a group basis by a large superannuation trustee would likely not be covered by the regime, as it would be unlikely to meet the definition of a small business, and is likely to have significant bargaining power in negotiating contracts, such that the contract would not meet the definition of "standard form".

The Explanatory Memorandum does not expressly consider the situation of group corporate policies. As currently drafted, if the owner of a group corporate policy fitted the definition of a "small business" – that is, they had fewer than 20 employees and the upfront price payable under the contract was not more than $300,000 or $1m if the contract is for more than 12 months – then this policy could be captured by the UCT regime. This ignores the fact that group policies are designed and negotiated between the policy owner and the insurer through an insurance broker, to ensure the terms meet the needs of the group's members. Insurance brokers are experienced financial professionals that negotiate insurance contracts on behalf of their clients, and who have existing legal obligations when providing financial services to retail clients, including the conduct and disclosure obligations under Part 7 of the Corporations Act.

It is not appropriate to allow a situation where a group insurance policy owner could later seek to void a term of a negotiated policy on the basis of alleged unfairness.

The interaction between the UCT regime, the duty of good utmost good faith, and anti-discrimination law is unclear

The Bill and the Explanatory Memorandum make it clear that the UCT regime is independent of the duty of utmost good faith under the Insurance Contracts Act. Considering the existing provisions relating to contract terms under the Insurance Contract Act, the UCT regime should sit along with this Act rather than independently.

The interaction between the Insurance Contracts Act and the ASIC Act is not spelled out, which may create uncertainty. If the UCT regime is applied through the ASIC Act or by way of amending the Insurance Contracts Act, the interplay between the legislation needs to be further considered when considering the existing provisions under the Insurance Contracts Act. Without further explanation, it is difficult to understand the independence which is intended.

Further, currently insurers need to meet certain requirements under anti-discrimination legislation in order to legitimately and reasonably assess risk in relation to an attribute which is protected by this legislation. Assessment of such risk must be based on actuarial or statistical data on which it is reasonable to rely, and the resulting assessment of risk must be reasonable having regard to the data and/or other relevant factors.

It is unclear what the interplay between the UCT regime and anti-discrimination law is intended to be. For example, if it is reasonable to offer someone an exclusion on the basis of data and/or relevant factors under anti-discrimination law, can an insurer assume that this would also meet the UCT test of the exclusion being reasonably necessary to protect the insurer's legitimate interests?

In our view, it is important to recognise the role that certain terms such as exclusion clauses in the insurance contracts play and to this end, we would recommend that such terms come within the "main subject matter" exclusion.

The application of the UCT regime to existing life insurance contracts is unclear

We would appreciate clarity around how the regime will apply to existing contracts in a life insurance context. The Bill does not have retroactive effect, which we believe is appropriate as existing contracts were not drafted and priced with the UCT requirements in mind.

As has been noted above, life insurance contracts are often held for the long-term, and are automatically renewable. It is our view that an automatically renewed contract that was taken out prior to the Bill commencing should not be captured by the legislation, even if premiums increase during the life of the policy. It remains the same contract as it was when it was taken out, and insurers do not have the ability to unilaterally change its terms.

Similarly, if a policy lapses due to non-payment of premiums and then is later reinstated so as to not require additional underwriting, we are of the view that this should continue to be seen as the same contract as when it was taken out.

Further, many retail life insurance products are "modular", in the sense that the insured can select the benefits and the extent of the cover to be purchased under a policy purchased by them. These products typically allow the insured to increase their existing cover, or add cover contemplated under the terms of the product held by the insured, following the insured's initial acquisition of the product. Such additions or increases remain governed by the terms of the contract initially entered into by the insured in respect of the product. If an increase or addition to cover in these circumstances was seen as a variation to the underlying insurance contract, then life insurers will effectively need to stop offering persons insured under existing contracts the ability to increase or add to their existing cover, and will instead need to require insureds to cancel their existing cover and enter into new contracts of insurance.

APRA's view on the prudential impacts of the regime should be sought

The feedback above makes it clear that there are likely to be broad prudential impacts if the Bill passes unamended. We suggest Treasury seeks APRA's input on the possible impacts on the industry as a whole, including implications for prudential sustainability.

Conclusion

We appreciate the opportunity to provide you with the above feedback. We would be happy to discuss any of the points raised in this submission in further detail. If you require any further information please contact in the first instance Sarah Phillips, Senior Manager, Corporate Affairs, at sarah.phillips@aia.com or 0498 494 791.