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Attention: Michelle Calder

UNFAIR TERMS IN INSURANCE CONTRACTS

DRAFT REGULATION IMPACT STATEMENT FOR CONSULTATION

The Insurance Council of Australia (Insurance Council) appreciates the opportunity to comment on the Unfair Terms in Insurance Contracts Draft Regulation Impact Statement (the RIS). The Insurance Council's specific responses to the questions posed in the RIS are contained in Attachment A.

In summary, it is our submission that:

- the existing regulatory regime for general insurance focused on the Insurance Contracts Act 1984 (Cth) (the IC Act) provides a strong level of consumer protection that is at least equivalent to that offered by the unfair contact terms (UCT) provision of the Australian Securities and Investments Commission Act 2001 (Cth) (ASIC Act);
- the RIS fails to sufficiently identify/quantify the problem or provide an adequate cost/benefit analysis to justify additional regulation;
- the application of the ASIC Act's UCT provisions to insurance contracts has the potential to lead to serious adverse consequences, for example in relation to availability of retail insurance products.

Adequate protection is already provided for consumers

The Government's stated objective in looking at this matter:

> *"… is to ensure that consumers who purchase insurance have an equivalent level of protection as that which currently applies to other financial products and financial services, and are thus, insofar as is reasonably possible, protected from actual or potential disadvantage or loss as a result of insurance contracts containing terms that are harsh and/or unfair."*[1]

The Insurance Council submits that the IC Act provides a high level of protection to consumers of general insurance products. In particular, the IC Act places an obligation on insurers and insureds to act with utmost good faith towards each other and prevents either party from relying on a contract provision that would be contrary to this requirement.

[1] Unfair Terms in Insurance Contracts Draft Regulation Impact Statement, December 2011, p21.

Furthermore, the protections that consumers enjoy in relation to general insurance products are bolstered by provisions of the Corporations Act 2001 (Cth) (the Corporations Act), the free (to consumers) external dispute resolution avenue provided by the Financial Ombudsman Service (FOS) and the General Insurance Code of Practice (the Code). Please refer to Attachment B for more detailed consideration of these existing protections.

It is worth noting that passage of the long awaited amendments to the IC Act following the Cameron/Milne Review would strengthen further the consumer protections offered by this Act. For example, the proposed section 14A of the IC Act Amendment Bill 2010 would make it clear that an insurer's breach of the duty of utmost good faith is a failure to comply with a financial services law. This will enable ASIC to apply against the offending insurer penalties such as suspension or cancellation of their Australian Financial Services Licence (AFSL). ASIC could also require an enforceable undertaking from an insurer to refrain from the use of terms found to be contrary to the duty of utmost good faith. These powers are commensurate with those available to ASIC in relation to UCT.

Failure to demonstrate the need for unfair contract terms provisions in general insurance

The RIS states that the problem to be addressed is:

> *"the current imbalance between protections offered under the existing regulation of insurance contracts and that which currently applies to other financial products and services, which may result in actual or potential disadvantage or loss to consumers due to insurance contracts containing terms that are harsh and/or unfair"*[2]

There are two claims within this statement. The first is an alleged 'imbalance' between the protections available to consumers of general insurance compared with protections available in relation to other financial products and services. The second is the notion that such imbalance may result in actual or potential consumer disadvantage. Before consideration is given to imposing additional regulation on the general insurance industry, evidence must be obtained to support both these claims.

Whilst insurance contracts are subject to different regulation in relation to UCT compared to other financial products, we do not accept that there is an 'imbalance' or a lesser standard of protection available to consumers of general insurance products. Furthermore, we submit there is no evidence that consumers are experiencing actual or potential disadvantage from the existing regulatory regime for general insurance.

The Commonwealth Office of Best Practice Regulation requires that a regulation impact statement should "provide information on the nature and magnitude of the problem and identify what government actions (if any) have been taken in the past to address the problem"[3]. The Unfair Terms in Insurance Contracts RIS does not provide any solid evidence that such an imbalance exists or that consumers are currently experiencing disadvantage or loss as a result of unfair contract terms. As we have stated previously, the Insurance Council is not aware of any data that would support the contention that there

[2] Unfair Terms in Insurance Contracts Draft Regulation Impact Statement, December 2011, p 5.
[3] Best Practice Regulation Handbook http://www.finance.gov.au/obpr/proposal/handbook/3-preparing-a-regulation-impact-statement.html#s32

are unfair terms in general insurance contracts which are causing consumers actual or potential loss or damage. Furthermore, the RIS does not demonstrate how existing remedies available to insureds are inadequate.

In assessing whether the current laws deal effectively with the perceived problem, the RIS notes the concern that many insureds do not read the policy document or Product Disclosure Statement and that there is a practical limit to reliance on pre-contractual disclosure to lessen the risk of 'surprises' to insureds.[4] However, we strongly submit that this issue is not one that the unfair contracts regime would solve.

Many of the examples cited in the RIS as potential examples of harsh or unfair contract terms relate to the use of exclusion clauses. The first example in the RIS, in relation to unattended luggage, is a type which is often cited. Whether a consumer has taken care to protect their luggage is a matter of degree. However, the fact that the term may result in a different outcome in differing circumstances does not make a term in a policy inherently unfair.

Whilst consumer advocates submit that the duty of good faith protections (section 13 and 14 of the IC Act) are rarely used as a basis for relief as consumers do not understand their rights to make a claim, a recent determination by FOS highlights the relevance of these provisions.

In Case Number 233410 (November 2011), the Applicant arranged a travel insurance policy and subsequently made a claim for theft of a bag, which was declined as the applicant left the bag unattended in a public place. In making a determination, the FOS applied both the law and fairness to the terms in the contract of insurance. The FOS Determination states there is potential to apply section 13 of the IC Act where the exclusion has been drafted so tightly that the cover becomes illusory. Paragraph 43 refers.

> *"43. By defining "Unsupervised" in such a strict manner, the insurer runs the risk that benefits under the policy become illusory because of what may appear to be absolute duty. If a decision maker took the view that a definition rendered the policy cover illusory and therefore in breach of the obligation to give the utmost good faith, the insurer may be denied the right to refuse the claim. Whilst I appreciate the need for insurers to clarify terminology, I feel bound to sound a warning that an insurer may fall foul of section 13 of the Insurance Contracts Act (the requirement to give the utmost good faith) and thereby lose the right to deny a claim."*

We submit it is misleading to claim that sections 13 and 14 are rarely used as a basis for relief. The provisions are clearly utilised in determinations by the FOS.

In addition, the nature of an insurance contract is such that limitations and exclusions are necessary to define the cover which the insurer is willing to provide. These enable the risk that the insurer is willing to provide to be matched with what the insured is willing to pay. We do not dispute that exclusions need to be transparent and disclosed to the insured. It appears that what is being advocated in some of the examples cited in the RIS is not the removal of 'unfair terms' but the removal of all exclusions, or in effect creation of a comprehensive all risks cover without limitation. We are unaware of any insurer who provides such cover and would query whether it would be available and, if so, affordable.

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[4] Unfair Terms in Insurance Contracts Draft Regulation Impact Statement, December 2011, p 16.

Using the unattended luggage example, it would be an open invitation to fraud if the insurer were not able to exclude instances where reasonable care had not been taken by the insured to safeguard their luggage. The policy would be expected to react if the insured had left their luggage in the middle of an airport. It would be extremely unlikely that an insurer would provide cover on such a basis.

Conclusion

For the reasons outlined above and detailed in the following attachments, the Insurance Council strongly recommends that the Government adopt the option of maintaining the status quo (Option A).

While not changing the law substantively, if it would give comfort to consumer advocates, the Insurance Council is willing (see response under Option B) to explore the possibility of clarifying in the IC Act that the duty of utmost good faith encompasses an obligation for both parties to an insurance contract treating each other fairly.

If the Government determines that public policy considerations require the application of the UCT provisions to insurance contracts, then for the reasons explained in Attachment A, the Insurance Council would urge the Government to adopt a "broad" definition of the main subject matter exemption.

Whether the UCT provisions in the ASIC Act should be applied to the IC Act (Option C) or similar provisions inserted in the IC Act (Option D) should be the subject of further consultation.

Relevant considerations include the scope of contracts to be subject to the UCT provisions. As the ASIC Act's UCT provisions only apply to consumer contracts, the removal of the exemption from judicial review provided by section 15 of the IC Act would create a divergent system of regulation for insurance contracts applying to retail customers and wholesale customers respectively – with the former being subject to the ASIC Act's UCT provisions and the IC Act and the latter regulated solely by the IC Act. This could lead to inconsistent interpretation and application of common terms between the two types of customers. Removal of section 15 would also make insurance contracts subject to State/Territory judicial review, with implications for the strength of the national regime of insurance regulation.

If UCT provisions are inserted into the IC Act under Option D, unless further amendments were made, it would result in insurance contracts for business being subject to review for unfair contract terms. On the other hand, application of the UCT provisions solely to retail (consumer) contracts would lead to the development of divergent business and consumer regulatory regimes within the IC Act. Option D would though preserve the IC Act as the main instrument of insurance contract regulation and provide scope for a main subject matter exemption tailored to insurance contracts.

However, we submit that the key issue for the Government's immediate consideration is not which piece of legislation contains the provisions, but whether a case has been made for the application of UCT to general insurance and if so, how to tailor the UCT provisions to more specifically meet the unique nature of insurance, including a meaningful definition of the main subject matter.

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

Yours sincerely

Robert Whelan
Executive Director & CEO

Attachment A

Chapter 2 - The problem
Consultation Question 1

A. In practical terms, is the current consumer protection provided in relation to the use of unfair terms in the Insurance Contract Act 1984 adequate?

B. Besides the provision of an additional legal avenue for consumers to explore if they are a party to a contract that has potentially unfair terms (if UCT provisions are introduced), are there any practical benefits for consumers?

C. Is there a reason for treating contracts of insurance different from other contracts relating to other financial products?

D. Will equivalent protection in respect to unfair contract terms lead to beneficial outcomes for consumers? If possible can you outline any situations where these benefits can be clearly identified?

E. What percentage of insurance contracts and types of insurance contracts are likely to be standard form contracts in accordance with section 12BK of the ASIC Act?

As explained in the covering letter, the Insurance Council holds that the IC Act provides consumers with more than adequate protection from unfair terms. On this basis, there does not seem any compelling reason to make insurance contracts subject to the UCT provisions of the ASIC Act. In the absence of any consumer benefit and considering the probable consumer and insurer detriment as detailed in the following responses to each of the options, retention of the status quo is the preferred outcome.

Although the application of the UCT provisions to insurance contracts would provide consumers with an additional legal avenue, it is unlikely many consumers will pursue a claim under unfair contract terms provisions when a cheaper alternative exists.

Under the Corporations Act, a condition of holding an AFSL is for insurers to both provide access to an Internal Dispute Resolution (IDR) service and also to be a member of an External Dispute Resolution (EDR) scheme which retail consumers can access for free. FOS is the EDR scheme to which insurers currently subscribe. The criteria for determination of disputes by FOS include not only consideration of legal principles, but applicable industry codes, good industry practice and what is fair in all the circumstances (see Clause 8.2 of the FOS Terms of Reference.).

It is important to note that FOS is not bound by precedent (although can have regard to it) and so can look at the individual circumstance of each case when making a decision. All determinations of FOS are binding on members but not consumers. If a consumer is dissatisfied with the outcome they can pursue legal action.

The Insurance Council has consistently argued that insurance contracts should be treated differently from other financial products. The insurance contract is the product purchased by the consumer. A general judicial power to review a contract and declare terms unfair (and therefore void) will have far more significant implications in the general insurance context. It could potentially force insurers to cover risks for which they have not collected premiums. Such uncertainty would be an adverse outcome as it is important to insurers that they are as certain as possible as to the risks they take on when underwriting and pricing risks.

It is likely that all retail insurance policies sold to individuals for non business purposes would be standard form contracts in line with section 12BK of the ASIC Act and so prima facie subject to the ASIC Act's UCT provisions.

Option A – Status Quo
(Consultation Question 2)
A. Please provide details of any additional costs or benefits of the status quo - if possible, please state the magnitude (either in dollars or qualitatively) of the costs and benefits?

	Benefits	*Costs*
Consumers	• Certainty • Affordability	
Industry	• Certainty • No unnecessary increase in compliance burden	
Government		

For the reasons explained in the covering letter, the Insurance Council submits that insurance policyholders enjoy equivalent, if not greater, protection than consumers of other financial services that are subject to UCT review under the ASIC Act. The Insurance Council therefore strongly recommends that the Government adopt the option of maintaining the status quo.

Option B – Enhance existing IC Act remedies
(Consultation Question 3)

A. Would you support changes to section 14 of the IC Act as a viable means to address the issue of unfair contract terms in insurance?

B. Are there any other changes to section 14 that would increase consumer protection from unfair contract terms?

C. What are the potential benefits to consumers (both monetary and non-monetary) - if possible, please state the magnitude (either in dollars or qualitatively) of the benefits?

D. From an industry perspective, what would be the potential compliance costs (both monetary and non-monetary) associated with this option – if possible please provide the magnitude of the costs and a breakdown of categories?

E. If this option is adopted will insurers:

(i) be likely to increase insurance premiums?

(ii) revisit some of their current contract offerings?

F. If this option is adopted, are there any:

(i) additional costs or benefits?

(ii) factors that impact on the options feasibility?

(iii) practical limitations on insurers that would impede their ability to comply with the changes?

	Benefits	*Costs*
Consumers	• Certainty • Affordability	
Industry	• Certainty • No unnecessary increase in compliance burden	
Government		

The Insurance Council is willing to explore the possibility of amending section 14 of the IC Act (either in the text or through a drafting note) to clarify that the duty of utmost good faith encompasses an obligation to act fairly.

The Insurance Council holds that this is already the case. In CGU Insurance Ltd v AMP Financial Planning Pty Ltd (2007) 14 ANZ Insurance Cases 61-739, their Honours Gleeson CJ and Crennan J said at paragraph 15:

> "an insurer's statutory obligation to act with utmost good faith may require an insurer to act, consistently with commercial standards of decency and fairness, with due regard to the interests of the insured."

The Insurance Council does not see that a clarification in section 14 would change the substantive law but it may give comfort and greater certainty to consumer advocates about the extent of protection provided to consumers under the IC Act.

Option C – Permit the unfair contract terms provisions of the ASIC Act to apply to insurance contracts
(Consultation Question 4)

A. What are the potential benefits to consumers (both monetary and non-monetary) of adopting this option - if possible, please state the magnitude (either in dollars or qualitatively) of the benefits?

B. From an industry perspective, what would be the potential compliance costs (both monetary and non-monetary) associated with this option - if possible please provide the magnitude of the costs and a breakdown of categories?

C. If this option is adopted will insurers:

(i) be likely to increase insurance premiums?

(ii) revisit some of their contract offerings?

D. If this option is adopted, are there any:

(i) additional costs or benefits?

(ii) factors that impact on the options feasibility?

(iii) practical limitations on insurers that would impede their ability to comply with the changes?

	Benefits	*Costs*
Consumers		• Possible increase in the cost of insurance • Risk of disadvantage from 'blanket' banning of terms • Confusion as to most appropriate remedy • Development of separate consumer and business regulatory regimes • Potential for limited or no access to cover in risky market segments
Industry		• Uncertainty • Increased compliance burden • Possible withdrawal of cover in risky market segments
Government		• Need to monitor appropriateness of separate consumer and business regulatory regimes

The following response is based on legal advice received by the Insurance Council (and provided to Treasury and the consumer advocates) concerning the operation of the exemption from UCT review which applies to terms that define the main subject matter of the contract. The legal authorities[5] indicate that the main subject matter of an insurance contract is taken to be, for example, the house or car over which insurance is taken. It is unlikely to be regarded at common law to equate to the scope of cover. This issue is explored in detail in response to RIS Options 1, 2(a) and 2(b).

The UCT provisions are not suited to insurance contracts

There are many factors that impact the feasibility of this option. The UCT provisions were not specifically drafted with insurance contracts in mind. Insurance contracts involve the application of individual terms to specific facts. Rather than voiding the term, it may well be a better outcome for the policyholder to apply a remedy as provided for in the IC Act (See the discussion under Option D on how the Act deals with terms on the Australian Consumer Law's (ACL's) list of potentially unfair contract terms.) Accordingly, we submit, the level of consumer protection is better and more appropriate under the IC Act.

We also note that while ASIC has a wide power to apply to the Court to make a variety of orders for the benefit of classes of persons, this may not necessarily be of practical benefit to insureds. Such a class of persons could include members of the public who are insureds under the same type of insurance contract but are not insureds under the particular contract in dispute. Determining whether a term is unfair can depend heavily on the circumstances of the particular case. We would query whether the application of declaratory powers across a broad class of consumers would involve appropriate consideration of individual circumstances. We submit that relief available under the IC Act does not pose such problems as any question of 'unfairness' is addressed on a case by case basis.

Potential implications of the removal of the exemption in section 15

The removal of the exemption provided in section 15 would potentially:

- reduce uniformity and consistency of insurance laws with respect to consumer contracts;
- the resulting uncertainty as to whether a term necessary to limit the insurer's risk could be found void may lead to increases in the cost of insurance and the possible withdrawal of cover in risky market segments; and
- affect the availability of reinsurance.

Reducing uniformity

The removal of section 15 would result in the ASIC Act's UCT provisions applying to insurance contracts. The unfair contracts terms regime would be yet another layer of regulation on top of existing remedies. It will only lead to confusion as to the operation of existing remedies and result in increased disputation. As the UCT provisions will apply only to consumer contracts, it will potentially create a dual system of regulation for consumer and commercial insurance contracts.

Consumers and insurers would not only have to consider the impact of the raft of remedies and protections available under the IC Act, the general law and clause 8.2 of the Terms of

[5] See Wallaby Grip Ltd v QBE Insurance (Australia)Ltd; Stewart v QBE Insurance (Australia) Ltd [2010 HCA 9; CCH Limited, Australian & New Zealand Insurance Commentary, (2010) at [1-410]

Reference but also how the unfair contracts regime may impact. This, we submit, would defeat the intention behind the ACL.

We note the second reading speech on the ACL by the Minister for Competition Policy and Consumer Affairs:

> "This tangle of consumer laws must be rationalised. We must reduce confusion and complexity for consumers and provide consistency of consumer protection. We must reduce compliance burdens for business". [6]

We submit that should the UCT provisions apply as well as the IC Act, none of these stated objectives will be achieved – it will not reduce confusion and complexity nor provide consistent consumer protection. It will also not reduce compliance burdens for business but increase them.

Another concern would be that, as the UCT provisions will only apply to consumer contracts, the removal of section 15 could create a dual system of regulation for insurance contracts applying to retail customers and wholesale customers respectively – with the former being subject to the UCT provisions and the Insurance Contracts Act and the latter regulated solely by the IC Act. This could lead to inconsistent interpretation and application of common terms between the two types of customers. We stress that, as the UCT provisions were not intended to extend to business customers, its application to insurance contracts as a whole would have serious unwarranted consequences for non retail buyers of insurance.

Uncertainty

In simple terms, insurance policies are priced according to the scope of cover provided and the likelihood and cost of possible claims. As noted in the RIS, insurers use terms in policies (i.e. exclusions) as a tool to define risk and price policies. The layering of the unfair contract term provisions upon existing remedies could result in:

- voiding of terms, including terms that define the scope of cover;
- uncertainty as to the outcome of individual claims by consumers for redress as the relief provided will depend on the relief mechanism chosen; and
- differences in the application of terms between retail and wholesale consumers.

This impact of this option is highlighted through its application to the first example cited in the RIS: the claim for stolen luggage.

> *"A claim for stolen luggage was denied after the insured left his baggage 'unattended' where the stolen baggage was within reach, but the insured was distracted at the time of theft, asking for directions."*[7]

It is not common for a travel insurance policy to require the insured to take 'reasonable care' of personal luggage. In this example, the potentially 'unfair term' in the policy would presumably be the term 'reasonable care'. The fact that the term 'reasonable care' can apply to different situations does not equate to the term being unfair. Terms in insurance contracts must have sufficient flexibility to enable them to apply in a variety of situations.

If the UCT provisions of the ASIC Act were to apply, there is a risk that the phrase

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[6] Dr Craig Emerson MP, *CPD (House),* 24 June 2009, p (need page number)
[7] Unfair Terms in Insurance Contracts Draft Regulation Impact Statement, December 2011, p8

‘reasonable care’ would be found to be unfair. In order to ameliorate this risk, insurers could either define ‘reasonable care’ in the PDS in significant detail, leading to longer more detailed PDSs or remove the exclusion, leading to higher premiums. Alternatively, insurers may withdraw certain types of cover from market segments until more certainty is obtained. We submit that none of these outcomes are desirable for consumers.

The material in Attachment B details some of the protections and remedies already available to insureds in relation to exclusion clauses.

Impact on reinsurance

It should be noted that terms within insurance contracts are also dictated by reinsurance arrangements. A reinsurer will specify what they will and will not cover. The extent of cover in any specific case will be determined by a reinsurance contract (treaty). Should a term commonly used within an insurance contract be found to be unfair under the ACL, this could have significant consequences on an insurer’s reinsurance arrangements. A breach of the reinsurance treaty may leave the insurer exposed to the full extent of the claims. (Please see Attachment C for a supplementary submission that the Insurance Council made in February 2011 on reinsurance issues.)

Option D – Extend IC Act remedies to include unfair contract terms provisions (Consultation Questions 5)

A. If UCT laws were extended to include insurance, is it preferable for these laws to sit within the IC Act or ASIC Act?

B. From an industry perspective, what would be the potential compliance costs (both monetary and non-monetary) associated with this option - if possible please provide the magnitude of the costs and a breakdown of categories?

C. Would these costs be likely to be higher or lower than under Option C?
D. What are the potential benefits to consumers (both monetary and non-monetary) - if possible, please state the magnitude (either in dollars or qualitatively) of the benefits?

E. If this option is adopted will insurers:
(i) be likely to increase insurance premiums?
(ii) revisit some of their contract offerings?

F. If this option is adopted, are there any:
(i) additional costs or benefits?
(ii) factors that impact on the options feasibility?
(iii) practical limitations on insurers that would impede their ability to comply with the changes?

	Benefits	*Costs*
Consumers		• Possible increase in the cost of insurance • Development of separate consumer and business regulatory regimes • Potential for limited or no access to cover in risky market segments
Industry		• Uncertainty • Increased compliance burden • Possible withdrawal of cover in risky market segments.
Government		• Possible need to monitor appropriateness of separate consumer and business regulatory regimes

The Insurance Council cannot see that anything would be gained under Option D by trying to fit the ASIC Act's UCT provisions into the Insurance Contracts Act. The Act's remedies are already satisfactory.

As can be seen from the table below, almost all of the situations dealt with in the ASIC Act's list of potentially unfair terms (the 'grey list'[8]) are covered explicitly by provisions in the IC Act. The IC Act provides solutions appropriate to insurance in response to potentially unfair situations.

Adoption of Option D would also result in either insurance contracts for business being subject to review for unfair contract terms when they would not be if the ACL applied directly in insurance contracts or the development of divergent business and consumer regulatory regimes if unfair contract term provisions were introduced into the IC Act solely to apply to consumer contracts.

	Example of unfair contract term	**Application to insurance policies covered by the IC Act and the protections the IC Act already provide**
a)	a term that permits, or has the effect of permitting, one party (but not another party) to avoid or limit performance of the contract	Avoidance Protections: The IC Act already prescribes when an insurer can avoid a policy and places limitations on avoidance (see section 28, 29, 31 and 56 of the IC Act). If the 'grey list' is contemplating something broader than "avoidance", namely one party having a right to choose not to perform its obligations (under an otherwise valid contract). This is generally not applicable to insurance. Limitation: Not applicable. Policies generally contain agreed limits on liability, but not provisions allowing the insurer to limit its performance beyond that which is set out in the policy terms and conditions.
b)	a term that permits, or has the effect of permitting, one party (but not another party) to terminate the contract	The IC Act already prescribes when and how an insurer can cancel a policy of insurance. Sections 59, 60, 61 and 62 permit cancellation in limited circumstances. Section 63 of the IC Act prevents an insurer cancelling a contract of insurance, except as provided by the IC Act. An insurer must give reasons for cancellation (section 75) and the notice of cancellation must be sent in accordance with a prescribed method (section 77).

[8] Australian Securities and Investment Commission Act 2001, section 12BH

c)	a term that penalises, or has the effect of penalising, one party (but not another party) for a breach or termination of the contract	Protection for breach of contract Insurance policies that are consumer contracts would not usually contain penalties for one party (but not the other party) for breach or termination of the contract. We should say that this conclusion is based on a narrow interpretation of "penalises" (i.e. in the sense of applying a penalty). If "penalise" is interpreted more broadly to mean reducing or refusing to pay a claim because of a breach of a policy term then it is important to note the protections under sections 13, 14, 46 and 54 of the Insurance Contracts Act. Significantly section 54 prevents an insurer relying on a breach of a policy term if the act or omission did not cause or contribute to the loss or cause the insurer actual prejudice. Protection for cancellation of contract Usually if a policy is cancelled a refund of a portion of the premium would be provided. It also possible (although not common) for a contract of insurance to contain a term that requires the insured to forfeit the entire premium paid if the insured chooses to terminate the contract before expiry of the policy period. This would have the effect of penalising the insured for early termination. A clause which allowed the insurer to charge a pro rata premium for "time on risk" would, arguably, **not** penalise the insured.
d)	a term that permits, or has the effect of permitting, one party (but not another party) to vary the terms of the contract	Section 53 of the IC Act renders ineffective a provision in a contract of insurance permitting the insurer to vary unilaterally the contract to the prejudice of the insured. It is possible for an insurer to vary the terms of a contract of insurance in a way that advantages or benefits the insured. Section 52 of the IC Act prevents an insurer excluding, restricting or modifying the operation of the IC Act to the prejudice of a person other than the insurer itself.
e)	a term that permits, or has the effect of permitting, one party (but not another party) to renew or not renew the	Section 58 of the IC Act provides important protection for insureds in relation to the renewal of a contract of insurance. It requires a notice to be provided to the insured in respect of renewable insurance covers and provides for the cover to

	contract	continue where that requirement is not met. Some policies allow an insurer to choose not to renew the contract if there is a change in the risk during the policy period.
f)	a term that permits, or has the effect of permitting, one party to vary the upfront price payable under the contract without the right of another party to terminate the contract	Some policies allow an insurer the right to charge an additional premium if there is a change in the risk during the policy period. For example, a home insurance policy may allow the insurer to charge an additional premium if the value of the home increases as a result of renovations. However, an insured would usually have a right to terminate an insurance policy at any time (subject to payment of a pro rata premium for the time that the insurer was on risk).
g)	a term that permits, or has the effect of permitting, one party unilaterally to vary financial services to be supplied under the contract	To the extent that providing insurance cover is a "financial service", section 53 of the IC Act renders ineffective a provision in a contract of insurance permitting the insurer to vary unilaterally the contract to the prejudice of the insured. A contract of insurance could contain a term that allows a unilateral variation to the prejudice of the insurer.
h)	a term that permits, or has the effect of permitting, one party unilaterally to determine whether the contract has been breached or to interpret its meaning	Insurance policies that are consumer contracts would not usually contain terms of this nature. In addition, no decision of an insurer is final – the insured may seek a determination from FOS or other judicial relief.
i)	a term that limits, or has the effect of limiting, one party's vicarious liability for its agents	Insurance policies that are consumer contracts would not usually contain terms of this nature. In addition, section 917 of the Corporations Act 2001 provides for the holder of an Australian financial services licence to be responsible for the conduct of its representatives.
j)	a term that permits, or has the effect of permitting, one party to assign the contract to the detriment of another party without that other party's consent	Insurance policies that are consumer contracts would not usually contain terms of this nature.
k)	a term that limits, or has the effect of limiting, one party's	Insurance policies that are consumer contracts would not prohibit the insured suing the insurer for refusal to pay a claim. If they did contain such terms they

	right to sue another party	would be likely rendered ineffective by the operation of section 13 or 14 of the IC Act.
l)	a term that limits, or has the effect of limiting, the evidence one party can adduce in proceedings relating to the contract	Insurance policies that are consumer contracts would not usually contain terms of this nature. Given the overriding duty of good faith in section 13 of the IC Act such a right could only operate in very limited circumstances.
m)	a term that imposes, or has the effect of imposing, the evidential burden on one party in proceedings relating to the contract	Insurance policies may contain terms of this nature However, the insurer's ability to include or rely on such terms would be restricted by various provisions of the IC Act including 13, and 14, Part IV dealing with non disclosure and misrepresentation and Part V dealing with provisions in the policy itself.
n)	a term of a kind, or a term that has an effect of a kind, prescribed by the regulations	[Not applicable - no terms are currently prescribed regulations.]

Option E – Encourage industry self-regulation to prevent use of unfair terms of insurers
(Consultation Question 6)

A. What would be the costs and benefits to consumers (both monetary and non-monetary) - if possible, please state the magnitude (either in dollars or qualitatively) of the benefits?

B. From an industry perspective, what would be the potential compliance costs (both monetary and non-monetary) associated with this option - if possible please provide the magnitude of the costs and a breakdown of categories?

C. How do these compliance costs compare to options C and D?

D. If this option is adopted will insurers:

(i) be likely to increase insurance premiums?

(ii) revisit some of their contract offerings?

E. If this option is adopted, are there any:

(i) additional costs or benefits?

(ii) factors that impact on the options feasibility?

(iii) practical limitations on insurers that would impede their ability to comply with the changes?

	Benefits	*Costs*
Consumers	• Certainty • Affordability	
Industry	• Certainty • No unnecessary increase in compliance burden • Enhanced reputation	
Government	• At no cost to Government, additional constraints on unfairness to complement black letter law and ASIC enforcement	

In 2009 the General Insurance Code of Practice underwent a review conducted by an Independent Reviewer, Mr Robert Cornall AO. The Independent Reviewer made 10 recommendations in his final report[9] all of which were accepted by the Insurance Council Board and the revised Code containing changes based on the recommendations came into effect on 1 May 2010.

One of the changes made to the Code is to highlight the duty of utmost good faith. The new clauses read as follows:

[9] The report can be accessed at www.codeofpracticereview.com.au

1.19 The objectives of this Code will also be pursued and its provisions applied having regard to the fact that a contract of insurance is a contract involving the utmost good faith which requires each party to the contract to act towards the other party with the utmost good faith in respect of any matter arising under the contract.

1.20 This Code requires us to be open, fair, and honest in our dealings with customers and commits us to high standards of service when selling insurance, dealing with claims, responding to catastrophes and disasters and handling complaints.

In light of these changes to the Code to emphasise the duty of utmost good faith and the obligation to treat customers fairly, the Insurance Council considers its members have already adopted self regulation in line with Option E.

Options when unfair contract terms provisions apply to insurance contracts – the main subject matter exclusion

Option 1 – Should the 'main subject matter' of an insurance contract be defined broadly?
(Consultation Questions 7)
A. Do you agree that main subject matter should be clarified in the context of insurance policy exclusions?

B. Do you consider terms that sought to limit liability genuinely constitute main subject matter of an insurance contract?

C. From an industry perspective, what would be the potential compliance costs (both monetary and non-monetary) associated with this option - if possible please provide the magnitude of the costs and a breakdown of categories?

D. What benefits are there for consumers (both monetary and non-monetary) - if possible, please state the magnitude (either in dollars or qualitatively) of these benefits?

E. If this option is adopted will insurers:

(i) be likely to increase insurance premiums?

(ii) revisit some of their contract offerings?

F. If this option is adopted, are there any

(i) additional costs or benefits?

(ii) factors that impact on the options feasibility?

(iii) practical limitations on insurers that would impede their ability to comply with the changes?

The Insurance Council supports Option A, the retention of the status quo. However, in the event that the Government determines it is necessary to apply unfair contract provisions to general insurance, we submit it will be essential to clarify how the main subject matter exemption would apply to insurance contracts.

It is misleading to use the term "broad" subject matter definition as being the insurance industry's preferred position as this implies that it is seeking special treatment. As explained above, the legal authorities indicate in Australia that the subject matter of an insurance contract will be taken to be the object insured. We are not aware of this situation applying to other product or service. For example, it is clearly nonsensical for the UCT main subject matter exemption to apply only to the provisions of a contract for sale of a motor vehicle that specify that the thing being sold is a motor vehicle without regard for the attributes of that particular motor vehicle.

The insurance industry's serious concerns about the application of UCT provisions would be largely addressed if it could be assured that the main subject matter exemption would operate meaningfully in relation to insurance contracts. Consequently, the Insurance Council submits that any amendment of the IC Act to apply UCT provisions to insurance contracts must clarify that the main subject matter exemption works in relation to insurance contracts to exclude from review terms and exclusions that define an insurance contract's scope of cover.

If the subject matter of an insurance contract was defined narrowly and limited to the object being insured, exclusion clauses would become meaningless in insurance. The impact would be that if a term or exclusion was challenged for unfairness, insurers would need to argue in court that it was necessary for business reasons. This view would convert unfair contract terms provisions from a means of redress for unfairness into a judicial review of an insurer's underwriting decisions.

The Insurance Council believes that the Australian unfair contract terms regime would need a clarification similar to that found in Recital 19 of the EC Directive 93/13/EEC on Unfair Terms in Consumer Contracts, which provides:

> "*Whereas, for the purposes of this Directive, assessment of unfair character shall not be made of terms which describe the main subject matter of the contract nor the quality/price ratio of the goods or services supplied; whereas the main subject matter of the contract and the price/ratio may nevertheless be taken into account in assessing the fairness of terms;* ***whereas it follows, inter alia, that in insurance contracts, 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.***" (our emphasis)

If a decision is made to apply the ACL's unfair terms provisions to insurance contracts, the Insurance Council strongly recommends that words similar to those of Recital 19 be included in the legislation or inserted into the appropriate regulations. A mention in the Explanatory Memorandum or in the Minister's Second Reading speech would not provide the certainty required by insurers. Similarly, guidance by ASIC on the operation of the exemption specifically in relation to insurance contracts would not have force of law.

In relation to the Recital 19 requirement that to benefit from the exemption contract terms must "***clearly*** (our emphasis) define the insured risk and insurer's liability", the Insurance Council would point out that the Australian regulatory regime already requires the clear, concise and effective disclosure of contract terms.

The Insurance Council submits that the overall result of utilising wording similar to the EC Directive 93/13/EEC would be to minimise the uncertainty for insurers arising from having their contracts subject to review for unfair contract terms while enabling consumers to test certain terms in insurance contracts for fairness.

Option 2(a) – Should the 'main subject matter' of an insurance contract be defined narrowly?
(Consultation Questions 8)

A. Are there any major obstacles (either legal or practical) preventing a narrow definition for main subject matter?

B. From an industry perspective, what would be the potential compliance costs (both monetary and non-monetary) associated with this option - if possible please provide the magnitude of the costs and a breakdown of categories?

C. What benefits are there for consumers (both monetary and non-monetary) - if possible, please state the magnitude (either in dollars or qualitatively) of the benefits?

D. If main subject matter was to be defined narrowly, what types of policy exclusions/ limitations should be excluded?

E. If this option is adopted will insurers:

(i) be likely to increase insurance premiums?

(ii) revisit some of their contract offerings?

F. Will premium increases (if they occur) be higher if the subject matter is narrow rather than broad?

G. Are there any (if this option was adopted):

(i) additional costs or benefits not referred to above?

(ii) factors that impact on the feasibility of this option?

(iii) practical limitations on insurers that would impede their ability to comply with the changes?

The Insurance Council does not support this option. The adverse consequences of adopting a narrow subject matter are outlined above in relation to Option1. In short, a narrow subject matter definition leaves key terms in the contract of insurance subject to review and has significant implications for the way insurers calculate risk. Exclusions are commonly used to define the scope of the risk that the insurer is prepared to accept. If products contained no exclusions, they would potentially be either unavailable or unaffordable. We reiterate that there has been no evidence presented to suggest that there is systemic unfairness in these forms of contracts.

Option 2(b) – Should unfair contract terms provisions be modified so that the remedies are restricted to exercise by a regulatory authority? (Consultation Questions 9)

A. Do you consider it necessary (or desirable) to restrict remedies to be exercised solely by the regulator if UCT laws were extended to include insurance?

B. Will individual consumers have the same level of protection (as provided in the ACL and the ASIC Act) if the regulator is the only party that can seek remedies in relation to UCT?

C. From an industry perspective, what would be the potential compliance costs (both monetary and non-monetary) associated with this option - if possible please provide the magnitude of the costs and a breakdown of categories?

D. If this option is adopted will insurers:

(i) be likely to increase insurance premiums?

(ii) revisit some of their contract offerings?

E. Are there any (if this option was adopted):

(i) additional costs or benefits not referred to above?

(ii) factors that impact on the feasibility of this option?

(iii) practical limitations on insurers that would impede their ability to comply with the changes?

F. If the subject matter is kept relatively narrow, will insurers face lower levels of uncertainty regarding the potential voiding of terms, if remedies in relation to UCT's are restricted to the regulator?

The Insurance Council does not support this option. As explained in relation to the previous options, if UCT provisions are to apply to insurance contracts, they should be afforded the equivalent protection given to other financial products through a realistic application of the main subject matter exemption.

Although restricting exercise of remedies to ASIC has a superficial attraction, it still exposes an insurer's scope of cover terms to review and potential voiding. The insurer will be obliged to take account of and price for this risk regardless of who can exercise the remedies.

Implementation and Review
(Consultation Questions 15)
If UCT provisions were applied to insurance, would a 2 year transition period be adequate for industry and consumers?

As noted above, the Insurance Council supports the retention of the status quo. The question of what is an appropriate transition period only becomes relevant if the Government elects to apply UCT provisions to general insurance and even then, it is difficult to comment on what would be an appropriate transition period until it known which option has been chosen. We submit the Government should consult further with industry on a suitable transition period once a decision has been made.

In the event that the Government decides to apply UCT provisions to general insurance products, ASIC should consider developing guidance for industry as soon as possible. Such guidance should outline what terms ASIC may see as unfair, thereby allowing insurers time to consider whether these terms could be redrafted or whether cover should be removed in this area.

Attachment B

EXISTING REGULATION AND CONSUMER PROTECTIONS

Insurance Contracts Act 1984 Provisions

Sections 13 and 14

Two very important obligations are contained in sections 13 and 14 of the Act.

Section 13 provides:

> *"A contract of insurance is 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 party, in respect of any matter arising under or in relation to it, with utmost good faith."*

Section 14(1) provides:

> *If reliance by a party to a contract of insurance on a provision of the contract of insurance would be to fail to act with the utmost good faith, the party may not rely on the provision.*

The duty of good faith imposed by sections 13 and 14 of the IC Act are not limited to contractual matters. The duty between insurer and insured applies in respect of any matter arising under or in relation to the contract. We therefore submit that the duty of good faith goes further than the question of whether a particular term in a contract is 'unfair' in the circumstances.

Kelly and Ball[10] refer to a number of cases decided in relation to the duty of utmost good faith imposed by the IC Act to suggest that a more stringent standard applies in relation to conduct by the insurer than the insured, noting as follows:

- Dishonest or fraudulent conduct by an insurer is certainly sufficient for a breach of the duty of utmost good faith; and
- Conduct that is capricious or unreasonable, or amounts to unfair dealing may also be sufficient to breach the duty of good faith.

Although there is no statutory definition of the duty to act in utmost good faith, it has been held by the Courts that it means to act with scrupulous fairness and honesty and the courts have broadly interpreted this concept. The High Court in CGU v AMP (2007) HCA 36 discussed utmost good faith in detail.

Gleeson CJ and Crennan J noted at paragraph 15 of the judgment that the concept of good faith is not limited to dishonesty. Further their Honours stated

[10] Kelly & Ball Principles of Insurance Law: Contract of Insurance: Chapter 5 Terms of the Contract - The duty of utmost good faith

> *"In particular we accept that utmost good faith may require an insurer to act with due regard to the legitimate interests of an insured, as well as to its own interests. The classic example of an insured's obligation of utmost good faith is a requirement of full disclosure to an insurer, that is to say, a requirement to pay regard to the legitimate interests of the insurer. Conversely, an insurer's statutory obligation to act with utmost good faith may require an insurer to act, consistently with commercial standards of decency and fairness, with due regard to the interests of the insured. Such an obligation may well affect the conduct of an insurer in making a timely response to a claim for indemnity."*

Callinan and Heydon JJ note at paragraph 257:

> *'From the outset we should say that we agree with the Chief Justice and Grennan J that a lack of utmost good faith is not to be equated with dishonesty only. The analogy may not be taken too far, but the sort of conduct that might constitute an absence of utmost good faith may have elements in common with an absence of clean hands according to equitable doctrine which requires that a plaintiff seeking relief not himself be guilty of tainted relevant conduct."*

Sections 21, 21A, 22 and 28 - Non Disclosure.

These sections place significant limits on when an insurer can rely on non disclosure by an insured to reduce or refuse a claim. For example, for eligible policies of insurance (being motor, home, sickness & accident, consumer credit and travel) when cover is first offered an insurer is required by law to ask specific questions rather than just relying on a general duty of disclosure.

Sections 23, 24 26, 27 and 28 - Misrepresentation

These sections of the IC Act place significant limits on when an insurer can rely on misrepresentation to refuse to pay a claim. For example, section 26 provides that where a statement that was made by a person in connection with a proposed contract of insurance was in fact untrue but was made on the basis of a belief that the person held, being a belief that a reasonable person in the circumstances would have held, the statement shall not be taken to be a misrepresentation.

Section 27 provides that a person shall not be taken to have made a misrepresentation by reason only that the person failed to answer a question included in a proposal form or gave an obviously incomplete or irrelevant answer to such a question.

Sections 35 and 37

We note that in relation to pre-contractual disclosure, standard cover and notification of unusual terms, the RIS states:

> *"One of the most common situations in which dissatisfaction and perceived unfairness arises in the context of insurance contracts is when an insurer seeks to deny a claim based on an exclusion or limitation on cover that the insured argued was not, until the time of the claim, fully known or understood by the insured"*[11]

[11] Unfair Terms in Insurance Contracts Draft Regulation Impact Statement, December 2011, p 9.

Sections 35 and 37 of the IC Act places obligations in insurers to make consumers aware of key terms in the contract. Section 35 requires insurers in relation to prescribed contracts to clearly inform customers up front as to how their contract terms differ from standard contract terms which are outlined in the Regulations to the Act. Section 37 requires insurers in relation to non prescribed contracts to clearly inform the insured up front as to unusual terms in their policies. If section 35 or section 37 is not complied with, the insurer will not be able to rely on those terms (except in the case of section 35 where the insured or a reasonable person in the circumstances could have been expected to have known of the term).

Section 39 and 62

Section 39 says an insurer cannot refuse to pay a claim in whole or part by reason of non payment of an instalment of the premium unless the instalment has remained unpaid for a period of at least 14 days and before the contract was entered into the insurer informed the insured in writing of the effect of the provision.

Section 62 says an insurer cannot cancel a instalment contract of insurance unless at least one instalment of the premium has remained unpaid at the time the contract is sought to be cancelled for a period of at least one month and before the contract was entered into the insurer clearly informed the insured of the effect of the provision.

Section 46

Section 46 says where at the time when the policy was entered into the insured was not aware of, and a reasonable person in the circumstances could not be expected to have been aware of a defect or imperfection in the property insured, the insurer may not rely on a provision included in the policy that has the effect of limiting or excluding the insurer's liability under the policy by reference to the condition of the property at a time before the policy was entered into.

Thus an exclusion clause that said "we will not cover you for a defect in your home that existed before the policy was entered into" would be subject to section 46 of the Act. Therefore if the insured did not know of the defect and a reasonable person in the circumstances could not have been expected to have been aware of the defect the insurer could not rely on the exclusion.

Section 52

Section 52 prevents an insurer from contracting out of the IC Act.

Section 53

Section 53 makes void a term of an insurance contract that seeks to authorise or permit the insurer to vary, to the prejudice of the insured, the contract (unless the contract is exempt from the section by the Regulations to the IC Act).

Section 54

Section 54 limits the ability of the insurer to rely on terms of the policy in relation to acts or omissions of the insured. There are two arms to the section. If the act or omission could not be reasonably regarded as being capable of causing or contributing to the loss (or even if it could but the insured proves none of the loss was actually caused by act or omission), the insurer cannot rely on a clause in the policy to refuse the claim on the basis of that act or omission unless it can prove actual prejudice.

Thus for example, if an insurer was relying on an unlicensed driver exclusion to refuse a claim, the insurer would need to prove the fact that the person was unlicensed caused the insurer actual prejudice or could reasonably be regarded as being capable of causing or contributing to the accident. If the insured was unlicensed because they had forgot to renew their licence two weeks ago this could not be regarded as causing or contributing to the loss or likely cause the insurer actual prejudice so the insurer, despite the exclusion clause, would have to pay the claim.

Further if the act or omission only partly contributed to the loss, the insurer can only reduce the claim by the extent the act or omission caused or contributed to the loss. If relying on prejudice the insurer needs to prove actual prejudice and can only reduce the claim by the extent of its prejudice in monetary terms. As was noted by the High Court in *Moltoni Corporation Pty Ltd v QBE Insurance Ltd* (2001) 205 CLR 149 it is what "would" have happened (i.e. what right the insurer would have exercised) rather than what might have happened (i.e. a right the insurer may have exercised) that is relevant. The prejudice must be able to be represented in monetary terms.

It is also important to note that an insurer cannot rely on an exclusion clause if the act or omission that brings into play the exclusion clause was necessary to protect the safety of a person or to preserve property, or it was not reasonably possible for the insured or other person not to do the act or omission

Other legislative protections available to consumers

Apart from the IC Act, there is also a variety of additional generic protections available to insurance policyholders. In particular, under the Corporations Act 2001 there is an over arching obligation on general insurers as the holders of Australian Financial Services Licences to do all things necessary to ensure that financial services covered by their licence are provided efficiently, honestly and fairly.

Further, section 991A of the Corporations Act 2001 states "A financial services licensee must not, in or in relation to the provision of a financial service, engage in conduct that is, in all the circumstances, unconscionable." This section provides if a person suffers loss or damage because a financial services licensee contravenes this provision they may recover the amount of the loss or damage against the licensee. This provision is not be impacted by the section 15 exemption.

Legal Principles

Onus on insurer

The onus is on the insurer to prove an exclusion clause applies, as recently confirmed in *Wallaby Grip Ltd v QBE Insurance (Australia) Ltd* (2010) HCA 9. In this case it was noted "it is well accepted that the insurer must prove that a loss falls within an exception".

The contra proferentem rule

If there is ambiguity in the language used the exclusion is strictly construed against the party that drafted the document in question, which will almost always be the insurer. This means the ambiguity will be resolved in favour of the insured. This is a long established legal principle. For an example of the application of the principle see *Manufacturers Mutual Insurance Ltd v Stargift Pty Ltd* (1985) 3 ANZ Insurance Cases 60-615. In that case the court made it clear ambiguity was to be resolved against the insurer. Kirby P said "*It must*

always be remembered that the solution to the problem now presented, in a standard form printed insurance policy, has always been in the hands of the insurer". By this Kirby P meant the insurer could have resolved the ambiguity by clearer drafting.

Internal and External Dispute Resolution

Under the Corporations Act, a condition of holding an AFSL is for insurers to both provide access to an internal dispute resolution service (IDR) and also to be a member of an external dispute resolution scheme (EDR) which retail consumers can access for free.

The current EDR scheme which insurers subscribe to is FOS. This independent umpire provides free, fair and accessible dispute resolution for those unable to resolve a dispute directly with their general insurer. External dispute resolution processes can help to resolve disputes through negotiation or conciliation as an alternative to court proceedings and can make decisions which are binding on participating general insurers.

The criteria for determination of disputes by FOS include not only consideration of legal principles, but applicable industry codes, good industry practice and what is fair in all the circumstances. That is, FOS has a broader charter and can look beyond the terms of the contract to what also fair in all the circumstances when making a decision. It is important to note that FOS is also not bound by precedent (although can have regard to it) and so can look at the individual circumstance of each case when making a decision.

All decisions of FOS are binding on members but not consumers. If a consumer is dissatisfied with the outcome they can pursue legal action.

General Insurance Code of Practice

The General Insurance Code of Practice (Code) is the general insurance industry's promise to be open, fair and honest in the way it deals with customers. The Code was first developed and introduced by the Insurance Council of Australia in 1994 and commits insurers to high standards which they uphold in the services they provide to their customers. These standards apply when selling insurance, dealing with insurance claims, responding to catastrophes and disasters, and handling complaints. FOS, as monitor of the Code, investigates and reports on compliance.

The Code applies to all general insurance products which are covered by the Insurance Contracts Act. For example, it applies to: home building; home contents; comprehensive motor vehicle insurance; travel insurance; consumer credit; and sickness and accident.

ATTACHMENT C

Unfair terms in insurance contracts: Options Paper
Corporations and Financial Services Division
Treasury
Langton Crescent
PARKES ACT 2600

Attention: Mr Andrew Sellars
Via email: ICAReview@treasury.gov.au

11 February 2011

Dear Mr Sellars

UNFAIR TERMS IN INSURANCE CONTRACTS

The Insurance Council of Australia[12] (Insurance Council) is pleased to provide you with this supplementary submission on the potential implications of the removal of section 15 of the Insurance Contracts Act (IC Act) on the reinsurance arrangements of insurers. This submission has been developed by the Insurance Council's Insurance Contracts Act and ASIC Working Groups and endorsed not only by the members of those Working Groups but also the Insurance Council's members General Re, Munich Re and Swiss Re.

In Attachment A of our submission of 5 May 2010, the Insurance Council argued that the removal of section 15, thereby allowing insurance contracts to be reviewed for unfair contract terms under the Australian Consumer Law (ACL), would potentially:

- reduce uniformity and consistency of insurance laws with respect to consumer contracts;
- result in uncertainty as to whether a term necessary to limit the insurer's risk could be found void and this may lead to increases in the cost of insurance and the possible withdrawal of cover in risky market segments; and
- affect the availability of reinsurance.

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[12]. The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent more than 90 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. September 2010 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $33.8 billion per annum and has total assets of $101.5 billion. The industry employs approx 60,000 people and on average pays out about $86 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).

With respect to reinsurance, we argued that terms within insurance contracts can be subject to existing reinsurance arrangements. The extent of reinsurance cover in any specific case will be determined by the reinsurance contract or treaty in place. Should a term commonly used within an insurance contract were subsequently found to be unfair and voided under the ACL, this could have significant consequences on an insurer's reinsurance arrangements. If an insurers' reinsurance treaty did not cover the resulting additional claims, this would leave the insurer exposed to the full extent of those claims, with potentially adverse implications for the insurer's capital adequacy position and even its solvency.

This submission will expand on how reinsurance operates and how a reinsurance contract would or would not respond in practice in the situation where a term necessary to limit the insurer's risk (for example, an exclusion) were found to be unfair.

Reinsurance contracts

An insurer will enter into a contract with a reinsurer to indemnify them against liability arising from the original or underlying contract of insurance. Insurers use reinsurance to limit their losses, for example, in the case of a natural catastrophe which results in a large number of claims, and hence costs, that the insurer is unwilling or unable to fund from its own claims reserves.

The way in which reinsurance would be impacted by the voiding of an exclusion varies depending on the approach taken in each reinsurance contract. A reinsurance contract is negotiated and the terms and conditions of cover and reinsurance premium are determined by the terms offered by an insurer to their clients.

Reinsurance contracts are commonly structured for a level of cover above an agreed amount. This agreed amount can be for the entire cost above a certain level, or different reinsurers may take layers of cover based either of dollar minimum and maximum or for the total amount above an agreed level.

Reinsurance contracts are generally negotiated annually for specific types of policies, for example, home building, motor or liability. To be able to arrange such cover, the reinsurer needs to be certain of the liability of the insurer under each of policy type, including what events are excluded. Reinsurance may be provided for catastrophic events where the cost to an insurer reaches a certain amount. This cover and the agreed reinsurance cover are based on the policy terms, events covered and any exclusions.

There are also facultative policies[13] where reinsurance is provided for a particular policy for a particular client. Again, the reinsurance cover is based on the specific terms agreed between the insured and insurer, including any exclusions.

Reinsurance treaties, including Line of Business Treaties, can be drafted in a variety of ways. Whilst some reinsurance treaties may be drafted without many exclusions, this may not always be the case depending on the level of risk the reinsurer is willing to bear. If a reinsurance treaty has been drafted with a specific term or exclusion which is the same as

[13] Facultative reinsurance contracts are not relevant to the current discussion because they relate to single, high value risks and would not be affected by regulatory developments impacting retail insurance.

that which has later been deemed 'unfair' under the original contract then it will not be covered by reinsurance. One approach would refer directly to the actual underlying policies.

An actual example of such a clause is as follows:

> "… the Reinsurer will reinsure … in respect of any liability arising under the terms of any Original Policies issued by … including any endorsements."

Therefore, risks which are excluded under the underlying policy may also be excluded from the reinsurance arrangement depending on how the reinsurance treaty is worded.

Like Lines of Business treaties, Catastrophe treaties can vary in the extent to which they include all the exclusions that are to be found in the underlying insurance policies. If a reinsurance treaty includes an exclusion that was subsequently voided by a court decision in respect of the underlying insurance policy, the treaty would not respond to cover the payment of any of the formerly excluded claims.

Commonly, the exclusions in a reinsurance treaty are more limited that those contained in the underlying insurance policies. If an exclusion was voided in an underlying policy and that exclusion was not replicated in the reinsurance treaty, the treaty may respond due to the operation of what is called a 'Follow the Fortunes' clause. Such clauses mean, for example, that the reinsurance policy would respond in circumstances where an exclusion in an underlying insurance policy was voided, say by a court decision or a legislative change. An example of a Follow the Fortunes clause is as follows:

> "The Reinsurers shall be deemed to have reinsured the risk insured by the Reinsured upon the same conditions as may for the time being by subsisting with regard to the policy of insurance, whether printed, written, ordinary or special, the intention being that the Reinsurers shall follow the fortunes of the Reinsured in regard to the policy of insurance in which the Reinsured by virtue of this Reinsurance takes part. It is, however, provided always that any restriction imposed on the Reinsurance by way of exclusion or otherwise shall not be avoided by this provision."

It is important to note that a Follow the Fortunes clause will not override any exclusion in a treaty. Given that even treaties with the broadest of coverage include some exclusions (e.g. war and terrorism), the risk remains in respect of all reinsurance contracts that the voiding of an exclusion in an underlying insurance policy will leave the insurer without adequate reinsurance cover.

However, the existence of Follow the Fortunes clauses in many reinsurance treaties would create a further significant adverse impact on the price and availability of reinsurance and hence insurance if the unfair contract terms provisions of the ACL.

It is common for general insurance policies to contain a number of exclusions. For example, a domestic home and contents policy can commonly have a large number of exclusions (e.g. 20 or more) covering a wide cross-section of matters ranging from war and terrorism, to asbestos, to damage occurring as a result of faulty design, lack of maintenance, or rust or corrosion.

Given the wide range and large number of exclusions potentially found in insurance policies, if reinsurers had to factor into their pricing the risk that they could be liable to pay a claim in

respect of any exclusion due to the operation of a Follow the Fortunes clause, the application of the ACL to insurance contracts could result in a significant increase in the cost of reinsurance which would lead to increased insurance costs.

Potential impact on reinsurance where an exclusion was found to be unfair under the ACL

In circumstances where an exclusion was found to be unfair under the ACL, the term would be void. It is possible that the term would not only be declared void for that specific contract but all similar contracts with that insurer. It is highly likely that reviews would then be sought of contracts where other insurers had used the same or a similar exclusion.

The immediate impact of an exclusion being voided would be:

1. the insurer would have to pay claims for losses which would otherwise not have been covered. Where an exclusion was relevant to the determination of a large number of claims (for example in the context of a major catastrophe, which resulted in many thousands of claims), and the reinsurance cover did not respond, the unexpected cost to the insurer could be very significant.
2. uncertainty whether the insurer's capital position and even its solvency were adequate;
3. if the reinsurer does provide cover for otherwise excluded claims (for example due to a Follow the Fortunes clause), there would be a subsequent increase in reinsurance costs.

   If reinsurers were aware of the additional risks created by the ACL prior to the commencement of a reinsurance treaty, those risks would be factored into reinsurance premiums before the risk of an exclusion being voided under the ACL even materialised. Such an increase in reinsurance premiums would obviously flow through to insurance premiums.

Reinsurers may also react to the uncertainty by introducing specific and detailed exclusions into their treaties, which may require the insurers to amend Product Disclosure Statements and policy wordings to reflect the exclusion wordings used in such treaties. This would add further cost and hence upward pressure on premiums as a result of the application of the ACL to insurance.

In the medium to long term, the finding that a term is void for unfairness may impact on the:

- availability of reinsurance cover, particularly where there is some uncertainty as to permissible cover or exclusions;
- cost or price of obtaining reinsurance (with direct flow on to pricing of the underlying insurance contracts);
- number of reinsurers and insurers providing cover for particular classes of insurance, particularly if they are seen as particularly vulnerable to the ACL; and
- assessment of claims provisioning where there is a reduction in reinsurance cover.

The negotiation of reinsurance contracts for the next treaty period after any decision which found that a term was void is likely to be adversely impacted. Where the insurer seeks reinsurance cover for the amended terms in order to avoid a gap in cover, at the very least the reinsurance premium is likely to increase. This is because the reinsurer will be providing cover for an item that was previously excluded and outside of their pricing model for the reinsurance. Reinsurance is an important part of how Australian insurers manage their risks.

Any increases in reinsurance premiums would flow through to the premiums paid for relevant insurance products by all Australians.

The worst case scenario is that reinsurers will not offer cover for policies that have provisions that exclude risks that the reinsurer is unwilling to take on. As a result, insurers would need to hold more capital to compensate for their inability to obtain reinsurance. This would also impact on the premiums paid by insurance customers. Consumers may find that there are few insurers offering particular insurance products, thereby reducing choice and increasing premiums in affected classes. In extreme cases, there may be a complete withdrawal of cover by insurers in particular areas.

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

Yours sincerely

Robert Whelan
Executive Director & CEO