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Dear Mr Spear

EXTENDING UNFAIR CONTRACT TERMS TO INSURANCE CONTRACTS

The Insurance Council of Australia¹ (Insurance Council) appreciates the opportunity to comment on the draft *Treasury Laws Amendment (Unfair Terms in Insurance Contracts) Bill 2019* (the draft Bill) and the accompanying materials.

The Insurance Council and its members have carefully considered recommendation 4.7 of the Financial Services Royal Commission's (FSRC) Final Report concerning the extension of unfair contract terms protections to insurance contracts. We support that extension in a manner that genuinely assists consumers. However, we are seriously concerned that the draft Bill, if enacted, would harm rather than improve consumer outcomes. In its current form, the draft Bill would operate more severely, by prescribing special rules on insurance, and create far more uncertainty, than the general UCT regime² does for other sectors of the economy. If insurers cannot rely on the terms forming the basis of their contracts, they will need to reprice the risks being underwritten and there will be significant implications for their reinsurance arrangements and the capital they need to hold. In turn, this will likely affect the scope of policy coverage and lead to higher premiums for consumers. In particular circumstances, insurers will be pressured to withdraw cover entirely.

Main Subject Matter

In the draft Bill, the 'main subject matter' for insurance contracts is limited "to the extent that it describes what is being insured". (schedule 1, item 3, subsection 12BI(4) of the *Australian Securities and Investments Commission Act 2001* (ASIC Act)). With this narrow definition,

¹ The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent approximately 95 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. June 2019 Australian Prudential Regulation Authority statistics show that the general insurance industry generates gross written premium of \$48.4 billion per annum and has total assets of \$128.4 billion. The industry employs approximately 60,000 people and on average pays out about \$151.4 million in claims each working day.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

² Contained in the ASIC Act and the equivalent provisions in the Australian Consumer Law.

the terms of an insurance contract setting out the risks covered would be reviewable, and the insurer would be required to justify why they are necessary to protect their legitimate interests. As previously submitted³, the terms describing the risks an insurer covers (which is used as a basis for determining the premiums charged by insurers) goes to the commercial bargain at the heart of the contract and are necessary to protect the interests of the insurer. Being required to justify the specified cover in the insurance policy is more onerous than what is required in other sectors. For example, a cleaning service is not required under the existing UCT regime to justify terms setting out areas that it will and will not clean. The failure to exclude from review terms in insurance contracts relating to the risks an insurer will and will not cover causes significant uncertainty. The scope of application of the proposed UCT regime in the draft Bill and impact of the uncertainty created by this scope on insurers will be significant, and will be passed on to consumers.

The design of the UCT regime should be informed by the experience of internationally comparable jurisdictions

In the FSRC Final Report, Commissioner Hayne referred to Treasury's proposals paper⁴ and noted:

"the extensive consideration that has been given in recent years – in Australia and overseas – to the question of whether UCT regimes should apply to insurance contracts. I need not repeat here the details of those inquiries or the experiences in comparable overseas jurisdictions. The important point is that this body of work consistently tends in favour of the application of such a regime to insurance contracts. In my view, this is unsurprising. The considerations that render a UCT regime appropriate for other contracts for financial products and services apply equally to insurance contracts." (p304)

The Insurance Council and its members support the application of a UCT regime to insurance contracts in a manner that is informed by the experiences of international jurisdictions. In Europe, the European Commission's 2017 evaluation of its consumer directives concluded that the unfair contract terms protections available in the region remain fit for purpose. Under that approach:

"...the terms which clearly define or circumscribe the insured risk and the insurer's liability shall not be subject to such assessment since these restrictions are taken into account in calculating the premium paid by the consumer;" (European Council Directive 93/13/EEC)

The Insurance Council submits that adoption of the European approach to the main subject matter of the contract would allow insureds to challenge terms which unfairly prevent them from receiving the protection which they thought they had purchased, while giving insurers certainty that the commercial basis of the insurance contract would not be undermined.

³ See the Insurance Council's submission of 24 August 2018 (available from www.insurancecouncil.com.au)

⁴ Treasury (June 2018) "Extending unfair contract terms protections to insurance contracts" (available from <https://treasury.gov.au/consultation/c2018-t284394>)

A UCT regime based on a broad definition of the 'main subject matter' genuinely assists consumers

In formulating recommendation 4.7 of the FSRC Final Report, the Commissioner provided this particular example of a term that should be reviewable for unfairness:

If we decide to pay you what it would cost us to rebuild or repair ... we will pay you ... the amount that we determine to be the reasonable cost of repairing or rebuilding. *The amount that we determine to be the reasonable cost will be the lesser amount of any quotes obtained by us and/or by you for the rebuild or repair. Discounts may be available to us if we were to rebuild or repair.* (p307, original emphasis)

We believe the terms in this example would be reviewable under a broad definition of the main subject matter. The onus would then shift to the insurer to demonstrate the necessity of those terms to protect its legitimate interests, and this not dissimilar to the application of the current UCT regime to other sectors of the economy.

Similarly, it has been suggested that the following terms, commonly raised by consumer groups⁵, would only be reviewable for unfairness under a narrow definition of the 'main subject matter' of the contract. We do not agree with this view.

Example A

A term that would allow the insurer to require the insured to pay an excess, before the insurer pays the claim.

Example B

A term in a contract that is linked to another contract (for example a credit contract) which limits the insured's ability to obtain a premium rebate on cancellation of the linked contract.

Example C

"Under Third Party, Fire and Theft or Third Party Property Only cover, up to \$5,000 or the car's market value, whichever is the lesser, for accidental damage to the car, if there was an uninsured third party motorised vehicle involved and if:

... we agree that the third party was completely to blame for the accident; you provide us with the name, residential address, contact phone number and vehicle make and registration number of the other party;...".

For each of the examples, the Insurance Council considers that, if the clause concerned were thought to be unfair, redress could be sought by either consumers or ASIC as none of these terms would fall within the broader subject matter exemption or any other exemptions as formulated above. The onus would then shift to the insurer to demonstrate the necessity of those terms to protect its legitimate interests. For example, with respect to Example C, the information required of the consumer is required to be able to recover the loss from the third party's insurer, especially given no premium is charged for this benefit and without this term the insurer's interests would be harmed. The term is also used to deter fraud.

⁵ See Consumer Action Law Centre (February 2018) "Denied: Levelling the Playing Field to Make Insurance Fair"

A narrow definition of the ‘main subject matter’ would harm rather than improve consumer outcomes

Under the proposed narrow definition of the main subject matter, the terms of an insurance contract setting out the risks covered would be reviewable. This undermines the commercial certainty necessary for the stable and sustainable long-term performance of the insurance industry. In many regions of Australia with elevated risk profiles, the business case for offering insurance is already marginal or unsupportable. In this context, the uncertainty associated with the draft Bill would put greater pressure on insurers and force some to withdraw from the market.

For example, the ACCC’s Northern Australia Insurance Inquiry confirmed that *“Insurers incurred heavy losses in northern Australia earlier this decade due to the impact of a number of damaging weather events, and while insurers’ financial performance in northern Australia has significantly improved in recent years, the region remains unprofitable for the industry in aggregate.”* The draft Bill, if enacted in its current form, would exacerbate the insurance availability issues identified by the ACCC.

Similarly, research by PwC found that the professional indemnity insurance market for building certifiers and surveyors has been unprofitable since 2011. Since 2017, nearly \$3.43 has been paid out in claims for every \$1 received in premiums. The Insurance Council’s members confirm that their continued participation in the market is predicated on the validity of their cladding exclusions. If these exclusions are reviewable for unfairness, insurers will not be able to remain in the market.

Appendix A contains case studies that further illustrate the impact of the proposed UCT regime on a range of consumers.

The proposed narrow definition of the ‘main subject matter’ both creates substantial ambiguity and lacks flexibility

The explanatory memorandum accompanying the draft Bill provides as examples of the ‘main subject matter’ “the house, car or person that is insured” (paragraph 1.31). However, this narrow approach creates substantial ambiguity for many insurance products. For example, what is the thing being insured in relation to management liability insurance or a travel insurance policy?

Moreover, it would be difficult to identify the ‘thing’ being insured in a variety of new insurance products being innovated to meet changing consumer needs such as combined family products covering multiple risks. Overly limiting the ambit of the main subject matter exemption will cause the UCT regime to ultimately fail to keep pace with innovations in the changing insurance market.

Terms required, or expressly permitted, by a law of the Commonwealth

Under s12BI of the *ASIC Act*, “a term required, or expressly permitted, by a law of the Commonwealth or a State or Territory” is not subject to the UCT regime. The Insurance Council would welcome confirmation that this extends to all contracts specifically regulated by the *Insurance Contracts Act 1984* and associated regulations. This includes the standard cover provisions, and an insurer’s rights to cancel a contract under sections 28 and 60 of that Act.

Scope of the proposed UCT regime

The UCT regime contained in the draft Bill applies to insurance contracts where at least one party to the contract is a consumer (as defined in subsection 12BF(3) of the *ASIC Act*) or a small business (as defined in subsection 12BF(4) of the *ASIC Act*). Specifically, the requirements of subsection 12BF(4) of the *ASIC Act* are:

- at least one party employs fewer than 20 persons; and
- either of the following is met:
 - the upfront price payable does not exceed \$300,000; or
 - if the contract has a duration of more than 12 months, the upfront price payable does not exceed \$1,000,000.

The Insurance Council previously submitted⁶ that the monetary value of the contract is inappropriate for defining the scope of small business UCT protections in general insurance contracts. As noted in the Explanatory Memorandum to the *Financial Services Reform Bill 2001*:

“General insurance is treated differently from other financial products for two reasons. First, it is difficult to identify a meaningful monetary limit for insurance, as either the premium or sum insured could be used. Secondly, if the premium were relied upon, few (if any) policies would exceed the product-value test outlined below, with the result that all purchasers of general insurance policies would be retail clients.” (2.28)

This is supported by data from our members which indicates that the average annual premium for a small business customer is \$2,500.

Further, under the monetary value of the contract approach, identically sized small businesses may fall into or out of the UCT regime simply because of their risk profile. A high hazard small business which would have a higher premium compared to a lower hazard small business of the same size would have different UCT outcomes.

We submit that a better approach would be to limit the insurance contracts reviewable for UCT to those that are currently within the product category jurisdiction of the Australian Financial Complaints Authority (AFCA). This approach would obviate the need to distinguish between small and large business contracts on the basis of premiums. It has the merit of offering protection to parties that are vulnerable to unfair terms in standard form contracts. In particular, under the AFCA rules (rule C.1.4), AFCA must exclude a complaint about a general insurance policy other than a:

- (i) Retail General Insurance Policy;
- (ii) Residential Strata Title Insurance Product;
- (iii) Small Business Insurance Product;
- (iv) Medical Indemnity Insurance Product; or
- (v) Title Insurance Policy.

⁶ See the Insurance Council's submission of 21 December 2018 (available from www.insurancecouncil.com.au)

The AFCA rules and operational guidelines specify retail general insurance policies by reference to s761G(5)(b) of the *Corporations Act 2001*, and list small business insurance products as:

- Computer and electronic breakdown;
- Fire or accidental damage;
- Glass;
- General Property;
- Loss of profits/business interruption;
- Machinery breakdowns;
- Land transit;
- Money; and
- Theft

Under the AFCA rules, a small business insurance product also includes general insurance policies between a small business and a general insurance broker. However, as highlighted in our submission of 30 November 2018, where contracts are sold through a broker, they should not be dealt with as a “standard form contract”. This would reflect the intent of the UCT regime which applies to contracts where one of the parties has lacked the bargaining power to negotiate or change the terms of the contract when agreeing to it.

Medical indemnity

Consistent with its exemption from the product disclosure provisions under regulation 7.9.95 of the *Corporations Regulations 2001*, and given its unique nature, medical indemnity insurance contracts should not be caught as a standard form contract.

Medical indemnity cover provides pecuniary protection to medical practitioners in relation to claims arising from actual or alleged negligence or misconduct. In Australia, medical indemnity cover is provided primarily by not-for-profit mutual organisations. In 2003 a range of legislation was introduced to govern the provision of medical indemnity cover, including the *Medical Indemnity Act 2002* and the *Medical Indemnity (Prudential Supervision and Product Standards) Act 2003* (MIPSPS Act). It was noted in the Explanatory Memorandum to the MIPSPS Act at the time that the measures will impose additional costs on MDOs, which will be reflected in insurance premiums. The MIPSPS Act is a prescriptive piece of legislation which stipulates the manner in which medical indemnity cover be offered, and provided, by means of a contract of insurance. It mandates minimum product standards relating to minimum cover limits, retroactive cover, run-off cover and complying offers of cover.

Because of the unique and particularised nature of legislation concerning medical indemnity insurance, the Government has excluded medical indemnity cover from the design and distribution obligations and ASIC’s product intervention powers. The Government accepted that imposing product design and distribution obligations would unnecessarily duplicate and complicate the mandated minimum medical indemnity product features, including the prescribed minimum cover amount, under the MIPSPS Act.

Medical indemnity insurance is also subject to a number of government funded schemes, which oblige medical indemnity insurers to offer universal cover to any medical practitioner within agreed state-based jurisdictions. The concept of universal cover and its detrimental impact on insurers is also incompatible with the obligations under the UCT regime.

Interaction between UCT and the duty of utmost good faith

The draft Bill conceives of the duty of utmost good faith (contained in section 13 of the *Insurance Contracts Act 1984*) and the unfair contract terms provisions as operating independently. However, legal advice received by the Insurance Council highlights the potential customer confusion that could result from the overlap between the two regimes due to duplicate avenues for complaint and redress. The Insurance Council suggests that if a claimant has been successful with a claim under utmost good faith, the draft Bill should preclude them from bringing a claim for breach of UCT for the same cause of action. Equally, the converse should be included in the legislation.

Transitional arrangements

The proposed UCT regime involves a substantial change in risk exposures and insurers will need to renegotiate their reinsurance contracts. Reinsurance agreements vary between 12 months to 10 years. At the lower end, a 12 month reinsurance contract for catastrophes requires 6 months for renewal. Furthermore, reinsurance renewals typically involve international offices in cross-border negotiations. As such, the Insurance Council submits that a 2 year transition period is required for insurers to be ready to comply with the new laws.

Conclusion

The Financial Services Royal Commission examined the role of UCT protections in improving consumer outcomes. The Insurance Council and its members share that aim. We support the extension of UCT protections to insurance contracts in a manner consistent with international best practice and in a manner that genuinely assists consumers. However, as detailed in this submission, the draft Bill as it currently stands would harm rather than improve consumer outcomes.

If you have any questions or comments in relation to our submission, please contact John Anning, the Insurance Council's General Manager Policy, Regulation Directorate, on (02) 9253 5121 or janning@insurancecouncil.com.au.

Yours sincerely



Robert Whelan
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Appendix A: Case studies illustrating the effect of the proposed narrow definition of the ‘main subject matter’

Case Study 1: Flood

At present, some insurers:

- exclude flood cover in home building and contents policies,
- allow the customer to opt-out from the flood cover,
- include flood cover as a standard mandatory component of the cover.

Customers can choose the policy that best suits their circumstance (flood prone or not flood prone), their appetite for risk, and their household budget.

Customers who believe they do not have flood risk, or are prepared to accept the risk in return for a lower premium, buy policies that exclude flood as basic premise of the policy, or a policy that allows them to opt-out, thus discarding the cover.

Scenario:

During the time the policy is in force, the customer’s home is flooded and is extensively damaged. Under the proposed application of a narrow definition of subject matter, the customer may be able to challenge this exclusion on the basis that it was unfair.

Potential outcomes:

Should the exclusion in this case study be deemed unfair, insurers would need to adjust policies to remove customer choice and only allow the full inclusion of flood risk within the policy. They would pass on the cost, including risk uncertainty, to consumers.

The removal of customer choice would result in:

- The ability for consumers to manage their insurance costs being reduced.
- A significant increase in non-insurance in high risk areas, where customers have managed their own risks, but find themselves unable to find a policy that does not cover flood.
- An average 646% increase premiums for customers living in a high flood risk area (2% probability) no longer able to opt-out of flood cover. A sample of the premium changes are provided below.

Insurer	Premium – Flood Excluded	Premium – Flood Included
A	\$1,444	\$5,557
B	\$2,126	\$20,264
C	\$1,855	\$9,231

Case Study 2: Parametric Insurance

Parametric insurance is an innovative and increasingly popular approach to insurance provision internationally⁷. The product involves contracts where a claim is defined with reference to a pre-determined index. Often, the index seeks to reflect losses arising from weather and catastrophic events, attracted by the opportunity to avoid the cost and administrative delay from traditional services of insurance claims assessors who need to assess physical damage to the insured asset.

For example, a parametric insurance product that addresses cyclone exposure for a building in a highly exposed island location, pays the policyholder contingent on the following triggers:

- BoM declared Category 1,2,3 cyclone within 50km of building - no payment;
- BoM declared Category 4 cyclone within 50km, \$2,000,000, excess \$5,000;
- BoM declared Category 5 cyclone within 50km, \$4,000,000, excess \$25,000;

No damage to the insured building needs to be assessed, indeed no damage needs to have actually occurred. The trigger for payment is the BoM release of a cyclone intensity and track.

Scenario:

A policyholder who suffers damage from a category 3 cyclone would not be entitled to any payment under the policy, but they may challenge the contractual trigger on the basis that it is unfair under the proposed laws.

Potential outcomes:

If insurers cannot rely on the integrity of the contractual triggers, they will be forced to withdraw the product. This would result in reduced choices for customers in high risk locations who are seeking to manage their risk through innovative products.

Case Study 3: 'Reasonably Maintained'

Domestic insurance policies require the policyholder to confirm, at inception, the condition of the property - if a property is poorly maintained or not repaired, is in bad condition, and is far more vulnerable to damage from weather events.

An insurer will adjust the premium according to this increased risk, and in some cases may decline to offer cover, deeming to risk of a claim to be too high.

Scenario:

A customer owns a home in Proserpine (QLD) that suffered from the impact of Cyclone Debbie in 2017. The customer elected to take a cash settlement from their insurer at the time and manage their own repairs to the property.

⁷ See IAIS (2018) "Issues Paper on Index Based Insurances Particularly in Inclusive Insurance Market".

In 2019 the property owner insures with a new insurer and declares (when asked) that the property is well maintained and fully repaired.

During the time the policy is in force, the customer's home is extensively damaged by fire but they have only purchased \$600,000 of cover. With an estimated rebuild cost of \$900,000 the customer is underinsured and will need to partially finance the rebuild themselves. Upon assessment the insurer detects that the property was damaged in a previous event and not (or poorly) repaired. The insurer declines to cover the damage on the basis that the home was not well maintained or fully repaired.

Under the proposed UCT regime, the customer could challenge the insurer's decision on the basis that it is unfair.

Potential outcomes:

Should maintenance terms be reviewable for unfairness, insurers may need to adjust policies in high risk areas to assume a level of poor maintenance or disrepair in all properties.

The removal of the maintenance terms in a policy would impact customers who have maintained their property and conducted all necessary repairs. Most insurers decline to quote on properties where the customer indicates the home is in a state of disrepair or not well maintained (for example is not watertight). The limited number of insurers who would insure this type of risk provided premiums that were on average 56% higher than quotes for property declared as well maintained.

Case Study 4: Pet Insurance

Pet insurance policies typically contain an exclusion that vet expenses relating to breeding and obstetrics are not covered. This exclusion is in place to allow the insurer to offer an affordable product to the majority of pet owners. Furthermore, costs related to breeding and obstetrics are foreseen costs associated with a pet owner's choice to breed pets. The burden of justifying these terms, if clearly disclosed to policyholders, should not fall on an insurer, and creates a very real risk that insurers will need to remove long established and well-understood general exclusions which will result in detriment to all policyholders in the form of higher premiums. Using this example, this would mean that policyholders who do not breed their pets will be cross-subsidising those policyholders who do.