



13 November 2017

Dr Patrick Hodder
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Dear Dr Hodder

Unfair terms in insurance contracts

The Financial Services Council (**FSC**) appreciates the opportunity to provide additional information to the Committee on Proposal 10 of Final Report for the Review of Australian Consumer Law.

Proposal 10 relates to the application of Unfair Contract Terms (**UCT**) protections to contracts regulated by the *Insurance Contracts Act 1984* (Cth), specifically, contracts of life insurance.

The FSC maintains that Proposal 10 is out of proportion to the size of any perceived issues attaching to life insurance.

The FSC has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, licensed trustee companies and public trustees. The industry is responsible for investing more than \$2.7 trillion on behalf of 13 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 third largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

The FSC's submission is limited to life risk insurance contracts. This paper is set out into sections as follows:

1. **Review of Australian Consumer Law**
2. **Purpose of the IC Act**
3. **The FSC Life Insurance Code of Practice**
4. **Critical Observations**
5. **ACL Test of Unfairness v Duty of Utmost Good Faith**
6. **Terms in life policies**
7. **Reinsurance Treaties**
8. **Benefit analysis**

If you have any questions in relation to material outlined in this submission, please do not hesitate to contact me on .

Yours sincerely

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1. Review of Australian Consumer Law

- 1.1 The FSC has previously made submissions in response to:
 - 1.1.1 2010: *Unfair Terms in Insurance Contracts: Options Paper (Options Paper)*; and
 - 1.1.2 2012: *Unfair Terms in Insurance Contracts Draft Regulation Impact Statement for Consultation Paper (Consultation Paper)*.
- 1.2 The Australian Consumer Law (**ACL**) commenced operation in 2011. It included a national unfair contract terms (**UCT**) regime covering standard form consumer and small business contracts. The UCT law specifically excluded contracts covered by the *Insurance Contracts Act 1984* (Cth) (**IC Act**). The ACL protects against the use of UCTs in standard form contracts by enabling courts to declare a UCT void, with the contract continuing to operate where possible.
- 1.3 On 19 April 2017 the Consumer Affairs Australia and New Zealand Final Report for the Review of Australian Consumer Law was published, being the first broad review of national consumer law since its commencement (**Final Report**). Relevantly, the Final Report assessed new and emerging issues to ensure the law reflects developments to Australian consumer products and ensures future flexibility for when new products enter the market.
- 1.4 The underlying intention of the review was for the ACL to operate as a generic, economy-wide law that minimises exemptions where possible, particularly where those exemptions are no longer considered appropriate, or in the public interest. A number of Proposals have been identified.
- 1.5 **Proposal 10** of the Final Report relates to the application of UCT protections to contracts regulated by the *Insurance Contracts Act 1984* (Cth) (**IC Act**), including contracts of life insurance.
- 1.6 Proposal 10 is identified as a legislative proposal requiring further development and/or regulatory impact assessment.
- 1.7 The Final Report states that while the IC Act contains its own protections for consumers, these are not the same as those contained in the ACL and have not been shown to provide equal or greater consumer protection.
- 1.8 The FSC maintains that Proposal 10 is out of proportion to the size of any perceived issues attaching to life insurance. The IC Act provides sufficient protection to consumers within its current framework against any contract terms operating unfairly. Any additional test of unfairness that does not build on existing protections, and does not pay regard to the special nature of life insurance, will be a backward step in a framework which is otherwise working effectively and appropriately.
- 1.9 If Proposal 10 is applied, the outcome will be two separate and potentially contradictory approaches, inevitably leading to legal confusion. This is not in the interests of consumers.

- 1.10 Any material shortfalls in the IC Act should be addressed by amendments to the IC Act, rather than through the application of an untested UCT regime. Any amendments would need to be carefully assessed to exclude unacceptable outcomes.

2. Purpose of the IC Act

- 2.1 The long title of the IC Act states that it is:

An Act to reform and modernise the law relating to certain contracts of insurance so that a fair balance is struck between the interests of insurers, insureds and other members of the public and so that the provisions included in such contracts, and the practices of insurers in relation to such contracts, operate fairly, and for related purposes.

- 2.2 In effect, the IC Act has operated for over 30 years with the intention of applying principles of fairness set out in the long title, and to strike a fair balance between various interests. This notion of a “fair balance” in this context requires a targeted recognition of the specific nature of contracts of life insurance and the interests of insurers.
- 2.3 This fair balance is more effectively achieved by the ongoing use of existing principles supported by a long history of jurisprudence, rather than by introducing untested, non-specific principles which are outside of life insurance in this jurisdiction.
- 2.4 Put simply, the test of fairness for contracts of life insurance should be judged in accordance with the application of the duty of utmost good faith, and not the UCT regime in the ACL.
- 2.5 The exclusion of contracts of life insurance for the UCT regime is based on the rationale that rights and remedies, including UCT considerations are embedded in the Act. For example:

ss35 and 37	These set out the obligation of the insurer to notify the proposed policy holder before a contract is entered into of terms that may limit liability or of any unusual terms. The consequence of failure to notify includes that the insurer is not able to rely on the provision that had not been notified to the policy holder
ss21 and 21A	These set out the insured’s duty of disclosure to the insurer before the contract is entered into and limits that duty by reference to what the insured knew and questions asked by the insurer
ss 26 and 27	These provide that certain statements made by the insured or the failure to give an answer or complete answer shall not be taken to be misrepresentations

ss 29, 30	These set out the limited remedies to the insurer in the event of non-disclosure or misrepresentation by the insured
s31	A Court may disregard the insurer's avoidance of the policy where it would be harsh or unfair not to do so
ss 46 and 47	These limit the rights of the insurer to reduce or exclude liability for defects or pre-existing conditions of which the life insured was not reasonably aware
s52	This prohibits the insurer from contracting out of the protective provisions of the Act
s54	This prohibits the insurer's refusal to pay a claim for acts of the insured after the contract was entered into

- 2.6 The IC Act has been specifically drafted over time with a strong understanding of the nature of insurance law, including the specific ability to deal with long term contracts such as those relating to life insurance. It is industry specific and generally, far more complex than general commercial contracts.

3. The FSC Life Insurance Code of Practice (Code)

- 3.1 Further to the comments made above regarding the duty of utmost good faith, the life insurance industry has voluntarily developed and implemented a Code setting out key commitments and mandatory obligations to customers on standards of practice, disclosure and principles of conduct for life insurance services. The Code is monitored by an independent committee which is administered by Financial Ombudsmen Service (**FOS**), to ensure effective compliance by life insurers and compliance with the Code became mandatory on 1 July 2017. Sanctions may apply if insurers breach the Code. It effectively increases consumer protections beyond the legislative and regulatory framework currently in place.

- 3.2 Relevantly, Section 3.1 of the Code relates to the introduction of new policies from 1 July 2017. Insurers will:

- 3.2.1 define suitable customers for the product;
- 3.2.2 include benefits intended to cover genuine risks that generally affect the relevant customers;
- 3.2.3 incorporate plain language into sales and policy information, and consumer-test the plain language information required in other parts of the Code;
- 3.2.4 ensure that the policy information for policies sold directly to individuals (with no financial adviser/planner or Group Policy-owner) is clear and informative for a consumer to reasonably assess the suitability of the policy for them; and
- 3.2.5 regularly review on-sale products to ensure they remain generally suitable for the relevant customers. Products will be re-designed where necessary.

- 3.3 It is submitted that the legislative and regulatory framework, supplemented by the new Code, provides significant, targeted and industry specific protection to consumers. As such, it remains unlikely that a more general consumer protection in the form of a one-sized test of “unfairness” can enhance outcomes for consumers.

4. Critical Observations

- 4.1 Whilst we agree that exemptions relating to UCTs should be minimised, it is not agreed that the exemption relating to life insurance is inappropriate, or outside of public interest concerns, such that there is any reasonable basis for the exemption to be removed.
- 4.2 There is no data evidencing a failure to address any UCTs within the current protective framework. The insurance based examples and observations provided in the Final Report relate to contracts of general insurance, which more easily lends itself to the proposed changes. Contracts of life insurance however, do not.
- 4.3 We continue to caution against an assessment of contracts of life insurance with data and observations relating to general insurance. The two are distinct, both in design and remedies, being the reason why contracts of insurance were originally carved out of previously proposed amendments to unfair contracts terms legislation.
- 4.4 We do not believe that a case has been made in relation to the incidence of unfair terms in contracts of life insurance. To extend the UCT legislation to these contracts will encourage forum shopping and increased litigation costs in defending baseless or unmeritorious claims. These costs may need to be passed on to consumers without any material benefit.
- 4.5 The FSC maintains the view that the UCT regime in the ACL is incompatible with contracts of life insurance. Specifically:
- 4.5.1 The UCT provisions apply to standard form consumer contracts. Contracts of life insurance are not standard form contracts. Each contract has unique characteristics such as long duration (cover can be for a lifetime), with the opportunity for multiple policy owners / lives insured, transfers of ownership, transactions and claims in the life of the contract.
- 4.5.2 When entering into the contract, there is a significant opportunity for consumers to ensure that the correct terms are issued through detailed disclosures and representations. The insurer has limited control, with any errors on the part of the consumer often not being apparent for many years, if at all.
- 4.5.3 Contracts of life insurance are non-cancellable by the life insurer (other than in specific circumstances, such as the non-payment of premiums);
- 4.5.4 The circumstances in which unilateral amendment is allowed is narrow and prescribed by legislation;

4.5.5 Contract pricing (including reinsurance arrangements) is subject to actuarial modelling to ensure that contract terms will apply as intended.

4.5.6 Most flagship life insurance products offered by major insurers are rated by rating agencies, which analyse policy definitions, benefit designs, exclusions and other aspects of the life insurance contract in detail when formulating ratings. Life insurers have a strong commercial incentive to obtain a good rating for their products, as the rating is an important factor to obtaining support and confidence from intermediaries, especially financial advisers who are legally obligated to act in the best interests of their clients when recommending a life insurance product.

4.6 As matters stand, consumers can access remedies by alleging a breach of the duty of utmost good faith contained in the IC Act and insurers are prevented from relying on terms which breach that duty. The applicable case law does not indicate that the legislation is inadequate.

4.7 While we accept that some recently publicised claims highlight the need for life insurers to have processes to update medical definitions in their policies, these cases do not indicate that the relevant policies contained unfair terms at the time they were entered into. Extending the UCT regime to life insurance policies would not address the issue of out-dated medical definitions in life insurance policies. This issue is being addressed by the FSC Life Insurance Code of Practice, which obliges life insurers to have processes to review their medical definitions on a regular basis.

5. ACL Test of Unfairness v Duty of Utmost Good Faith

5.1 The ACL protects against the use of UCTs in standard form contracts by enabling courts to declare a UCT void, with the contract continuing to operate where possible with reference to a three-limbed test for unfairness which states that a term of a consumer contract is unfair if:

- a. it would cause a significant imbalance in the parties' rights and obligations arising under the contract; and
- b. it is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term; and
- c. it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

5.2 Assuming a term can be relied on by a life insurer to refuse a claim, limbs (a) and (c) are both necessary and expected. As such, they cannot also exist within an insurance test of whether a term is unfair. This leaves limb (b) which of itself, is an unsatisfactory test and one which could impact detrimentally on the application of the duty of utmost good faith provisions in the IC Act.

5.3 The IC Act describes a contract of insurance as a contract based on the utmost good faith, and there is implied in such a contract a provision requiring each party to it to act towards the other with the utmost good faith in relation to any matter arising in relation to the contract. A breach of the duty is a breach of the IC Act. (*ref: s 13*)

- 5.4 The duty of utmost good faith is a fundamental concept and guiding principle of life insurance. Whilst it is not defined in the IC Act, it has existed as a common law concept for hundreds of years. Common threads on its meaning include elements of “fairness”, and “acting in conformity with community or commercial standards of decency and fairness”. It requires more than honesty on the part of the insurer.
- 5.5 There is significant associated jurisprudence, including High Court authority, on the notion of “fairness” within the duty of utmost good faith as expressed in the IC Act. Any new test, especially when expressed as a formulation of “unfairness” rather than “fairness” is unnecessary, repetitive, potentially confusing and could undermine the duty of utmost good faith by reducing its flexibility and adaptability.
- 5.6 Rather than the UCT regime applying to contracts of life insurance, it is arguable that the test for unfairness in the ACL should adopt the existing duty of good faith with its essential element of fairness.
- 5.7 The IC Act provides that if reliance by a party to a contract on a provision of the contract would be to fail to act with the utmost good faith, the party may not rely on the provision. (*ref: s14*). In effect, it is an existing UCT regime as it prevents unfair reliance. It is not necessary that a term be found to be inherently unfair. A term may be fair or unfair in its application, but s 14 of the IC Act will prevent that term from being relied on. As such, s 14 operates more widely and fairly than the UCT regime which is based on a term itself being unfair in accordance with the three-limbed test set out above.
- 5.8 Section 14A of the IC Act was added in 2013 to make a breach of the duty of good faith in the handling or settlement of a claim or potential claim a reportable matter with potential consequences for the insurer’s licence. In the same tranche, ASIC acquired the power to intervene in civil proceedings where there is a breach of the IC Act.
- 5.9 Given the existing IC Act provisions works in a directed and specific manner to address the special nature of contracts of life insurance, it is unlikely that a more general consumer protection in the form of a one-sized test of “unfairness” can enhance outcomes for consumers.
- 5.10 On 9 May 2017, the Federal Government announced a new framework for dispute resolution, being the Australian Financial Complaints Authority (**AFCA**), scheduled to commence on 1 July 2018. AFCA will be overseen by ASIC and will replace the SCT, FOS and Credit and Investments Ombudsman (**CIO**). To introduce the UCT regime at this time will simply add to potential confusion and inefficiencies.
- 5.11 Before any further steps are taken, it is submitted that proper investigation occur into how the UCT regime could be said to provide a superior mechanism to those currently in place. As detailed above, consumer interests in contracts of life insurance, including the terms that apply, are properly protected by the existing body of laws and forums. The end-to-end consumer experience is already subject to a high degree of legislative intervention.

- 5.12 In addition to the sections detailed above, consumer protection is also provided through the following sections:

National Credit Code

Part 8 of the National Credit Code (contained in the National Credit Protection Act 2009 (Cth)) regulates credit-related insurance contracts (including insurance contracts over mortgaged property, consumer credit insurance, or insurance prescribed by the regulations, in connection with a credit contract) by placing restrictions on the financing of premiums of certain regulated insurance policies and the amount of commission paid to insurers. Additionally, the National Credit Code imposes obligations on insurers to supply documentation to debtors and, where relevant, inform debtors of rejections for cover. It also links the termination of credit contracts to the termination of insurance.

Corporations Act & ASIC Act

Furthermore, the consumer protection provisions in both the Corporations Act 2001 (**Corporations Act**) and the ASIC Act apply to most insurance products, including contracts of insurance and specifically life policies, and financial services in respect of the provision of such products. For example, there are provisions prohibiting misleading or deceptive conduct, unconscionable conduct, and the making of false or misleading representations. The Corporations Act also imposes an extensive licensing, disclosure and conduct regime in respect of the issue, sale and distribution of financial products, including contracts of life insurance.

These provisions above apply notwithstanding section 15 of the IC Act, because the relief under these legislative regimes are not of the kind contemplated under section 15.

The Financial Ombudsman Service

FOS, in resolving disputes, is required by its Terms of Reference (**TOR**) to have regard to legal principles (including common law and the terms of relevant legislation such as the IC Act and the Corporations Act) when deciding disputes but is not bound to strictly apply such legal principles. FOS must decide what, in its opinion, is fair in all the circumstances (TOR paragraph 8.2).

Accordingly, it is not necessary to include additional remedies under the IC Act to assist FOS in deciding the cases which come before it as it already has a mandate to decide what is fair in all the circumstances regardless of other available legislative and common law rights and remedies. Further, FOS will not be bound by any unfair terms provisions in the IC Act in deciding the disputes before it.

Life Insurance Act 1995 (Life Act)

Section 32 of the Life Act requires a life company, in its investment, administration and management of the assets of a statutory fund, to give priority to the interests of policyholders and prospective policyholders referable to that fund. In addition, section 48 of the Life Act requires a director of a life company to take reasonable care and to use due diligence to ensure that the life company gives priority to the interests of policyholders and prospective policyholders in preference to those of its shareholders, where these are in conflict, and imposes personal liability on directors for loss suffered where a breach of this statutory rule has occurred.

Importantly, section 9A of the Life Act provides controls on policy terms in that the insurer cannot issue continuous disability policies that enable the unilateral variation of terms (except where the variation will improve the benefits for the policy holder). Further premiums cannot be varied in a manner that singles out an individual policy holder.

General legal doctrine that applies to risk insurance contracts

In addition to protections embedded in the IC Act and Life Act, significant protection to consumers also lies in the operation of the *contra proferentum* rule. That rule requires that ambiguous terms in the contract be construed against the party that drafted the term. That is, any ambiguity will always be construed against the insurer and in favour of the consumer.

Design and Distribution Obligations and Product Intervention Power- Proposals Paper 2016

As you would be aware, following the 2014 Financial Services Inquiry, the Government is considering a proposal to introduce obligations regarding the design and distribution of financial services products and providing ASIC with a product intervention power.¹ If introduced, this would provide consumers with further protection in relation to the design of products that are targeted to them.

6. Terms in life policies

6.1 The objective of the *Life Act* is to:

...protect the interests of the owners and prospective owners of life insurance policies in a manner consistent with the continued development of a viable, competitive and innovative life insurance industry (sub-section 3(1)).

6.2 The assessment and pricing of risk is core to the business of life insurance and are directed at maintaining the long term sustainability of life insurance companies, in the interests of policy holders and other stakeholders. Life insurers are closely regulated in order to meet this objective. The Life Act and prudential standards provide for the 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.

6.3 Before a life insurance product can be issued, it must receive the advice of its appointed actuary as to the “proposed terms and conditions” of the policy (paragraph 17, Prudential Standard LPS 320 Actuarial and Other Matters. Prudential standards are issued by the Australian Prudential Regulation Authority under s230A of the LIA and have the force of law).

¹ Treasury Design and Distribution Obligations and Product Intervention Power Proposals Paper December 2016.

- 6.4 In providing this advice, the appointed actuary undertakes investigations of the financial viability of the proposed policy, to determine whether the risks being undertaken are appropriately priced in the context of the policy terms, benefit design, targeted demographic group and projected claims experience.
- 6.5 The FSC maintains the view that whilst an individual policyholder may be aggrieved when an exclusion or limitation clause contained in the contract of life insurance is applied to decline or reduce a claim payment, the existence of such clauses are necessary for the prudent management of insurance risk, in order to protect the financial viability of life insurers in the long term interests of policyholders as a whole.

7. Reinsurance Treaties

- 7.1 Reinsurance is a critical component of the life risk contracts. The transference of the financial risk from the insurer to the reinsurer is dependent on an understanding of the policies that fall within that insurance arrangement and the terms of those policies, particularly what may or may not be excluded from benefit payments.
- 7.2 Reinsurance arrangements may be long or short term and the risk may be spread across several reinsurers or partially spread between the insurer and reinsurer. By entering into a particular type of reinsurance arrangement, the life insurer may be able to create a more balanced portfolio of insured risks. Reinsurance assists insurers to redistribute or diversify the risks associated with insurance policies. This leads to a greater predictability in the portfolio results and income smoothing.
- 7.3 Any UCT regime needs to consider the impact on reinsurance arrangements. If there is uncertainty in the scope of cover under a life policy, the insurer has the additional risk that the reinsurer may not support the risk. There is also a possible precedent value in a finding that a significant contract term, such as an exclusionary provision, is unfair. Given that exclusions usually apply in a uniform way across a book of business for the same type of cover (and most likely those exclusion provisions would also apply in similar contracts across the life insurance industry), a finding in respect of one consumer is likely to set a precedent across the insurer's book of business as well as potentially across the industry itself.
- 7.4 The FSC maintains that the more balanced, fair and appropriate method for this to occur is under the IC Act where the insurer's and consumer's conduct is and can continue to be tested against the specific requirements of the IC Act.

8. Benefit analysis

- 8.1 The FSC is of the opinion that for the reasons discussed above, the existing regulatory framework provides targeted and appropriate protection for consumers against harsh and/or unfair terms in life risk policies, and it is unlikely that Proposal 10 will have any real effect on the terms of such contracts and therefore provide little, if any, benefit to consumers.

- 8.2 In addition, the UCT regime in the ACL has the potential to compromise the balance achieved through current protective regimes of the interest of the consumers and life insurers. This balance is achieved in large part by legislation which comprehensively addresses the more typical issues that arise in relation to life risk contracts and in the Life Code which applies to all major life insurers.
- 8.3 The Australian Consumer Law contains a list of examples of the kinds of terms of a consumer contract that may be unfair. We have considered each in the context of life insurance contracts in the table below.

ACL example	Life insurance contract experience
A term that:	
permits one party only to avoid or limit performance of the contract	The IC Act prescribes the circumstances in which a life insurance company can avoid or limit the performance of a life insurance contract.
permits one party only to terminate the contract	All life insurance contracts allow the policy holder (the consumer) to terminate the contract at any time. S 59A of IC Act will limit the circumstances in which a life company can terminate a life insurance contract.
penalises one party only for breach or termination of the contract	Provisions of this kind are not included in life insurance contracts.
permits one party only to vary the terms of the contract	The Life Act (s9A) in effect prohibits certain life risk contracts from unilateral variation by the insurer except for changes to premiums and beneficial changes for the life insured. Industry practice, driven by the IC Act and market forces, is such that life companies reserve to themselves very limited powers to vary the terms of life insurance contracts - for example to increase premiums in respect of a class of policyholders. These limited powers of amendment are necessary to ensure the continued viability of a life company's business.
permits one party only to renew the contract	Life risk policies work on the basis that only a policyholder (the consumer) will have the right to renew a life insurance contract.
permits one party only to vary the upfront price of the contract without giving the other party the right to terminate the contract	Policyholders will always be able to terminate a life insurance contract. Again, the right to vary premiums reflect the need to ensure the continued viability of a life company's business.

	Information about premiums and the right to vary are clearly set out in disclosure documents and quotes the consumer received prior to entering the contract.
permits one party to unilaterally vary services supplied under the contract	As for the power to vary the terms of the contract.
limits one party's vicarious liability for its agents	Provisions of this kind are not included in life insurance contracts.
Permits one party to assign the contract to the detriment of the other party without their consent	It is not possible for a life company to assign a policy or its rights under a policy. It would require the policyholder's direction to do so or under very limited circumstances of a court approved scheme (refer to Part 9 of the Life Act).
Limits one party's right to sue another party	Provisions of this kind are not included in life insurance contracts.
Limits the evidence that can be adduced in proceedings relating to the contract	Provisions of this kind are not included in life insurance contracts.
Imposes the evidential burden on one party in proceedings relating to the contract	Provisions of this kind are not included in life insurance contracts

- 8.4 The introduction of a new legislative regime would, inevitably, result in increased compliance costs for life insurers, primarily relating to responding to complaints and defending claims that particular terms of insurance contracts are unfair, irrespective of merit. There will be the potential for a policyholder to bring multiple claims in multiple forums based on a single complaint, resulting in increased costs, time and resources in responding and/or defending the claims in a tribunal or court. These additional costs will, in the ordinary commercial course, be passed on to consumers, who will not have gained any advantage or greater protection for the cost imposed upon them.
- 8.5 Conversely, where a UCT claim has merit, it is submitted that the current framework provides consumers with the proper remedies.