

Re: Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

Written Submissions of the Australian Prudential Regulation Authority (APRA) in response to policy questions arising from Module 6

Module 6: Insurance

A. Introduction

1. The Australian Prudential Regulation Authority (APRA) makes the following submissions in response to the policy questions arising from Module 6.
2. Counsel Assisting raised a series of questions arising out of the conduct investigated in Module 6, including as to whether changes should be made to aspects of the legal and regulatory framework within which insurers operate so as to better protect consumers.
3. APRA is the prudential regulator of the life and general insurance industry. Two fundamental points are important in relation to APRA's prudential mandate in the insurance context – firstly, that APRA exists to protect policyholders against the risk that an insurer fails, and does not have the financial resources to pay the legitimate claims of policyholders; secondly, that prudential regulation is primarily concerned with the interests of the pool of policyholders as a group.
4. In APRA's view, in considering whether and what changes should be made it is important to consider the need to balance different interests – in particular the interests of individual policyholders, of policy holders collectively, and wider community interests. Changes made with a specific focus on individual policyholder interests, for example, may have adverse consequences for policyholders collectively or the wider community. All interests are most likely to be balanced over the long term through having a sustainable insurance industry, with viable insurers that offer a range of insurance cover at affordable prices and pay legitimate claims efficiently.

5. APRA's submission is made in that context, and discusses broader considerations that are relevant in informing recommendations for change in the insurance industry.¹
6. Insurance serves an important economic and social role by allowing for risks that would have catastrophic consequences for an individual to be shared amongst a broader group. Through reinsurance, this risk sharing occurs on a global scale, so the ability of Australian insurers to continue to access global reinsurance markets is critical in supporting ongoing insurance availability. Access to cost effective insurance is important to the well-being of Australians; without insurance, economic and community activity can be impeded.
7. The fair treatment of customers is an important public policy goal and so judgment is needed to determine in what manner and the degree to which the insurer's flexibility should be constrained to support the achievement of that goal, while also meeting other public policy goals such as having insurers that are able to offer cost effective cover and prudently manage their business. This requires insurers to have:
 - sufficient certainty around their ability to rely on the contractual terms of the policy to allow it to set premiums and reserves, enter into reinsurance arrangements and manage its capital position;
 - sufficient flexibility to design products (including setting the terms and conditions), underwrite and set premiums, so that they can choose the risks they wish to insure and the terms on which they will accept those risks;
 - ability to manage claims so that legitimate claims are paid promptly and efficiently, but that claims that are not within the terms of the contract are identified and declined.
8. These are all relevant matters to take into account when considering whether and what changes should be made.
9. Module 6 also addressed issues arising in connection with insurance within superannuation. APRA's submissions in respect of the issues associated with

¹ APRA supervises life insurers, general insurers and private health insurers. Generally, these different types of insurers are supervised in a consistent way. The Commission has raised a number of issues that are relevant to both general insurers and life insurers as well as some that are relevant only to life insurers or to general insurers. In this submission, APRA will clearly indicate where a comment relates specifically to general insurers or life insurers. Otherwise, the comments are of general relevance.

insurance in superannuation are also made from the perspective of APRA's regulatory role under the *Superannuation Industry (Supervision) Act 1993* (Cth).

10. This submission responds to a number of the specific policy questions that have been raised, adopting the numbering utilised in the Policy Questions arising from Module 6.

B. Underwriting and disclosure by policyholders (Questions 31 and 32)

Question 31:

Have the 2013 amendments to section 29 of the Insurance Contracts Act 1984 (Cth) resulted in an “avoidance” regime that is unfairly weighted in favour of insurers? If so, what reform is needed?

Question 32:

Does the duty of disclosure in section 21 of the Insurance Contracts Act 1984 (Cth) continue to serve an important purpose? If so, what is that purpose? Would the purpose be better served by a duty to take reasonable care not to make a misrepresentation to an insurer, as has been introduced in the United Kingdom by section 2 of the Consumer Insurance (Disclosure and Representations) Act 2012 (UK)?

11. Questions 31 and 32 raise issues around disclosure by policyholders to insurers. APRA submits in response to question 32 that the duty of disclosure continues to serve an important purpose. That purpose is to allow insurers to obtain reliable information from policyholders, so that they can make informed decisions around pricing, underwriting and reserving. For the duty of disclosure to operate effectively and fairly for policyholders, the insured's duty to disclose must be supported by effective communication by the insurer of the obligations imposed by the duty on the insured.
12. Care needs to be taken in designing requirements around disclosure and the associated remedies to set an appropriate balance between protection of individual policyholders and the ability to manage the business of the insurer in the interests of the policyholders as a group. If the onus on consumers to make full disclosures to insurers was lessened, insurers would likely respond by including an additional risk margin in their pricing or may, in extreme cases, be unable to insure the risk and so withdraw from the market.

C. Product design (Questions 2, 3, 5, 6 and 29)

Question 2:

Are there particular products – like accidental death and accidental injury products – which should not be sold?

13. There have been questions raised in the policy questions from Module 6 (and also in the Interim Report) as to whether certain types of insurance products should be banned. APRA submits that the starting point should be that if a risk is insurable and is capable of causing a loss, then insurers should be able to offer cover to policyholders for whom that cover is suitable. APRA comes to this view on two main grounds:
- first, that prohibitions undermine the ability of insurance to perform its beneficial social and economic role, and
 - second, that any prohibition will inevitably give rise to marginal cases that fall just inside and just outside its terms. Incentives may also be created to circumvent the prohibition, by complying with regulations in form but not in substance.
14. All products need to be designed and sold in a way that is fair to consumers. To that end, critical matters around product design, pricing, distribution arrangements and sales practices, and disclosure must be considered to ensure that consumers are protected.
15. A number of examples of products that have been considered in depth by the Royal Commission have not produced good outcomes for consumers in their current form. This has included, for example, types of funeral insurance, life insurance sold directly through outbound sales and types of add-on insurance. ASIC has undertaken reviews of a number of these products and made recommendations to improve the overall design and operation of those products. As noted above, APRA's in principle preference is not to ban products. However, outcomes identified by the Royal Commission have highlighted the importance of strong product intervention powers

for ASIC, to allow for targeted actions in relation to specific products that are causing consumer harm.² APRA supports those powers being granted to ASIC.

Question 3:

Should the requirements of the Life Insurance Code of Practice in relation to updating medical definitions be extended to products other than on-sale products?

16. Question 3 raises important issues around out-of-date medical definitions in life insurance products.
17. In relation to life insurance products that are on-sale to new policyholders, it is clearly appropriate that life insurers update medical definitions regularly, so that products are not sold with definitions that are out of date. APRA is supportive of the requirements of the Life Insurance Code of Practice in that regard. Similarly, where a life insurer has made a contractual promise to the policyholder to give them the benefit of updated definitions over time, that promise ought to be honoured and the definitions updated promptly, fairly and efficiently. However, the life insurer will also need to price that contractual promise and reserve against it in a prudent way.
18. Issues regarding out of date medical definitions often occur in the context of life insurance products where past policies remain in force but where the policy is no longer on sale to new policyholders. These products are commonly referred to as legacy products and arise from the fact that life insurers enter into insurance policies on a guaranteed renewable basis. As a result, there are legal constraints that create complexity for life insurers in updating the terms and conditions of such policies. While updates to medical definitions that are beneficial to policyholders can be passed on, premiums will likely increase to reflect the increased costs, and it may have implications for the extent to which an insurer can rely on its reinsurance to provide risk mitigation.
19. APRA has long advocated a legislative mechanism to allow for rationalisation of life insurance legacy products, by allowing modification of out-of-date contractual terms in appropriate cases to bring them up to date.³ Legacy products heighten operational risks for life insurers and have the potential to produce poor consumer outcomes due

² Refer: <https://treasury.gov.au/consultation/c2018-t312297/>

³ Refer for example to: https://www.apra.gov.au/sites/default/files/APRA-2014-FSI-Submission-FINAL_0.pdf and <https://www.apra.gov.au/sites/default/files/161130%2520APRA%2520submission%2520final.pdf>

to out-of-date definitions or other terms and conditions. APRA supports a rationalisation mechanism that includes appropriate consumer protection and prudential controls to ensure that policyholders are not left worse off and sustainability is not damaged. Recommendation 43 of the final report of the Financial System Inquiry supported the need for a mechanism for rationalising legacy products. This recommendation was subsequently accepted by the Government, however it has not yet been implemented.⁴

Question 5:

Is the standard cover regime in Division 1 of Part V of the Insurance Contracts Act 1984 (Cth) achieving its purpose? If not, why not, and how should it be changed?

Question 6:

Is there scope for insurers to make greater use of standardised definitions of key terms in insurance contracts?

Question 29:

Is there any reason why unfair contract terms protections should not be applied to insurance contracts in the manner proposed in “Extending Unfair Contract Terms Protections to Insurance Contracts”, published by the Australian Government in June 2018?

20. Questions 5, 6 and 29 raise issues around the design of insurance products and the setting of terms and conditions. APRA notes that:

- setting terms and conditions (such as definitions) is one lever available to an insurer to manage its business. Constraints on that ability can involve prudential trade-offs, and can also be expected to increase reliance by insurers on other levers, such as pricing; and

⁴ Refer to the Final Report of the Financial System Inquiry: <http://fsi.gov.au/publications/final-report/> and the Government’s response to that report: <https://treasury.gov.au/publication/government-response-0to-the-financial-system-inquiry/>

- while insurers operate in an environment of pervasive uncertainty, they need sufficient certainty to be able to price insurance accurately, assess appropriate levels of reserves and capital and access reinsurance capacity.

21. Regarding question 29, APRA agrees that the terms of insurance contracts should be fair to consumers and supports the extension of an appropriately designed unfair contract terms regime to insurance contracts. In designing the detail of the regime, it will be important to minimise the amount of uncertainty created, particularly around the key terms and conditions that underpin the pricing of the policy.

D. Claims management (Questions 17, 18 and 21)

22. The following group of questions relate to the practices of insurers in managing claims. Each of them goes to balancing the interests of individual policyholders and the need for the insurer to manage its business in the interests of policyholders as a group.

23. APRA and ASIC are working together to enhance transparency and accountability of the practices of life companies in relation to claims, by collecting and publishing extensive data that provides new and valuable insights into claims and disputes outcomes.⁵

Question 17:

Should the obligations in section 912A of the Corporations Act 2001 (Cth) apply to all aspects of the provision of insurance, including the handling and settlement of insurance claims?

Question 18:

Should ASIC have jurisdiction in respect of the handling and settlement of insurance claims?

24. APRA supports ASIC having jurisdiction over handling and settlement of claims, and supports obligations on insurers to undertake these functions efficiently, honestly and fairly.

⁵ Refer: <https://www.apra.gov.au/life-claims-data-collection>

Question 21:

Should life insurers be prevented from engaging in surveillance of an insured who has a diagnosed mental health condition or who is making a claim based on a mental health condition? If not, are the current regulatory requirements sufficient to ensure that surveillance is only used appropriately and in circumstances where the surveillance will not cause harm to the insured? If the current regulatory requirements are not sufficient, what should be changed?

25. APRA notes that it is particularly important for insurers to deal sensitively with claims involving mental health. The case studies explored instances where claims management practices of insurers may have exacerbated the claimant's condition. Such conduct is clearly unacceptable. The Life Insurance Code of Practice includes requirements around use of surveillance aimed at protecting claimants with mental health claims and APRA supports those requirements as striking an appropriate balance.
26. In relation to claims management more generally, the Commission has heard a number of case studies that demonstrated unacceptable behaviour from insurers. APRA does not defend or endorse that conduct. Unfortunately though, there are also examples of insurance fraud, which can, if not properly detected and managed, lead to higher premiums for insurance and, in extreme cases, the ability for insurers to provide cover. In that context, a blanket prohibition on engaging in surveillance of insureds who make claims that are challenging to assess would not strike the right balance. If it becomes known that the insurer is unable or unwilling to reject claims that involve fraud or otherwise do not meet the terms of the policy, an inappropriate incentive is created to attempt to take advantage of those circumstances.

E. Insurance in superannuation (Questions 23, 24, 25, 26 and 28)

APRA's responses in this section should be read together with its submissions on the policy questions arising from Module 5 and also with its submissions on the Interim Report.

Question 23:

Should universal:

23.1 minimum coverage requirements; and/or

23.2 key definitions; and/or

23.3 key exclusions,

be prescribed for group life policies offered to MySuper members?

27. In principle, RSE Licensees should be best placed to know the needs of the members of their fund, and so should be best placed to determine the level and type of cover to be provided. Additionally, they are required to act in the best interests of members and take into account the cost of insurance so that it does not inappropriately erode member's benefits.⁶ However, the ability of RSE Licensees to balance the insurance needs of their members with the requirement to not inappropriately erode members' retirement incomes has been challenging for them in practice, and some members have experienced undue erosion of retirement benefits, for example due to duplicate cover or cover that is otherwise not appropriate to their circumstances.
28. Accordingly, APRA supports the Government's proposed Protecting Your Super package. These proposals are expected to address some of the concerns around erosion of retirement incomes, duplicate cover and unnecessary cover through limiting the offering of insurance to an opt-in basis for:
- MySuper members below the age of 25;
 - inactive accounts that have not received a contribution in 13 months (where the member has not elected to retain existing cover); and
 - on low balance accounts with balances below \$6,000.
29. In light of concerns regarding erosion of member benefits, APRA also supports a move towards more cost effective and simpler insurance benefits being provided in MySuper products, which may involve increased standardisation of particular aspects of the benefits provided. This may further assist in ensuring more consistent delivery of quality, value for money retirement outcomes for MySuper members over the longer term. All members should, however, continue to have the ability to choose higher levels of cover should they wish (subject to being willing to pay additional contributions above the minimum Superannuation Guarantee level in the case of

⁶ Refer section 52(2) and section 52(7) of the *Superannuation Industry (Supervision) Act 1993*.

MySuper members). It would also be appropriate to continue to allow more customised terms and conditions to be provided for choice members (subject to appropriate disclosure).

30. Consideration would need to be given to a mechanism that allows for any standardised design parameters to be reviewed and updated in a timely way to ensure they remain fit for purpose and reduce the likelihood of poor consumer outcomes.

Question 24:

Should group life insurance policies offered to MySuper members be permitted to use a definition of “total and permanent incapacity” that derogates from the definition of “permanent incapacity” contained in regulation 1.03C of the Superannuation Industry (Supervision) Regulations 1994 (Cth)?

31. There are clear benefits for members in having a single, aligned definition – it provides certainty for members and allows for easy comparison of different products. As noted above, there is a need for an appropriate mechanism to allow for the legislative definition to be updated, so that it remains fit for purpose over time. APRA’s view is that life insurance policies offered to MySuper members should have a definition of “total and permanent incapacity” that is no narrower than the legislative definition of permanent incapacity. It may be beneficial for members to allow for definitions that enable a claim payment in a wider range of circumstances than the legislative definition. APRA observes that the main differences across the industry typically occur in the other terms and conditions in policies, such as exclusions and waiting periods, rather than the definition of “total and permanent incapacity”.

Question 25:

Should RSE Licensees be obliged to ensure that their members are defaulted to statistically appropriate rates for insurance required to be offered through the fund under section 68AA(1) of the Superannuation Industry (Supervision) Act 1993 (Cth)?

32. Yes, APRA’s view is that members should be defaulted to insurance rates that broadly reflect their characteristics, so that a fair price is paid for the relevant cover. Under *Prudential Standard SPS 250 Insurance in Superannuation*, RSE licensees are required to have an insurance strategy which would, inter alia, consider which

members are to be provided with insured benefits and at what level. Due to data limitations faced by RSE Licensees, ensuring that insurance rates reflect the characteristics of individual members can be a challenging task. In practice, RSE Licensees and insurers will not always know in full the characteristics of any individual member, such as their health status, whether they are blue collar or white collar and their smoker/non-smoker status, and so premiums will reflect an average across the group of members to at least some extent.

33. An option to reduce the risk that insurance arrangements are not appropriate would be for RSE Licensees and insurers to seek out additional information about members, so as to create more customised insurance benefits for them. Such an approach moves away from group insurance to a more individual approach and may reduce some of the benefits that come from group insurance, such as reduced administration costs and automatic acceptance. Ultimately, that may not be in the interests of members as a group.

Question 26:

Should RSE Licensees be prohibited from engaging an associated entity as the fund's group life insurer?

Question 27:

Alternatively, should RSE Licensees who engage an associated entity as the fund's group life insurer be subject to additional requirements to demonstrate that the engagement of the group life insurer is in the best interests of beneficiaries and otherwise satisfies legal and regulatory requirements, including the requirements set out in paragraphs 22 to 24 of Prudential Standard SPS 250, Insurance in Superannuation?

34. APRA addressed questions related to structural arrangements for RSE Licensees and the relationships between RSE Licensees and related parties in its round 5 policy submission. Many of those comments are also applicable to the specific case of arrangements with related party insurers.
35. APRA does not agree that RSE Licensees should be prohibited from engaging an associated entity as the fund's group life insurer, and is of the view that there is general benefit to the Australian financial system in the law continuing to allow diverse structures to compete in the market. The key issue is the appropriate

management of conflicts of interest and APRA agrees that engaging an associated entity as the fund's group life insurer gives rise to heightened risks in that regard. APRA's view is that, with care and diligence on the part of RSE Licensees, these potential conflicts of interest can be appropriately mitigated. To that end, APRA's prudential framework sets requirements for RSE Licensees to manage the inherent conflicts between member interests, and the interests of other parties involved in delivering superannuation services.

36. APRA acknowledges the need to strengthen the requirements placed on RSE Licensee boards in relation to arrangements with potential conflicts, including governance arrangements and assessing performance; adequacy of resources to support the RSE Licensee in fulfilling its obligations; and the authority and independence of the RSE Licensee within corporate structures. APRA also acknowledges the need to deepen its supervision of related party arrangements, particularly within conglomerate groups.

Question 28:

Are the terms set out in the Insurance in Superannuation Voluntary Code of Practice sufficient to protect the interests of fund members? If not, what additional protections are necessary?

37. APRA supports the Insurance in Superannuation Voluntary Code of Practice as an important step forward and expects adoption of the Code by RSE licensees will lead to better quality outcomes for members over time. APRA's view is that there is a need to progressively strengthen the Code to address deficiencies including lack of enforceability, lack of standard definitions for disability insurance, the issue of multiple accounts and unnecessary multiple insurance covers, and the need to fully reconsider the role and level of default insurance through MySuper versus insurance provided by choice products.
38. A key deficiency of the Code is its lack of enforceability. APRA understands that there are legal impediments in relation to making certain parts of the Code enforceable but has encouraged industry to make as much of the Code enforceable as legally feasible.
39. APRA observes that concerns have also been raised about the enforceability of the Life Insurance Code of Practice and the General Insurance Code of Practice, as well as about the extent to which enforcement of the codes has occurred in practice.

APRA's view is that each of the codes applicable in the insurance industries should have appropriate mechanisms to provide for enforceability by the relevant industry body and the code signatories and should be robustly enforced in practice.

F. Distribution and remuneration

40. Module 6 also raises issues around remuneration arrangements and the impact of remuneration on conduct. APRA addresses issues in relation to the impact of remuneration in its submissions on the Interim Report under the heading 'incentives and remuneration'.

G. Compliance and culture

41. Questions 36, 37 and 38 raise broad issues around compliance frameworks and culture within financial institutions that intersect with matters raised in the Interim Report. APRA's submissions on these questions are addressed in its submissions in response to the Interim Report.

H. Codes and self-regulation

42. Questions 12, 33 and 34 raise issues around the role and effectiveness of industry self-regulation via codes and standards that intersect with matters raised in the Interim Report. APRA's submissions as to the role and effectiveness of industry self-regulation via codes and standards are addressed under the heading 'industry codes of conduct' in its submissions in response to the Interim Report.

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