3 June 2022

Quality of Advice Review Secretariat, Financial System Division

The Treasury

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Submission to the Quality of Advice Review

The Treasury

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While this submission does not directly respond to all the issues raised in the Quality of Advice Review, it does cover some of the issues mentioned. This submission examines one of the major challenges facing Australian financial advisers and their clients and that is the provision of advice on personal risk insurance products. This submission specifically addresses the following two consultation questions:

> 53. Has the capping of life insurance commissions led to a reduction in the level of insurance coverage or contributed to underinsurance? If so, please provide data to support this claim.
>
> 54. Is under insurance a present or emerging issue for any retail general insurance products? If so, please provide data to support this claim.

1. Introduction to the submission

These two questions not only have major implications for the reduction in the level of disability and income protection insurance that is being purchased by customers, but it relates directly to the financial situation facing the National Disability Insurance Scheme (NDIS). As the level of personal risk insurance declines, the greater is the reliance on the NDIS in the event of an accident resulting in a disability for those individuals that have no personal risk insurance.

The objective of this submission is to show why financial advisers should not only be well qualified and experienced in providing advice on personal risk insurance products but also why a fee for service type of remuneration strategy may not be the most appropriate way to incentivise advisers to offer personal risk insurance advice. The main contention in this submission is that some form of commission arrangement should be maintained even though the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Hayne Royal Commission) recommended that commissions be abolished.[1]

Customers should as a matter of priority be advised and encouraged to purchase personal risk insurance products if the can afford to meet the cost. The need for personal risk insurance should be viewed in the same way as the need for private hospital insurance or even superannuation. Individuals without private hospital insurance use the public hospital system and the Government provides the cost. If an individual does not have any superannuation balance on retirement, then they rely on the Government to provide them with an age pension. If an individual becomes disabled due to an accident or an illness, then they rely on the Government to provide support through the National Disability Insurance Scheme (NDIS) and through a disability pension. By encouraging those individuals that can afford to purchase personal risk insurance then they may reduce the need for the Government to provide financial support in the event of an accident or an illness. This is one of the main reasons why individuals with sufficient income were given an incentive to purchase private hospital insurance instead of relying on the Government. The problem that faces both customers, the financial adviser, insurance providers and ultimately the Government is how to incentivise customers to purchase personal risk insurance when they have the financial capacity to do so.

Customers need to be advised on the benefits of personal risk insurance in the event of an accident or illness and the adviser must be rewarded sufficiently to not only advise on risk insurance but also to engage in becoming sufficiently knowledgeable in these specialised products in the first place. This submission will commence with an overview of why personal risk insurance products are of vital importance for customers followed by a section examining the potential for Australian customers to be disadvantaged if a commission basis for remuneration is not continued. Part 3 of the submission will discuss the dangers of underinsurance in Australia unless there is an adequate form of remuneration for advisers and Part 4 will examine an actual case study based on clients of Foothills Financial Services which illustrates the importance of risk insurance.

2. Why personal risk insurance products are an important requirement for customers

If a customer of a financial adviser purchases personal risk insurance, then if adequate, their future financial needs are met by the insurance company in the event of an accident or illness that leads to a temporary or permanent disability. The accident or illness can take many forms, but the insurance is designed to provide a payment for the insured or their family if they require special needs such as wheelchairs and ongoing medical support. If they do not purchase these personal risk products or are not advised as to their benefits and then something happens, they rely on the Government for financial support in the form of a disability pension or assistance from the NDIS.

Currently in Australia if someone is born with a disability or suffers a disability because of an accident or illness then they may be eligible for assistance through the NDIS. The NDIS was established in 2013 to provide funding assistance to individuals with a disability. The

[1] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, recommendations, 2.4 and 2.5.

National Disability Insurance Scheme Act 2013 (Cth)(NDIS Act), Section 3 states that: The Objects of Act are to provide for the National Disability Insurance Scheme in Australia; and support the independence and social and economic participation of people with disability; and provide reasonable and necessary supports, including early intervention supports, for participants in the National Disability Insurance Scheme; and enable people with disability to exercise choice and control in the pursuit of their goals and the planning and delivery of their support. Subsection 2 states that these objects are to be achieved by: providing the foundation for governments to work together to develop and implement the National Disability Insurance Scheme; and adopting an insurance-based approach, informed by actuarial analysis, to the provision and funding of supports for people with disability.

These objects of the NDIS are exactly similar to the objectives of a financial adviser and their client when considering the purchase of disability and income protection insurance policies. The difference is that financial advisers and their clients want to self-insure and not rely on Government support. They want to be free to make certain financial decisions themselves in conjunction with their adviser. This is similar to individuals in Australia taking out private hospital insurance cover.

Section 4 of the NDIS Act provides general principles guiding actions under this Act. It states that: People with disability have the same right as other members of Australian society to realise their potential for physical, social, emotional and intellectual development and people with disability should be supported to participate in and contribute to social and economic life to the extent of their ability and people with disability should be supported to receive reasonable and necessary. Again, this is the main reason why Australian individuals, and their financial advisers purchase personal risk insurance. If they do that, they do not need to rely on Government support under the NDIS.

In 2019 the Australian Government commissioned Mr David Tune AO PSM to review the *National Disability Insurance Scheme Act 2013* (the NDIS Act).[2] The review was completed in 2021 and the report contained 29 recommendations to improve the experience of participants with the NDIS and support the introduction of the Participant Service Guarantee.

The key findings of the Report include:

- the need to provide clarity on the concept of 'reasonable and necessary'
- participants experience lengthy waits to receive decisions from the National Disability Insurance Agency (NDIA)
- participants consider NDIA decision-making is not transparent and is inconsistent
- participants consider there is a lack of information provided to support their engagement with the NDIS

[2] Australian Government response to the 2019 Review of the National Disability Insurance Scheme Act 2013 report August 2020 < https://www.dss.gov.au/disability-and-carers-programs-services-for-people-with-disability-national-disability-insurance-scheme-2019-review-of-the-ndis-act-and-the-new-ndis-participant-service-guarantee/government-response-to-the-ndis-act-review >

- areas of the NDIS Act are unnecessarily rigid and do not encourage flexibility.

Nineteen of the recommendations suggest necessary amendments to the NDIS Act and NDIS Rules to support the implementation of the Participant Service Guarantee, improve outcomes for children and people with psychosocial disabilities, clarify the basis of reasonable and necessary packages of support and streamline NDIS processes. The other ten recommendations go to supporting an improved participant experience through operational or other service delivery reforms, ensuring the NDIS meets expectations.

There are around 4.3 million Australians who have a disability. Within the next five years the NDIS will provide an estimated 500,000 Australians who have permanent and significant disability with funding for supports and services. For many people, it will be the first time they receive the disability support they need.[3] This should be a major concern for all governments in Australia that are responsible for ensuring that there is adequate funding for the scheme into the future. There must be recognition that unless individuals especially those as members of Self-Managed-Superannuation funds purchase personal risk insurance products then the demand for the NDIS support will only keep growing.

3. The capping of life insurance commissions has the potential to lead to a reduction in the level of insurance coverage or to contribute to underinsurance by customers

There are two ways in which financial advisers can be remunerated for the provision of personal risk insurance products. First, the system of commissions where the insurance company pays the adviser can be maintained. Second, the adviser can charge the customer a fee for service and the insurance company pays no commission. The result of preliminary research based on an average male in good health purchasing disability and income protection insurance showed that if no commissions were paid to the adviser that the annual premium would not be reduced to a level below that which would have included the commission. In other words, the premium was at least 20 percent greater than it would have been if the commission had been deducted in full. The customer is still paying more even though the insurance company is not paying the adviser a commission. If the customer is being charged a fee for service by the adviser for personal risk insurance advice and this is on top of the fee for general financial advice, then it is highly unlikely that they will purchase either all or some of the risk insurance being recommended. The report by KPMG provides evidence of the reduction in risk insurance being purchased by individuals and anything that exacerbates this trend will only force individuals to resort to the NDIS for financial support.

The KPMG Life Insurance Insights 2021 report highlights the fact that the number of individuals purchasing life insurance and disability insurance has declined over the past few years. The report states that:

> The number of lives insured, summed across cover and channel types, has decreased by 10% over the last year and by 23% over the last two years. A significant proportion of this is expected to be due to the Protect Your Super (PYS) and Putting Member's Interest First (PMIF) legislation. The average premium per policy has increased by 12% over the past year and by 24% over the last two years. Decline rates have been broadly stable across the industry

[3] https://www.ndis.gov.au/understanding/how-ndis-works

over the last 12 months. TPD traditionally has the highest decline rate at 10.8% for Group Super (increased from 9.1% last year) and 18.5% for Individual Advised (stable from last year).[4]

The financial services industry is already seeing a reduction in the level of Australians having insurance and the level of cover they are taking out in order to reduce the cost of the premium. This is being driven by a number of factors. The main two factors being raised by advisers are:

- Less advisers providing insurance advice which is examined in the section below. The cost to deliver this advice and possible level of risk if the advice is not adequate does not outweigh the commercial benefit for advisers looking to engage in advising on personal risk insurances, and
- The premium increases associated with regulatory changes and actions from APRA is resulting in customers and advisers moving away from this market. Advisers are seeing significant rises in insurance premiums, making access to insurance for day-to-day Australians more difficult. Clients are seeking to move their cover or take lower levels of cover or other options to enable the cost to be paid.

4. Under insurance is a present and emerging issue for advisers on retail general insurance products

In the 2020 Report by Rice Warner the following comment highlights the immediate problem with the shortage of financial advisers:

> Retail advised insurance new business volumes sales have been reducing, due to a similar reduction in active insurance advisers. The aggregate sum insured held via this distribution channel has been decreasing since the end of 2018. Although we will see product innovation as insurers respond to APRA's intervention on Retail Income Protection products, it will be challenging to completely reverse this trend.[5]

The report prepared by Adviser Ratings, '2022 Australian Financial Advice Landscape' provides a dismal picture of the number of risk insurance advisers providing professional services in Australia. The following statement provides an excellent summary:

> In last year's Landscape Report, we boldly predicted that up to a further 700 specialist risk advisers could leave the industry over the projected 12 months – that number came to 609 advisers! There are now only approximately 1,200 risk advisers in Australia, with risk advisers leaving the industry at a rate 2.48 times greater than their "holistic advice peers" in the calendar year 2021 (2019 & 2020: 2.4 times greater). Table 9.3 highlights the reduction of advisers split by advisers' propensity to write risk advice. Whilst pure risk, mostly risk and moderate risk advisers have left the industry in disproportionately high numbers, the next brackets of those writing risk have also left in fairly high numbers. The exits have left a high

[4] KPMG https://home.kpmg/au/en/home/insights/2021/10/life-insurance-insights.html?msclkid=6784658cd02211ecacfe1d91811b10c7

[5] Rice Warner, 'New Research Shows a Larger Underinsurance Gap' (20 November 2020) https://www.ricewarner.com/new-research-shows-a-larger-underinsurance-gap/

proportion of orphaned policyholders, with insurers reporting up to 40-50% of policies in some cohorts becoming orphaned (i.e., not under the remit of an adviser).[6]

The solution to this problem is twofold. First, advisers must be incentivised sufficiently in order to provide advice on personal risk insurance. This is one of the main contentions in this submission, namely that commissions may have to be maintained and with the possibility that the level is increased. Second, action must be taken by the financial advice industry and educational institutions to formally acknowledge that specialist training must be developed for advisers to be qualified to provide advice in this area of finance. It would not only recognise the specific attributes of this type of financial product, but it would also provide the adviser with a level of comfort and competence to continue to advise on personal risk insurance. That would help to overcome advisers leaving this sector of the industry and being reluctant to provide advice on this type of insurance.

The following actual case study based on the experience of Foothills Financial Services illustrates the importance of customers purchasing personal risk insurance products.

5. A case study illustrating the importance of personal insurance products

This case study is based on an actual situation with clients of Foothills Financial Services. The names and identity of the clients have been removed to safeguard their privacy. The facts of the case study are as follows:

> The husband and wife, S and J are aged 51 and 53 respectively in 2017. S is a part owner in a SME business that supplies building products in Melbourne. In 2017, S had a taxable income of approximately $50,000 and J had taxable income of approximately $26,000. J is the part time receptionist and bookkeeper for business. J had $40,256 with a retail Superannuation fund and S had a total of $279,280 with two retail superannuation funds.
>
> S and J approached Foothills Financial Services in mid-2017 as they were looking at investing in direct property within a Self-Managed Superannuation Fund (SMSF). The total purchase price being considered for the investment property was $750,000 with borrowings in the order of $500,000. S and J were looking forward to retiring in 15 years on an income of approximately $65,000.
>
> In 2017, J had a Life and a Total and Permanent Disability (TPD) policy with an industry fund of $60,000 and no income protection. S had life cover of $891,000 inside his superannuation fund, TPD of $272,000 inside his superannuation fund and $70,600 Life and TPD with an industry fund. S also had an income protection policy with a monthly benefit of $6,029 subject to an eight-week waiting period and the benefit paid to 65 years of age.

In October 2017, the Couple signed the ‘Authority to Proceed’ within the Statement of Advice that recommended the following:

[6] Adviser Ratings, ‘2022 Australian Financial Advice Landscape’, 143.

The establishment of a SMSF that would pool the couple's super of approximately $319,546 and to apply for the following personal risk insurance policies:

For J, a Life insurance policy and TPD of $500,000. This included income protection of $1,675 per month with a 30-day waiting period and benefits payable up to age 65. For S, Life insurance and TPD of $500,000. This included income protection of $3,639 per month with a 30-day waiting period and benefits payable up to age 65.

Why was insurance recommended?

In a SMSF a Trustee is required to consider insurances for the members of the fund.[7] The Trustee was intending to borrow money inside the superannuation fund to purchase the investment property. If an unforeseen event occurred such as death or total permanent disability, then the debt inside the fund would need to be extinguish or the investment asset sold and the benefit. Hence the need for insurance to extinguish the debt. The SMSF did not find a suitable real property investment and the funds were subsequently invested in term deposits and Australian equities on the advice of their financial adviser.

J suffers a stroke in June 2020, just short of her 56 birthday, and is transported by ambulance to Hospital. She is not expected to live. J survives after a number of weeks in hospital. J had surgery to relieve the bleeding on her brain. She has significant weakness on her left side and is unable to walk. S contacts his financial advisor at Foothills Financial Services to start the process of making an insurance claim on the income protection policy.

The financial outcome – the following results were achieved:

A six-month income protection payment was made in advance. This was followed by fully indexed (CPI) monthly payments of $1,831.42. As CPI increases so too will the benefit payment. J's payment will continue until she reaches her 65 birthday in June 2029. A total permanent disability payment of $530,450 was made on 25 March 2021. Nine months after J's stroke. The work undertaken to bring about the claim to a successful end was significant. This involved obtaining various doctors' reports, communications with the client and the insurer.

The lifestyle outcome

S has continued with his building supply business, and he can do this because they can afford to provide full time day care for J. J required a special wheelchair because of her lack of mobility. The wheelchair cost $38,000.

The Foothills Financial Services outcome

The adviser was paid an upfront commission of $1,777 when the insurance was put in place in 2017 and then received an annual commission from 2018 to 2020 while J's policy was in force. The adviser firm received commissions of just over $6,000 but they did not receive a payment for providing a service during the claim process. This

[7] Refer *Superannuation Industry (Supervision) Act 1993* (Cth) and SIS Regulation 4.09 2(e)

commission payment was attributed to putting the appropriate insurances in place and then secondly, in processing the claim. The financial gain was moderate compared to what may have been charged on a fee for service basis. If the adviser had not put in place the personal risk insurance policies, then J would not be in the same financial position that she is today.

This case study is intended to illustrate not only the importance of advising clients on the importance of having personal risk insurance, but also the role that advisers play in assisting their clients. It is important to note that Foothills Financial Services did not charge the clients for the time and work involved in pursuing their claim with the insurance company and keeping the clients informed. If an hourly rate had been applied, then clearly the initial commission and the ongoing commission would not have covered costs. The upfront commission failed to cover the necessary costs and the significant claims work meant the business had made a commercial loss in supporting the clients. The Principal of Foothills Financial Services made the decision not to charge the clients a fee for pursuing the claim on the basis that the clients had suffered considerable hardship and that an additional fee would have only added to their future financial challenges.

The following financial analysis based on the above case study provides a guide as to what the actual costs would be if the clients were charged at an hourly rate.

Activity	Time Taken
Initial Meeting to discuss insurance requirements	1.25hrs
Statement of Advice Production	3.00hrs
Meeting with Client to discuss the SoA	1.25hrs
Meeting with Client to confirm instructions as to insurance cover	1.00hrs
Discussions with Underwriter/BDM	0.25hrs
Discussions with Client as to premiums and level of cover	0.25hrs
TOTAL	7.00HRS

The total cost for the above service on an hourly rate would have been $1,750

Foothills Financial Services currently have an hourly 'Charge out Rate' of $250.00 per hour. This charge was arrived at by considering the following cost components:

- Compliance Manager on a Part-time basis and this is $24000 per year to draft SoA's. The principal spends two hours on a Friday reviewing the SoA to ensure that it complies with the AFSL and Advice procedures.
- $50 per month for education updates and an additional cost associated with spending 60 hours on CPD (non-chargeable)
- An average cost of $500 for the preparation of the Statements of Advice
- A cost of $8,000 per year to WorkSorted (the CRM Provider)
- A fee of $7,000 per year to ASIC
- AFCA a membership fee

- $15,000 per year in PI Insurance and $2000 per year in Business Insurance
- $30,000 per year in rent and outgoings
- Wages for support staff

The premium paid by the clients for their personal risk insurances was $2,919 per annum. As shown above, the advisor spent approximately 7 hours to establish the most appropriate insurance contracts for the clients and if they were charged on a fee for service basis, they would have paid approximately $1,750. However, if this is compared with the commission paid by the insurance company the difference is insignificant. In this case the commission received was $1,777, an increase of $27, and yet the fee for service would have been $1,750. As demonstrated the difference is insignificant from the perspective of the adviser. Furthermore, the insurance premiums would not have been reduced by the amount of $1,750.

It is important to note that if the financial adviser had charged a fee to cover the claims process, the upfront commissions would not cover those costs and any significant claims work would lead to the advisor making a financial loss in supporting the clients.

6. Recommendations and Conclusion for the future of risk insurance advisers and customers in Australia

The major implication for the Federal Government and the State and Territory Governments are that those individuals who can afford to purchase personal risk insurance products do not do so and instead rely on the NDIS to provide support if they suffer a disability through an accident or illness. The cost of maintaining the NDIS is now a serious issue for all governments in Australia and this situation may only deteriorate further unless something is done to control the cost. Individuals who are members of Self-Managed-Superannuation funds (SMSF) are in a position where they can afford to purchase personal risk insurance. However, they will not do so unless they receive expert advice as to the nature and benefit of these insurance products. As discussed above, the number of individuals purchasing insurance has declined and the number of advisers involved in supporting these products has also declined. The following recommendations are based on the contentions set out above:

1. Retention of commissions similar to the current levels should be maintained. The question of whether the current practice of insurance companies paying insurance commissions is contentious and there are issues still to be resolved. As discussed above one of the main contentions in this submission is that the current level of commissions should be retained rather than advisers charging their clients a fee for service based on an hourly rate. Coupled with this contention is the fact that as a result of preliminary research it can be shown that if commissions are not paid by the insurance company, the premiums are not reduced by the commission which is approximately 60 percent in the first year and a further 20 percent each year thereafter. The abolition of commissions does not result in the customer paying less for the premium and yet if they are charged a fee for service by the adviser then they are paying more. The other factor is that if the customer is required to pay a fee for the advice, then they may are reluctant to purchase the personal risk insurance in the first place.

2. Greater training and experience for financial advisers with the focus on personal risk insurance products. Currently financial advisers are moving away from personal risk insurance advice due to the complexity of these financial products and any resultant risk of

legal action if the advice is wrong. Universities and other higher education institutions should be encouraged to provide courses and qualifications for advisers undertaking specific study in personal risk insurance and estate planning. The courses could consist of graduate certificates in risk insurance or graduate diplomas in risk insurance which would allow for those individuals with the qualification to specialised in insurance advice and be denoted as such by their peers and customers alike. This would provide a level of comfort for not only the regulators but also potential and existing customers and take some of the reticence out of advisers not wanting to be involved in providing insurance advice.

3. Consideration by Government for the introduction of an incentive for wealthy individuals to purchase personal risk insurance similar to what is in place with Private Hospital Insurance and the Medicare Levy Surcharge. As discussed above, if less individuals purchase personal risk insurance, then the greater the reliance on the NDIS and the financial impact this will make on Governments in Australia. There is a good argument that some form of incentive or financial penalty could be introduced especially for members of a SMSF to purchase adequate personal risk insurance once they receive adequate advice.

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The authors wish to acknowledge the assistance provided by Brian Pollock, Director Corporate Governance, The Principals Community, Melbourne.