INSURANCE COUNCIL OF AUSTRALIA

26 October 2018

The Hon. Kenneth Hayne AC QC
Commissioner
Royal Commission into Misconduct in the Banking,
Superannuation and Financial Services Industry

Submitted through online form

Dear Commissioner

SUBMISSION ON THE INTERIM REPORT

The Insurance Council of Australia (the Insurance Council) welcomes the opportunity to provide this submission on the Interim Report of the Royal Commission. It complements our submission of 25 October 2018 in response to the policy questions posed by the Royal Commission following Round 6 of the public hearings in relation to general insurance.

While noting that the Interim Report does not draw on the evidence provided during Round 6 of public hearings, the Insurance Council and its members are carefully considering the observations made and questions raised on issues such as corporate governance, culture and remuneration. General insurers are closely examining their own practices to identify opportunities for improvement.

In seeking to address the causes of poor consumer outcomes, the Insurance Council submits that the approaches which may be appropriate to address issues in the banking or superannuation sectors should not be automatically applied to general insurance. In our experience, past broad-based reforms that have not taken into account the needs of general insurance consumers have created complexity in their application, to the detriment of consumers.

It is important to keep in mind the broad statistics which characterise the industry's performance[1]:

- 40.9 million retail policies sold annually (44.0 million in total including wholesale policies)[2];
- 4.0 million claims made on retail policies (4.6 million claims in total)[3];
- 95.8% of overall claims paid[4];
- 27,919 internal disputes, 0.06% of policies, received by general insurers (29,682 in total)[5]; and

[1] Unless specified otherwise, the data is for 2016/17, the latest available.
[2] General Insurance Code Governance Committee, General Insurance in Australia 2016-17, Page11.
[3] General Insurance Code Governance Committee, Op.cit., Page20.
[4] General Insurance Code Governance Committee, Op.cit., Page27.
[5] General Insurance Code Governance Committee, Op.cit., Page45.

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- 8,603 general insurance disputes, 0.02% of policies, accepted by FOS (2017-18 data).[6]

The Insurance Council acknowledges the unhappiness and financial cost to consumers highlighted in the general insurance case studies examined by the Royal Commission in Round 6 of the public hearings. Lessons can always be learned. However, the case studies are not typical of the outcomes experienced by Australian policyholders. It would be wrong to draw generalised conclusions and apply them across the entire financial services industry, without first considering the implications in terms of the impact on particular sectors and products.

It should also be kept in mind that all of the policy issues raised in the general insurance hearings are being addressed. Questions such as the need for restrictions on commissions and protections from unfair contract terms have been closely considered for some time; discussion is ongoing because they are complex issues and unwarranted consequences need to be avoided. However, the Insurance Council is confident that the time is right for long term solutions to be agreed and that the political will is there to legislate where necessary.

This submission discusses several of the major themes explored in the Interim Report that have particular importance for the general insurance industry.

The Nature of Financial Services Regulation

The Insurance Council agrees with the observation in the Interim Report that "almost all of the conduct identified and criticised in this report contravened existing norms of conduct". As the Royal Commission noted "given the existing breadth and complexity of the regulation of the financial services industry, adding any new layer of law or regulation will add a new layer of compliance cost and complexity. That should not be done unless there is a clearly identified advantage" (p290). The Insurance Council considers that the focus of any proposal to address these concerns should not be to introduce another layer of law but to achieve better outcomes for both consumers and industry.

In asking whether the financial services regulatory regime has become so complex that it has lost sight of its overall purpose, the Royal Commission raised a matter which strongly resonates with general insurers. Too often the Insurance Council and its members have had to work through abstruse regulatory problems where more attention has to be given to the requirements of sub-sections of the Corporations Act, rather than whether compliance would actually help consumers.

The Insurance Council is not advocating for wholesale repeal of all financial services laws. However, if priority were given to the principles enunciated in the Interim Report, much of the detail in the legislation could be removed and compliance focused on consistency with the principles. The Insurance Council understands that the United Kingdom has successfully implemented such an approach, with the Financial Conduct Authority being able to determine insurance-specific rules on application of principles where necessary.

Such a change in regulatory approach should not be undertaken lightly, but the Insurance Council would support a major consultation on its feasibility.

[6] FOS, Annual Review 2017-18, page 78.

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The Role of Self-Regulation

Self-regulation as a reflection of community expectations

The Royal Commission's investigation of self-regulation seemed to proceed from the premise that obligations arising from self-regulatory arrangements should operate in a similar manner to obligations imposed by law. There was a strong implication that any differences were shortcomings that needed to be rectified. However, using the terminology from the Royal Commission's Terms of Reference, Government mandated legislation can be considered as embodying the community's considered judgement as to conduct which is unacceptable and should be subject to Government applied sanctions.

Self-regulation on the other hand is an effort by industry members to raise service standards beyond that minimum and to fill in gaps that may otherwise exist in the law. Even though it may be a collective effort and, as in the case of the General Insurance Code of Practice (GI Code), embody a commitment by the vast majority of industry members, self-regulation stems from an entity's competitive urge to differentiate itself in serving its customers.

The Insurance Council and its members firmly hold the view that there is a clear role for robust self-regulation in financial services to complement legislated provisions.

In working collectively to raise service standards, businesses aim to satisfy if not exceed community expectations, but over time industry imposed standards may become the minimum that is acceptable. The long history of the GI Code demonstrates this process. For example, the Insurance Enquiries and Complaints scheme developed by the Insurance Council was the forerunner of what will soon be the Australian Financial Complaints Authority (AFCA).

At the point where self-imposed requirements become the minimum standard acceptable, it may be appropriate for Government to consider whether the obligation is certain enough and the ramifications of non-compliance serious enough that it should be made a legal requirement with sanctions imposed for non-observance. In contrast, principles designed to lift industry practice in a particular area are best left to self-regulation.

The flexibility of self-regulation

Because of its closeness to the consumer, industry is better placed to pursue improved consumer outcomes in light of evolving community needs and expectations. The GI Code is a living document which reflects changes in community expectations over time and has been reviewed and amended four times since its inception in 1994. The Insurance Council is currently conducting a wide-ranging review to ensure it remains fit for purpose, acting on feedback from consumers, regulators and other stakeholders.

When necessary, self-regulation can respond quickly to changing consumer expectations and needs. For example, after the significant impact of natural disasters in 2010-11 (most notably the Queensland floods and Cyclone Yasi), in response to public feedback improvements were made to the catastrophe provisions in the GI Code within a year. The quick revision of Code provisions delivered enhanced consumer protection at a speed unlikely to have been achieved through legislative or other regulatory mechanisms.

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Self-regulation provides effective enforcement mechanisms

Obligations under the GI Code are enforceable through its governance structure. Insurers subscribe to the GI Code by way of a Deed of Adoption entered into between the insurer, the Insurance Council and the independent Code Governance Committee (CGC). As such, GI Code subscribers are bound to comply with the Code obligations and are subject to CGC monitoring, enforcement and sanctions. The CGC is empowered to receive allegations about breaches; investigate alleged breaches; and determine whether a breach has occurred.

Sanctions enforceable by the CGC include requiring the Code subscriber to take rectification steps (including compensating consumers); conduct a compliance audit; and publication of the non-compliance. To date, the CGC has not needed to exercise its sanctions powers as corrective measures have been taken by Code subscribers when breaches have occurred. These include remedying the cause of the breach and addressing related financial losses suffered by consumers. The Insurance Council submits that this focus on correcting breaches is appropriate and fosters a cooperative and constructive approach to compliance.

The GI Code is also enforceable through the Financial Ombudsman Service (FOS). The FOS Terms of Reference provide that it can take into account industry codes in determining disputes. This will continue when AFCA becomes operational. GI Code subscribers promote their adherence to Code obligations to their customers. This very public commitment to compliance with Code provisions, together with the insurer's obligations to act with utmost good faith and to avoid misleading and deceptive conduct, gives rise to a compelling argument that the GI Code has force.

The GI Code's corporate governance arrangements were significantly strengthened in the current 2014 Code. The CGC now has much greater institutional independence and increased resourcing has allowed it not only to continue desk top audits of Code subscriber compliance but to undertake regular own motion inquiries into particular concerns. While the industry accepts that Code compliance and Code breach reporting can be improved, the Insurance Council believes that the degree of self-reporting of breaches[7] which occurs indicates the seriousness with which Code obligations are undertaken. The Insurance Council understands that the CGC is taking vigorous action to encourage even higher levels of breach reporting.

The current approach to enforceability of the GI Code allows it to better reflect the role of self-regulation as aiming to satisfy community expectations which go beyond the law. For example, the next iteration of the GI Code will incorporate best practice guidance on topics that have emerged as important issues to the community, such as family violence and mental health. There are also new Code obligations for how subscribers interact with and assist consumers experiencing vulnerability. Treating breaches of a voluntary code as breaches of the law with enforcement pursued by ASIC or the ACCC may reduce the GI Code to minimum prescriptive standards. This would be a retrograde for the industry as well as consumers.

[7] As cited in the Witness Statement of Ms Lynelle Briggs, Chair General Insurance Code Governance Committee.

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Conflicted remuneration

General insurance products and sales processes can be differentiated

While examining case studies on financial advice (in the Interim Report) and add-on insurance (during the Round 6 hearings), the Royal Commission considered the exemptions from the prohibition on conflicted remuneration. Conflicted remuneration is any benefit connected with the provision of personal or general advice that could influence the choice of financial product recommended, or the advice given, to retail clients (s963A *Corporations Act 2001*). Section 963B(1)(a) exempts benefits for advice on general insurance products from the conflicted remuneration provisions.

The conflicted remuneration provisions were designed to create a market-based incentive for advisers to act in the interests of their clients by ensuring an adviser's main source of remuneration was from clients, rather than from third parties (such as product manufacturers).[8]

However, in considering the link between poor consumer outcomes and remuneration, it needs to be acknowledged that general insurance products are not like other financial products. As noted in the Explanatory Memorandum to the *Corporations Amendment (Future of Financial Advice Measures) Bill 2011*, "general insurance [products] are recognised as being simple in nature and are more widely understood by consumers. This means that there is a lower risk of consumer detriment in relation to the provision of advice on these products". It is typically the case that the consumer knows whether they want general insurance or not. Furthermore, general insurance products do not have an investment component; are usually subject to standard terms and conditions; are generally cancellable by the consumer; and are of limited duration, usually 12 months.

Retail general insurance is sold either directly to the consumer by the insurer or through an intermediary. Intermediated sales include distribution through an agent or authorised representative of the insurer, or through an agent of the consumer (such as an insurance broker). The large majority of intermediated sales are sales through an agent or authorised representative of the insurer; where the intermediary is only distributing the products of one insurer – for these sales, the possibility of conflicted advice is reduced given the limited product set. In any case, distribution of retail general insurance through these intermediaries is often conducted without the provision of personal advice. Other intermediaries acting on the consumer's behalf may provide personal advice, but this is not common for retail general insurance. Where advice is provided, the intermediary has a clear legal responsibility to act in the consumer's best interest.

For intermediated sales, commissions are a common method of remunerating product distributors for the service provided. There are costs for all forms of distribution. For intermediated sales, these costs are embodied in the commissions paid whereas for direct sales, these costs are internal to the insurer. Distribution costs include the cost of training staff and the cost of building IT systems to enable underwriting to occur at the point of sale.

Other jurisdictions (such as the United Kingdom) are different, where additional regulatory exemptions apply (such as for 'incidental arrangements'), so distribution channels can operate without the need for more onerous compliance costs and obligations. Without

[8] Commonwealth Treasury, Key Reforms in the Regulation of Financial Advice: Royal Commission Background Paper 8, page 8

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similar exemptions in Australia, it is important that distribution channels here are appropriately remunerated for their time and compliance costs in providing financial services.

Given the unique nature of general insurance and the market structures within which it is sold, the Insurance Council does not support a blanket ban on commission-based remuneration arrangements.

Restrictions on commissions may be beneficial in some situations
The Insurance Council recognises that in certain situations remuneration arrangements can incentivise poor behaviour.

As explained in our response to the policy questions arising from Round 6 hearings, the Insurance Council sees merit in the Government exploring the options for regulatory action, such as the imposition of caps, to ensure commissions are not so significant that they distort consumer outcomes. This could be accompanied by greater transparency about commission payments, such as more effective disclosure of the portion of the premium attributable to commissions and other intermediary fees. Any such reform should be confined to retail general insurance policies, should follow extensive consultation with industry, and should be mindful of differences across the suite of general insurance products and the associated variation in the level of commissions in the market.

Contact for further information

If you would like to any further information in relation to matters addressed in this submission, please contact Mr John Anning, the Insurance Council's General Manager Policy, Regulation Directorate, on tel: [redacted] or email: [redacted]

Yours sincerely

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