Australian Government
The Treasury

Financial Services Royal Commission

Submission

Hearings on Insurance

CONTENTS

INTRODUCTION

1. Treasury welcomes the opportunity to make a submission in response to the policy questions arising from the Round 6 hearings on the regulatory regime for the insurance industry.

2. This submission responds to the questions related to the following key themes:

    - product design and distribution, including whether the sale of certain products should be banned, and the proposal to rename general advice;
    - the extension of the unfair contact terms protections to insurance contracts;
    - enhancing ASIC oversight over claims handling in insurance; and
    - issues related to insurance in superannuation.

3. Question 1 of the questions posed by the Commission seeks views on whether the current regulatory regime is adequate to minimise customer detriment. This submission looks at the specific policy questions raised and does not comment on broader aspects of the regulatory framework — for example, the role of corporate governance and firm culture – which, while relevant to insurance, apply more broadly across the system.

4. Treasury has previously provided views to the Commission on these issues in its policy submission in July and will also address these issues in its forthcoming submission responding to the Commission's Interim Report.

5. The submission also does not respond to questions related to codes, compliance and breach reporting, and remuneration. Matters relevant to these issues will be considered in the submission responding to the Interim Report.

PRODUCT DESIGN AND DISTRIBUTION

6. The Commission has asked whether particular insurance products, like accidental death and accidental injury products, should not be sold (Question 2); and if particular distribution practices, like the direct sale of insurance via outbound telephone calls, should be better regulated or banned (Question 10).

7. In Treasury's view, there are financial products that are poorly designed and/or distributed inappropriately to customers and that have resulted in significant consumer detriment.

8. The Government has recently introduced legislation into Parliament (the Bill) implementing design and distribution obligations (DDO) and a product intervention power (PIP) – pursuant to recommendations from the 2014 Financial System Inquiry.[1]

9. The aims of the PIP/DDO regimes are to promote the provision of suitable financial products to consumers and to enable ASIC to proactively reduce the risk of consumer detriment from unsuitable products. As such, these regimes will assist in preventing consumer detriment resulting from poor design or inappropriate distribution, and should be taken into account in considering whether further regulation relating to the availability of products or distribution practices is required.

10. They are consistent with the principles of the 2014 Financial System Inquiry – including that consumers should receive fair treatment from financial firms so as to assist them to bear responsibility for their own financial decisions, including losses; and that product issuers and distributors should take responsibility for the design, targeting and distribution of financial products.

DESIGN AND DISTRIBUTION OBLIGATIONS

A principled approach to 'banning' products

11. DDO will require product issuers (such as insurers) to develop a 'target market determination' that will specify the target market for each of their products. This target market must be such that the product will likely be consistent with the likely objectives, financial situation and needs of customers within that target market.

12. The effect of these obligations is that if an issuer designs a product that does not meet the likely objectives, financial situation and needs of any customers – or only does so for such a narrow target market, so as to be commercially unviable – the issuer is effectively precluded from offering that product.

[1] Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018.

13. This will particularly be the case when the new penalty regime, which is being implemented in response to recommendations of the ASIC Enforcement Review, takes effect. The new penalty regime is anticipated to take effect after the Bill implementing DDO is passed, but before DDO commences (which is two years after Royal Assent to the Bill is given). These higher penalties act against the current approach of some firms to treat the consequences of breaching laws, such as the DDO as a 'cost of doing business', as the maximum civil penalty for bodies corporate will be the greater of $10.5 million, three times the profit derived from the breach or 10 per cent annual turnover (capped at $210 million).

14. To the extent that a product may be suitable for a small, but commercially viable target market, DDO will allow issuers to offer that product with the distribution obligations directing that product to the target market.

15. In comparison to an outright ban of a particular product type, the design of the DDO involves establishing an ongoing approach that is responsive to financial product innovation, while not unnecessarily restricting product choice. At the same time, it effectively provides a ban on products that do not provide a benefit to at least a segment of consumers.

A principled approach to regulating distribution practices

16. DDO also requires issuers who distribute their own products and third-party distributors to take reasonable steps, such that the way they market, advise on or sell products is consistent with the target market determination for that product.

17. In determining what constitutes reasonable steps, the Bill requires the following to be considered:

    - the likelihood of inconsistency between the target market and proposed distribution methods;
    - the likely consequence of an inconsistency;
    - the extent to which the risk can be practically mitigated; and
    - what a reasonable person ought to know about the risks and how to mitigate them.

18. To give an indication of ASIC's expectations on what constitutes reasonable steps, ASIC will publish and consult on regulatory guidance when the legislation is passed.

19. A distributor will not have failed to take reasonable steps merely because someone outside the target market acquires a product. The DDO are not intended to mandate the distribution of all products through personal advice — which is what would be required if each prospective client were to be individually assessed to determine if they were a member of the identified target market. Such a requirement would result in a number of products that could otherwise be of benefit to a wide range of consumers being subject to a prohibitively high regulatory burden because they could only be provided through personal advice channels.

PRODUCT INTERVENTION POWER

20. To complement DDO, ASIC will be provided with the power to make a range of intervention orders to prohibit specified conduct in relation to financial or credit products, to proactively reduce the risk of significant consumer detriment.

21. As well as imposing an outright ban on the sale of a product, ASIC will also be able to make a range of intervention orders that are more targeted. This power is broad and flexible. For example, ASIC may determine it is appropriate to direct that a product only be offered to particular classes or consumers or in particular circumstances, or direct that a product not be distributed unless accompanied by an appropriate warning or label. ASIC will also be able to impose requirements relating to remuneration, where that remuneration is conditional on the achievement of objectives directly related to the financial product.

22. If ASIC makes an intervention order, the order can operate for up to 18 months, after which time the responsible Minister has the power to make the order permanent.

23. In summary, the PIP and DDO are flexible approaches that enable graduated responses to products or distribution practices that can lead to consumer detriment. The regimes will be responsive to financial product innovations, while not unnecessarily restricting product choice.

24. Treasury suggests that primary legislation banning products, or mandating or banning distribution practices are most suited to situations where it is necessary to set clear and permanent expectations about acceptable practices and products and ensure they are uniformly followed by firms. Outside of these situations, a principles-based approach promotes simplicity and efficiency by stating the outcomes sought or obligations imposed, while leaving the regulated population free to find the most efficient way of achieving that outcome.

25. Furthermore, while these reforms increase the onus on firms to treat their customers fairly, Treasury also considers that it is not good policy to entirely legislate or regulate away consumer responsibility. As noted in Treasury's Policy Submission, the regulatory framework aims to ensure that there is integrity in the system so that consumers, in making decisions, can understand the risks and can interact with firms with confidence. When financial products are too complex (or inherently too risky) for retail consumers to understand and make informed decisions about, stronger protections apply. But, there will always be a need for consumers to take responsibility for their own decisions and actions.[2]

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[2] Treasury, *Submission on Key Policy Issues* (July 2018), 4

IMPLICATIONS FOR GENERAL ADVICE

26. Question 11 seeks views on whether the proposal to rename general advice, which was recommended by Financial System Inquiry (Recommendation 40) and the Productivity Commission's report on *'Competition in the Australian Financial System'* (Recommendation 10.2), would be sufficient to address the problems that can arise where financial products are sold under a general advice model. The Government, in its response to the Financial System Inquiry, accepted Recommendation 40.[3]

27. Renaming general advice would increase customer awareness of the nature of the (sales) service they are receiving. This, coupled with the introduction of the DDO (discussed above) would be expected to result in a more careful consideration of how and where sales are made, but are unlikely to provide an equivalent level of protection compared to when personal advice is provided.

28. As noted in Treasury's submission to the Round 5 Superannuation hearings, the challenges in enhancing protections in relation to general advice are the breadth of the existing definition and the fact that the line between general advice and personal advice is not always clear.[4] Reforms in this area could benefit from considering the merits of having a more graduated approach to consumer protection, having regard to the different types of advice that consumers need; but recognising that this could bring additional complications and issues of their own.

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[3] Australian Government, *Improving Australia's financial system: Government response to the Financial System Inquiry* (20 October 2015), 22.

[4] Treasury, *Submission: Hearing on Superannuation* (Treasury Superannuation Submission) (September 2018), 14.

UNFAIR CONTRACT TERMS

30. Question 29 seeks views on whether the unfair contract terms (UCT) provisions should be extended to insurance contracts in the way proposed in the Australian Government's Proposals Paper of 27 June 2018 (Proposals Paper).

31. The Government has committed to extending the UCT provisions to insurance contracts and the Proposals Paper set out a model for this could be achieved. The Paper proposed:

- Amending s 15 of the *Insurance Contracts Act 1984* (IC Act) to allow the UCT laws in the *Australian Securities and Investments Commission Act 2001* (ASIC Act) to apply to life and general insurance contracts, and then tailoring the UCT laws to accommodate specific features of insurance contracts.

- Excluding certain terms in insurance contracts from the application of UCT laws, including terms that define the 'main subject matter' of the contract (for example, description of what is being insured such as a house or a motor vehicle) and terms that set the upfront price payable under the contract (that is, premiums and excess payable).

- Defining 'legitimate interests' (which would be excluded from the application of the UCT laws) as a term that reasonably reflects the underwriting risk accepted by the insurer and that does not disproportionately or unreasonably disadvantage the insured. A term that is not reasonably necessary to protect the legitimate interests of the party who would be advantaged by it would be considered 'unfair' under the current UCT laws.

- Determining which types of insurance contracts would be 'standard form' contracts to which the UCT laws will apply. A contract would be considered as 'standard form' even if the consumer or small business could choose from various policy options and levels of coverage before the contract is entered into (including excess amounts, sum insured amounts and policy exclusions).

- Listing examples of contract terms which may be deemed 'unfair'. The UCT laws provide a non-exhaustive list of examples of contract terms which may be deemed unfair. Other examples specific to insurance contracts that could be added include terms that permit an insurer to pay a claim based on the cost of repair or replacement that can be achieved by the insurer but not reasonably achieved by the policy holder.

- Expanding the remedies available if a contract term in an insurance contract is considered 'unfair'. Under the current UCT laws, if a term is declared to be unfair the remedy is that the term is void. In some circumstances this remedy may not be appropriate for insurance contracts – and the court should be able to make other orders, such as an injunction restraining a party from enforcing an unfair term, and ordering compensation or non-party redress.

- Providing for a transition period of 12 months before new UCT provisions take effect. After this period, UCT provisions will apply to new insurance contracts, renewals and variations of insurance contracts.

PUBLIC CONSULTATION ON THE PROPOSED REFORM

32. Submissions were received from 24 parties in response to the Proposals Paper.

33. Most submissions expressed in principle support for the proposed reform which would bring Australia into line with other jurisdictions' UCT regimes for insurance contracts (in particular the European Union, the United Kingdom and New Zealand).

34. Key issues regarding policy design that were raised in submissions include:

- The legislative model for the reform: while the Proposals Paper proposed including the UCT regime for insurance in the ASIC Act, some stakeholders argued it would be more appropriate to include the UCT laws in the IC Act, with amendments to the ASIC Act to allow ASIC to administer UCT requirements in insurance contracts. The argument put forward was that including UCT provisions in the IC Act would have the benefit of keeping all provisions governing the rights, obligations and remedies available to parties under insurance contracts in a single Act.
  - One benefit of having the provisions in the ASIC Act is that all provisions governing unfair contract terms would be located in a single piece of legislation, which would avoid the risk of changes being made to one UCT regime but not another and the UCT regimes diverging over time.
- The way in which 'main subject matter' of a contract is defined: most submissions supported having a legislative definition of 'main subject matter', rather than leaving courts to decide on a case-by-case basis. Consumer groups favoured a narrow definition of 'main subject matter' to broaden the scope of the UCT regime while insurers and insurance industry groups advocated for a broader definition similar to the EU regime, which exempts terms which 'clearly define or circumscribe the insured risk and the insurer's liability' from the UCT regime.
  - Regardless of whether a narrow or broad definition of 'main subject matter' is adopted, the policy intent (as noted earlier) is to exclude (from the UCT laws) terms that reasonably reflect the underwriting risk accepted by the insurer and that do not disproportionately or unreasonably disadvantage the insured.
- Uncertainty as to how the UCT regime is to interact with the existing duty of 'utmost good faith' in s 13 of the IC Act, given that the UCT regime could introduce another, and different, concept of fairness into the IC Act.
  - The policy intent is that the two obligations would act independently of each other, and Treasury is considering how this could be achieved.
- That the transition period of 12 months may not be adequate, given the reform would necessitate reviewing affected contracts, re-wording policies, re-issuing product documents and determining new risk exposures. This is of particular concern for reinsurance arrangements due to the timing of negotiation of reinsurance treaties.

35. Treasury is currently considering these issues in refining the model for applying UCT laws to insurance contracts.

CLAIMS HANDLING

36. Questions 17 and 18 sought views on how insurance claims handling should be regulated.

37. Insurance claims handling largely falls outside the regulatory framework for ASIC's oversight (set out in Chapter 7 of the *Corporations Act 2001* (Corporations Act)) as:

    - many of the activities undertaken in relation to insurance claims handling do not fall within the current definition of providing a financial service under the Corporations Act; and

    - those activities carried on in the course of handling an insurance claim that would normally be considered a financial service are in effect excluded by reg 7.1.33 of the Corporations Regulations 2001 (Corporations regulations). This regulation excludes the activities of giving advice and dealing (as defined in the Corporations Act) from the definition of providing a financial service, where this is provided in the course of and is a necessary or incidental part of handling of a claim or potential claim in relation to an insurance product or the settlement of a claim or potential claim in relation to an insurance product.

38. The Government commissioned Treasury to progress work to remove the current exemption for insurance claims handling but, given the overlap with the remit of the Royal Commission, subsequently put this work on hold pending the outcomes of the Commission's Final Report.[5]

39. It is desirable that any changes to the regulation of claims handling are achieved without imposing unnecessary additional regulatory requirements, as such costs inevitably affect pricing and access to insurance, and so give rise to an alternative form of consumer detriment. Minimising these costs requires recognition of the unique characteristics of the claims handling process that differentiate it from other financial services.

OPTIONS AVAILABLE

40. Treasury has considered two options for enhancing ASIC's oversight of insurance claims handling.

Option 1: Remove Regulation 7.1.33

41. The first option is to remove reg 7.1.33. This was the option initially recommended by ASIC in its 2016 report into life insurance claims.[6] It has the merit of simplicity but suffers from two deficiencies that would significantly limit its ability to provide ASIC with the powers needed to properly oversee claims handling and also unnecessarily increase regulatory costs.

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5 The Hon Kelly O'Dwyer, Minister for Revenue and Financial Services, Address to Insurance Council of Australia Annual Forum (Sydney), 7 March 2018.

6 Australian Securities and Investments Commission *REP 498: Life insurance claims: An industry review*, 102.

42. Firstly, many of the activities carried on by an insurer in relation to claims handling are unlikely to meet the current definition of 'providing a financial service'. This is likely to create uncertainty as to which activities are or are not regulated, which would also limit ASIC's ability to increase its regulatory oversight of claims handling.

43. Secondly, removing the exemption in reg 7.1.33 could trigger a number of requirements under the Corporations Act that would apply to Australian Financial Services (AFS) licensees where they provide financial advice in the course of handling or settling an insurance claim.

44. Some of these requirements would help achieve the policy objective; for example, the general licensing obligations, conduct obligations and prohibitions against conflicted remuneration.

45. Other requirements, however, could be difficult to apply or would impose a heavy and unnecessary compliance cost on either insurers or third parties who may be involved in insurance claims handling. For example, where financial advice is provided in the course of handling a claim, all of the obligations imposed on a financial adviser (such as the educational, ethical, exam and continuing professional development requirements linked to the professional standards reforms) would apply. This would be inappropriate as claims handling is fundamentally different to providing financial advice.

Option 2: Make handling and settling an insurance claim a new financial service

46. This option would involve using existing legislative powers to define the activity of handling or settling an insurance claim (in relation to both life and general insurance products) as a financial service for the purposes of the Corporations Act.[7]

47. In order to cover all conduct of the insurer (or its representatives) in relation to claims handling, 'handling or settling of an insurance claim' could be defined to include:

    - receiving, considering and handling a potential or actual claim; and
    - dealing with an actual claim (for example: receiving and considering the claim; appointing experts including investigators; making a decision; and informing the retail client of the decision).

48. The definition could also clarify that this financial service does not entail providing advice or dealing in relation to insurance products.

49. The benefit of extending the definition of financial services to include claims handling activities is that it would bring these activities within the high-level conduct obligations as well as improving ASIC's regulatory oversight, without imposing requirements that are not specifically tailored to these activities (such as those applying to advising or dealing).

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[7] S 766A(1)(f) of the Corporations Act allows for a financial service to be defined under the Corporations regulations.

50. On this basis, key requirements that could be considered to apply to this financial service could be in Division 3, Part 7.6 of the Corporations Act. The application of the general conduct obligations (including the general licensing obligations in s 912A, as per Question 17) to all claims handling conduct engaged in on behalf of insurers would improve consumer outcomes, for example by:

    - ensuring that AFS licensees are required to act efficiently, honestly and fairly, potentially enabling ASIC to take action to address systemic misconduct such as delaying decisions on claims;

    - requiring AFS licensees to have adequate measures in place to manage conflicts between representatives' own interests in refusing claims, and the legal obligations owed to clients (including obligations under s 912A, the contract terms or industry codes of conduct); and

    - requiring AFS licensees to adequately supervise claims handling conduct engaged in by their representatives and ensure that representatives are adequately trained and competent to engage in those services.

51. This option would also improve ASIC's toolkit in relation to claims handling, for example by improving ASIC's ability to request information, receive notifications on key matters, and ability to undertake surveillance.

52. While this option would allow for a more tailored application of requirements, it does raise a number of design issues that would need to be addressed, including:

    - who could be covered under the definition of handling or settling an insurance claim; and

    - whether it should apply to all insurance claims or only services provided to retail clients.

Who could be covered?

53. To ensure that there is adequate regulation of claims handling activity, it may be considered appropriate for the new claims handling requirements to apply to all persons involved in receiving and dealing with a potential or actual claim. This could include:

    - insurers that provide a claims handling service, including their employees and contractors, and related body corporates that provide a claims handling service on behalf of the insurer; and

    - third party representatives of insurers that provide a claims handling service on behalf of the insurer, including service providers such as investigators, loss adjustors, loss assessors, collection agents and claims management services.

54. To provide flexibility to address problematic conduct by other persons in the future, consideration could be given to providing ASIC with a power to prescribe additional persons.

55. One issue that would require further consideration is the extent to which this approach should exclude entities such as superannuation fund trustees who play a role in claims handling. Superannuation trustees hold policies on behalf of members and have an existing obligation to do everything that is reasonable to pursue insurance claims with reasonable prospects of success for beneficiaries.8 As part of this role, trustees engage in activities (such as overseeing the progress of claims and reviewing insurers' decisions) that could reasonably be considered to be handling and settling insurance claims, although they are not acting on an insurer's behalf.

What types of claims would be covered?

56. It would be necessary to consider what types of claims any new requirements would apply to.

57. One option is for the claims handling requirements to apply to all insurance claims. Alternatively, given the issues identified by ASIC have generally related to retail clients, consideration could be given to limiting the requirements to services provided to retail clients to avoid unnecessary compliance costs.

58. There is an existing definition of 'retail client' in relation to general insurance products.[9] As this definition is restricted to specified kinds of general insurance product, it would be necessary to consider whether use of the definition would result in the claims handling conduct requirements not applying to a significant number of policies commonly acquired by individuals or small businesses. It would also be necessary to consider whether this definition would adequately cover claims handling services for insurance products acquired and held by a person as a 'group product' that provides cover to other people (for example, group life insurance policies provided through superannuation, given its significance as a distribution channel for life insurance).

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8 *Superannuation Industry (Supervision) Act 1993* (Cth) s 52(7)(d).

9 S 761G(5) of the Corporations Act

INSURANCE IN SUPERANNUATION

59. The Commission has sought views on a range of issues relating to insurance provided through superannuation.

STANDARDISATION OF INSURANCE PRODUCTS FOR MYSUPER MEMBERS

60. Question 23 seeks views on universal minimum coverage requirements, key definitions and key exclusions for group life insurance products offered to MySuper members.

61. The Cooper Review envisaged MySuper products as simple, comparable, low cost products for members who do not choose their own fund.[10] In light of this purpose, there is a question of whether default insurance should provide a basic standardised insurance cover for members who have not considered their insurance needs. Such standardised insurance cover could include a universal minimum coverage requirement.

62. Standardising terms for insurance products provided with MySuper products could provide some benefits, such as improved comparability of products that would make it easier for members to exercise informed choices about their cover. However, funds that have member cohorts with bespoke needs would require some flexibility to tailor the terms and conditions of cover. Standardisation may also reduce the scope for innovation in the sector. These considerations would also be relevant in the context of insurance more broadly.

63. With respect to minimum coverage requirements, Treasury notes the *Superannuation Guarantee (Administration) Regulations 2018*[11] (SGA Regulations) currently require that MySuper members are provided with a minimum level of death cover based on age (subject to reasonable conditions as the trustee determines). The regulations also provide that death insurance for MySuper members under the age of 56 must be provided at a premium of at least $0.50 per week. While a uniform minimum level of life insurance cover in MySuper products would ensure a baseline of coverage for default superannuation members, there are challenges with this approach. There is no single level of cover that would be appropriate for all member cohorts. Many factors, including age, occupation, level of income, superannuation balances and other savings, as well as family structure, would play a role.

10 Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System, *Super System Review Final Report Part 2* (2010), 5 (*Cooper Review Part 2*).

11 The *Superannuation Guarantee (Administration) Regulations 2018* replaced the *Superannuation Guarantee (Administration) Regulations 1993* which set the minimum levels of death cover based on age prior to the 2018 regulations being endorsed by the Governor General on 13 September 2018.

64. In addition, the Cooper Review recommended repealing the minimum levels of death cover contained in the SGA Regulations as these levels had eroded in real terms since they were introduced in 2005.[12] The Cooper Review also noted that these levels have been largely redundant as trustees had generally set default insurance cover levels in excess of the legislated minimums.[13] The Cooper Review recommended that the minimum level of cover be instead set by trustees, who are best placed to determine the level with respect to the needs of their members. [14]

DEFINITION OF TOTAL AND PERMANENT INCAPACITY

65. Question 24 asks whether group life insurance policies offered to MySuper members should be permitted to use a definition of 'total and permanent incapacity' that derogates from the definition of 'permanent incapacity' contained in the Supervision Industry (Supervision) Regulations (SIS Regulations).

66. The current definition of permanent incapacity in reg 1.03C of the SIS Regulations requires the insured member to be unable to work in any occupation for which they are reasonably qualified by education, training or experience in order to receive a benefit. This definition is formulated to align with the conditions of release for superannuation in the SIS regulation and thus allow members to receive insurance payouts at the time of their disability.[15]

67. Any changes to the definition of total and permanent incapacity that may make it easier for members to receive an insurance payout, for example a shift to a definition based on incapacity to work in the member's own occupation, may lead to increases in the cost of insurance premiums and, subsequently, lower balances at retirement.

INSURANCE IN SUPERANNUATION VOLUNTARY CODE

68. Question 28 seeks views on the effectiveness of the Insurance in Superannuation Voluntary Code of Practice ('the Code') and asks whether additional protections are necessary. Treasury notes that the SIS Act contains existing obligations on trustees with respect to insurance. These include the formulation of an insurance strategy for the benefit of all beneficiaries and ensuring that the cost of insurance does not inappropriately erode the retirement income of the beneficiaries.[16] The Code is intended to operate alongside these obligations in the law.[17]

69. The Code contains elements that should deliver a benefit to members and address the inappropriate erosion of retirement balances. The provisions relating to claims handling would provide greater clarity and more certain timeframes for members. In addition, the Code introduced disclosure requirements such as a Key Fact Sheet and a welcome pack containing information about how much an individual is insured for and what premiums they will pay.[18]

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12 Cooper Review Part 2, 143.
13 Ibid, 143.
14 Ibid, 144.
15 Australian Government, '*Stronger Super' Information Pack* (2011), 7.
16 *Superannuation Industry (Supervision) Act 1993* s 52 (7).
17 Insurance in Superannuation Voluntary Code of Practice, section 3.10.
18 Ibid, cl 5.1-5.10.

70. However, the non-binding nature of the Code — which allows trustees to voluntarily adopt the Code on an 'if not, why not' basis — is a key shortcoming. This allows trustees to both decide if they will adopt the Code, and which provisions of the Code they will adopt and in what circumstances. While this provides trustees with more discretion, it also undermines the Code's effectiveness in protecting member interests.

71. Some elements of the Code, in particular the provisions concerning protecting members from balance erosion, are also likely to fall short of what is necessary to protect member interests. To address the balance erosion issue, the Code imposes premium caps and introduces automatic cessation rules for inactive accounts. However, those rules apply only to Automatic Insurance Members, a definition which may result in some members unknowingly foregoing the protections of the Code if they exercise any choices relating to their cover (for example, increasing the level of cover).[19]

72. The premium cap provisions also allow trustees to exceed the specified caps if they publish the rationale for doing so. However, these provisions are cast broadly and do not set out the specific circumstances in which the exception would apply. These provisions, in combination with the general non-mandatory nature of the Code result in a significant amount of discretion for trustees regarding benefit design.

73. Despite earlier indications, the Working Group has not sought formal approval and oversight of the Code from ASIC.[20] Trustees who adopt the Code will themselves be responsible for monitoring and reporting on the Code. The Code's flexible requirements and absence of an independent administrator mean that it would be unlikely to meet ASIC's requirements for approval of codes of conduct.

74. The Government has proposed legislative changes to address certain issues relating to insurance in superannuation.[21] The 'Protecting Your Super' Package, announced as part of the 2018-19 Budget, included amendments to how insurance is offered inside superannuation.

75. The package introduces additional protections for low balance accounts (below $6,000), younger members (under 25) and inactive accounts. It prohibits the provision of default opt-out insurance to new members under 25 and accounts with balances below $6,000. The package also aims to address the current levels of duplicate insurance policies in the system by requiring insurance to cease after 13 months of account inactivity. These measures were designed to address the inappropriate erosion of retirement balances across the sector, as well as more appropriately target default insurance provided within superannuation.

76. A number of elements of the 'Protecting Your Super' Package were independently recommended by the Productivity Commission's draft report, including the change to opt-in insurance for members under 25 and automatic cessation of insurance for inactive accounts.[22]

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19 The Code defines Automatic Insurance Members as a member that has been provided insurance automatically; and has not told the fund that they wish to maintain their cover, made an application for cover or varied their cover in any way; and that insurance cover is not paid for wholly by their employer; and is not a defined benefit member. Ibid, 24.

20 Insurance in Superannuation Working Group, *Consultation Paper: Insurance in Superannuation Code of Practice* (2017), 6.

21 Treasury Laws Amendment (Protecting Your Superannuation Package) Bill 2018 (Cth).

ASSOCIATED ENTITIES

77. Questions 26 and 27 ask whether Registrable Superannuation Entities (RSE) licensees should be prohibited from engaging an associated entity as a fund's group life insurer, or if additional requirements are required to ensure such arrangements are in the best interests of beneficiaries.

78. These issues are similar to the issues regarding related parties more broadly, which were discussed in detail in Treasury's previous submission on superannuation to the Commission.[23]

79. As noted in that submission, the Productivity Commission considered the issues arising out of related party outsourcing arrangements and its draft report includes a recommendation that the regulator strengthen prudential standards requiring trustees to conduct due diligence on such arrangements every three years.[24] However, the Productivity Commission also observed that the evidence from its survey of funds generally indicated that the process for selecting insurers usually involved tenders and was competitive. [25]

DEFAULTING MEMBERS INTO STATISTICALLY APPROPRIATE RATES

80. Question 25 asks if RSE licensees should be obliged to ensure that their members are defaulted to statistically appropriate rates for insurance.

81. Default insurance is provided through group insurance arrangements, typically at a lower cost than individually underwritten policies due to the scale and pooling of risks.[26] An inevitable consequence of group insurance is that the premiums paid by members reflect the average risk of the group and low risk members cross-subsidise high risk members.

82. However, trustees should ensure that the default insurance reflects the needs and characteristics of the membership as a whole. Where a trustee incorrectly defaults members as a group into a higher risk profile (for example, blue collar or smoker), those members are likely to be paying higher than necessary premiums.[27] Treasury notes that under s 53(a)(iii) of the Superannuation Industry (Supervision) Act, trustees are already required to have regard to the demographic composition of their fund when formulating an insurance strategy. Introducing a further requirement for RSE licensees to ensure that insurance policies reflect the characteristics of individual members would likely lead to a material increase in premium levels.[28]

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22 Productivity Commission, Superannuation: Assessing Efficiency and Competitiveness: Draft Report (2018) (PC Superannuation Draft Report).

23 Treasury Superannuation submission, 15-16.

24 PC Superannuation Draft Report, 40.

25 Ibid, 333.

26 Ibid, 20-21.

27 For example, *ASIC's Report 529: Member experience of superannuation* found that defaulting all of a fund's members as 'smokers' or 'blue collar workers' in the absence of information about member status is inappropriate – given the likelihood of a member actually meeting these criteria. However, in a follow up *Report 591: Insurance in Superannuation*, ASIC stated that all of the identified trustees had either ceased, or were in the process of ceasing this practice.

28 For example, in its submission to the Productivity Commission, Rice Warner provided examples of the price of group insurance cover being 20 to 60 per cent lower than the price of individual 'retail' cover. Rice Warner, *Superannuation Efficiency and Competitiveness: Submission to the Productivity Commission* (2016), 25.