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Ms Lorraine Lenthall
Manager, Insurance and Financial Services Unit
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The Treasury
Langton Crescent
PARKES ACT 2600

By Email: UCTinsurance@treasury.gov.au

Dear Ms Lenthall

**EXTENDING UNFAIR CONTRACT TERMS PROTECTIONS TO INSURANCE CONTRACTS
– SUBMISSION**

The Financial Services Council (**FSC**) welcomes the opportunity to make a submission in response to Treasury's Proposal Paper *Extending Unfair Contract Terms Protections to Insurance Contracts* (**Proposal Paper**).

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in Australia's largest industry sector, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies.

Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing almost \$3 trillion on behalf of more than 14.8 million Australians.

The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

The FSC supportive of the intent behind applying the unfair contract terms (**UCT**) regime to new life insurance. However, there could be significant adverse unintended consequences for consumers without specific carve-outs.

We look forward to discussing our submission in more detail with you.

Yours sincerely



Nick Kirwan
Senior Policy Manager

Overview

The following provides an overview of our submissions in relation to the UCT model outlined in the Proposal Paper:

The existing UCT laws should be incorporated into the *Insurance Contracts Act 1984* (Cth) (**IC Act**) with the appropriate carve outs for life insurance to ensure there are no adverse unintended consequences for consumers.

These could include the following matters which may result in higher premiums and/or less choice:

- products may be withdrawn from sale that could be prone to volatile claims experience.
 - products may be priced to allow for the fact that the life insurers cannot increase premiums. This could see products priced at considerably higher levels from the outset.
 - life insurers may also seek to mitigate risk by limiting the maximum duration of cover, meaning that consumers would need to reapply for a new contract when their cover expires, and their health may have changed.
 - reinsurance premiums may also increase in order to match the static risk exposure of life companies.
- The new UCT provisions in the IC Act should be applied to new contracts only. Life insurers should be given a reasonable period to amend their contracts before the new regime commences;
 - The ‘main subject matter’ of an insurance contract should be defined broadly to include terms that have, or have the effect of, defining the scope of cover;
 - Clarification should be provided that the ‘upfront price’ will include the premium and the waiting period, as well as additional premiums, fees or charges that are payable by the policyholder, regardless of the stage in the policy's life, and that these will not be subject to review;
 - For life policies, as defined by the *Life Insurance Act 1995* (Cth) (**LI Act**), which are which are long term contracts, it should be made clear that a term which provides a life company with the ability to unilaterally increase premiums will not be considered unfair in any circumstances where the increase is related to the management of the insurer's risk and is consistent with the requirements of that Act;
 - A contract should be considered as standard form even if the consumer or small business can choose from various options of policy coverage;
 - The definition of ‘consumer contract’ and ‘small business contract’ should include contracts that are expressed to be for the benefit of an individual or small business, but who are not a party to the contract, with the exception that contracts of insurance entered into with wholesale clients should be excluded in recognition of their robust bargaining power which protects their members' interests;

- The existing UCT test for determining whether a term is unfair should be applied, without any additional specificity in relation to underwriting risk which would unduly focus on only one of a number of risks to insurers' legitimate interests;
- Examples specific to insurance ought to be added to the list of examples of the kinds of terms that may be unfair. However, this should be provided through regulation and following appropriate consultation;
- Where a term is found to be unfair, as an alternative to the term being declared void, a court should be able to make other orders if it deems that more appropriate; and
- ASIC should be given the power to exempt or declare that a life insurance product or a term of a life insurance product is not subject to the UCT regime or that it is not subject to the UCT regime in particular circumstances.

Detailed submissions, which follow the Proposal Paper's topic categories, are outlined below:

Introduce the existing UCT laws into the IC Act

The IC Act should be amended to introduce a stand-alone set of UCT protections in the IC Act which largely mirror those in the ASIC Act, tailored to take account of the specific features of insurance contracts and the existing regulatory framework of the IC Act.

It follows that section 15 of the IC Act should continue to operate so that the unfair contract terms provisions of the ASIC Act would not apply.

This model is preferable to either applying the ASIC Act to general and life insurance contracts, or enhancing the existing IC Act remedies because it will ensure that the IC Act remains the primary source of legislative provisions in relation to insurance products. It will also ensure that insureds are provided with the same protections under UCT laws that already apply to consumers in relation to other financial products and services.

Extending the ASIC Act UCT regime to general and life insurance contracts potentially raises risks in relation to conflict between that regime and the existing IC Act regime. This could give rise to uncertainty regarding the correct legal interpretation of the IC Act and its existing legal principles and consumer protections.

For example, where a policyholder contests a life company's decision to decline a claim based on an exclusion that applies to the policy, the determination of whether that exclusion is 'unfair' necessarily needs to take into account whether the life company complied with notice requirements under the IC Act (i.e. duty of disclosure notification and section 37 notification of unusual terms).

No other financial products to which the ASIC Act UCT regime applies are subject to an existing standalone contract intervention regime, and therefore, distinct treatment of insurance contracts is justified.

Main subject matter

A broad definition of the main subject matter of the contract which includes all provisions that have the effect of defining the scope of cover should be adopted. This approach would be consistent with the European Union definition under ECD 93/13 which exempts from the UCT regime terms which 'clearly define or circumscribe the insured risk and the insurer's liability'.

It would be inappropriate to adopt a narrow definition of the main subject matter of the contract as it is the nature of insurance that terms which establish the scope of what is covered, when it is covered, and the extent to which it is covered, are the core of the contract, and therefore its main subject matter.

In relation to life insurance, absurd outcomes would arise if any term beyond the description of the life insured was potentially voidable e.g. definitions (particularly of what constitutes 'total and permanent disability'), benefit limits, waiting periods and eligibility criteria in respect of the commencement of cover.

Controlling the scope of cover is critical to product design, pricing and underwriting criteria. The assessment of the risk across a pool and the management of that risk through product design, pricing and underwriting criteria are the essence of life insurance business. These are core activities intended to ensure the sustainability of the long-term duration of policies.

The life insurance regulatory scheme as set out in the Life Insurance Act provides for registration of life insurance companies, the establishment and management of statutory funds, capital and solvency standards, governance standards, actuarial investigations and risk management requirements. The prudential framework for life insurance recognises that the assessment of risks and the setting of premium rates play a central role in the prudential management of life companies.

Uncertainty in relation to the potential exposure to such controls being made void could potentially lead to insurers offering more restricted ranges of insurance contracts, including the possible withdrawal of more affordable contracts that provide relatively less cover purely because the scope of cover is limited.

This has the potential to limit choice for consumers and to make cover more expensive as insurers may also be forced to increase premiums pre-emptively to protect against the risk of contractual uncertainty.

There are also life insurance products which may need to be withdrawn from the market entirely if pre-existing condition exclusions (**PECs**) could potentially be found void, as it is common for products to include PECs in order to be offered without active individual underwriting, or on a 'guaranteed acceptance basis' and at the premium rates for which they are offered.

A broader definition would not give rise to the risk that UCT protections will be diminished by contractual drafting techniques or consumers being uncertain about which terms are subject to review. This is because, in our view, ASIC, the courts and external dispute resolution bodies

are sufficiently skilled to discern any attempt to disguise other provisions within the main subject matter of life insurance products.

If the definition of the main subject matter is appropriately drafted to ensure that it only applies to provisions which have the 'effect' of defining the scope and risk of cover, then any such attempts would be ineffective.

The proposed product design and distribution regime is also likely to provide ASIC with precise powers to intervene to the extent that a product feature gives rise to consumer detriment regardless of whether it is characterised as the main subject matter of the contract.

Upfront price and tailoring for specific insurance products

Consistent with the existing UCT laws, terms setting the upfront price should be excluded from review.

Upfront price should expressly include any terms that allow the insurer to vary premiums, fees or charges payable by the policyholder regardless of when in the policy's life they become payable, provided that these terms are transparent and clearly disclosed to the consumer before entering the insurance contract.

For example, it is common for Term Life and TPD policies to provide automatic additional cover if the life insured has a defined life event. The terms setting out the additional cover and associated premiums should be considered as part of the 'upfront price' if disclosed in a transparent and clear way.

It also needs to be made clear that a term which provides a life company with the ability to increase premiums unilaterally will not be considered unfair. Given that life insurance contracts can span many decades, it is critical that the ability to adjust premium rates applying to products is preserved.

This approach is consistent with the European Union and New Zealand, models and the broader policy objectives of the UCT regime which is not to regulate the price of goods and services.

In the absence of the ability to unilaterally vary premiums, the following could result in higher premiums and/or less choice for consumers:

- products may be withdrawn from sale that may be prone to volatility;
- products may be priced to allow for the fact that the life insurers cannot increase premiums and therefore would cost considerably more from the outset;
- life insurer might also seek to mitigate risk by limiting the maximum duration of cover, meaning that consumers would need to reapply for a new contract when their cover expires; and
- reinsurance premiums may also increase in order to match the static risk exposure of life companies.

Any terms that result in some form of penalty to consumers in the event of cancellation in response to a unilateral variation, should also be excluded. This is to ensure that any unfavourable consequences resulting from policyholder cancellation do not indirectly result in a unilateral variation right being found unfair e.g. loss of surrender value.

Life companies should not be limited to premium increases within the limits and under the circumstances specified in the policy, as the imposition of variations are already subject to robust compliance measures imposed under the LI Act and APRA's Prudential Standards. In any event, disclosure in summary form is unlikely to meaningfully communicate the complexity associated with repricing or be determinative in relation to consumers' decisions whether to acquire or continue to hold life insurance products.

Standard form contracts and third party beneficiaries

A contract should be considered standard form in a manner consistent with existing section 12BK of the ASIC Act.

This would be the case even if the consumer or small business can choose from various options of policy cover (including, but not limited to, excess amounts, riders, sum insured amounts and policy exclusions). It would be prudent to clarify that such contracts would still be considered standard form for interpretative certainty. However, the 'small business contract' upfront price threshold amounts of \$300,000 (and \$1 million for contracts of more than 12 months duration) specified in section 12BF (4)(b) of the ASIC Act would need to be reduced to thresholds reflective of the lower cost of life insurance policies.

The UCT regime should apply to 'consumer contracts' and 'small business contracts' as defined under the existing UCT regime as well as consumers and small businesses who are third-party beneficiaries under the contract.

Nonetheless, contracts of insurance entered with wholesale clients within the meaning of sections 761G and 761GA of the *Corporations Act 2001* (Cth) (**Corporations Act**), such as trustees of APRA-regulated superannuation funds, should be excluded. This exclusion recognises the sophistication of such policyholders who negotiate extensively on terms and pricing for bespoke cover with the assistance of insurance brokers and other professionals. There is no suggestion of any commercial asymmetry, which may otherwise exist in relation to individuals and small businesses compared to insurers. Put simply, the trustees of APRA regulated superannuation funds are professional purchasers of life insurance.

Such policyholders may also be subject to their own legal obligations which could cause the trustee to agree to a particular term that, when read in isolation, may be considered unfair in its application to a particular beneficiary. For example, when negotiating changes to a contract of insurance a trustee of a superannuation fund may agree to a particular exclusion (e.g. an exclusion on cover where a consumer is overseas for more than three months, limiting cover to Australian residents etc.) in order to reduce premium expenses. In doing so, the superannuation trustee would be required to act in the best interests of beneficiaries as a whole and to comply with its duty under *the Superannuation Industry (Supervision) Act 1993* (Cth) to ensure that insurance premiums do not inappropriately erode the retirement income of beneficiaries.

If the UCT regime was to apply in such circumstances, this is likely to increase premium costs for superannuation members because the insurer would bear any associated risk of the term being voided. The regime could also conflict with the trustee's duties to act in the best interest of members because it would inhibit a trustee's ability to negotiate terms that it considers best suit the membership of the fund whilst also ensuring premium costs are reasonable and sustainable.

It is also recommended that this exclusion for contracts of insurance entered into with wholesale clients would also apply to individually transacted cover under group policies to the extent the relevant provisions are part of the contracts of insurance entered into by the group policyholder. That is, the terms on which an individual could amend their cover were part of the negotiations with the wholesale client, for example, by simply selecting a greater level of cover on the same terms.

We note that MySuper arrangements are proposed to be carved out of the Design and Distribution Obligations and Product Intervention Powers regime due to the mandatory nature of superannuation, the product rules already in place for MySuper products and the higher standards expected of trustees of MySuper products. We recommend that the UCT regime have a similar exemption.

Meaning of unfair

The existing UCT regime fairness test should be applied to contracts of life insurance, including the aspect of the test that the term is "not reasonably necessary to protect the legitimate interests of the party who would be advantaged by them."¹

This term should remain broad to ensure that life insurers can continue protect the legitimate interests across the broad range risks involved in life insurance contracts.

Life companies are exposed to a broader range of risks than underwriting risk on an individual basis and a narrower test would not have regard to reasonableness based on the price of the cover in question.

Life insurance is about 'pooling' of risks where pricing is designed in relation to cohorts rather than particular individuals. Therefore, the acceptance by a life insurer of a risk is in the context of not only the protection of its' legitimate interests, but also the interest of the pool of customers (for example to keep prices at a sustainable level and address the risk of anti-selection).

The test ought to allow the consideration of factors such as product development and setting of contract terms by reference to the pool of risks.

For example, a suicide exclusion or change in disability definition for a person depending on age or employment status needs to be considered in the context of the pool the insurer is protecting.

¹ ASIC Act

Terms that may be considered unfair

Examples specific to life insurance contracts could be added to the non-exhaustive list of the kinds of terms that may be unfair within the existing UCT regime.

These examples would need to be defined with a high degree of precision and extensive consultation would need to be undertaken prior to enactment, to ensure the life insurance industry is given a sufficient opportunity to consider the potential application of any examples to be included and the justification for inclusion.

Remedies for unfair terms

Consistent with the current UCT regime, the consequence of a term being found to be unfair should be that the term is void. As an alternative to the term being void and consistent with other IC Act provisions, a court should also be able to make other orders if it thinks the order will provide a more appropriate and just outcome in all the circumstances.

Alternative remedies may be necessary where declaring a term void is not appropriate. For example, where a term is both of benefit to the consumer and partly unfair, declaring the term void would deprive the consumer of the beneficial aspects.

Application and transitional arrangements

We suggest that there be a minimum two-year transitional period, after the date of enactment. Once the transitional period ends, the UCT provisions should apply only to contracts which commence after the expiration of the transitional period.

We suggest this transitional period as adapting to the regime will involve significant product design considerations and negotiations with reinsurers.

The reforms will also need to be considered in light of the proposed product design and distribution regime.

It is submitted that the UCT regime process should be integrated with these parallel reforms given the inextricable link between their subject matter.

Relief-making power

The UCT regime included within the IC Act should include provisions that give ASIC the power to exempt a general or life insurance product, or a term of a general or life insurance product, from being subject to the UCT regime, ASIC ought also to be able to grant an exemption via a relief making power from the UCT regime in particular circumstances.

Such exemptions or declarations could be made by legislative instrument in a similar way to the existing relief-making provisions in Chapter 7 of the Corporations Act and could be granted either conditionally or unconditionally.

This power is needed because general and life insurance products are unique, and have very different characteristics from other types of financial and non-financial products to which the UCT regime currently applies.

There may be features of insurance products which are not inherently unfair, although when applied in certain circumstances could result in an unfair outcome. This would not warrant a declaration that the provision was void on a wholesale basis in respect of all contracts of insurance of the same kind.

A relief-making power of this nature would provide flexibility and eliminate the need for Treasury to be burdened with reform to the IC Act or Regulations in every instance where exemption or modification of the regime in respect of general or life insurance was appropriate.

It is also possible that with the evolving nature of insurance products and their consumer base, that new products or product features will be introduced where certainty in relation to their status under the UCT regime may be required.

Pending the enactment of the proposed product design and distribution regime, applications for comfort relief may also serve as an appropriate avenue of communication for general insurers and life companies to initiate discussions with ASIC in relation to whether a product feature is likely to be considered unfair.

The inclusion of such a power within the IC Act cannot give rise to any consumer detriment because its use would be at ASIC's absolute discretion.