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Regulatory repercussions for the general insurance industry following the Financial Services Royal Commission

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Commissioner Kenneth Hayne delivered his Final Report following the Royal Commission into Banking, Superannuation and Financial Services (**Financial Services Royal Commission**) on 4 February 2019. In total he made 76 recommendations, with 15 recommendations specifically relating to insurance.

With the Australian Government accepting all but one of the recommendations, an unprecedented amount of regulatory change has transpired in the last 12 months, with more to follow.

In August 2019, the Government released its Financial Services Royal Commission Implementation Roadmap to 'provide clarity and certainty'. The timetable is ambitious and has meant that there has been limited opportunity for extended consultation with the general insurance industry.

While many of the proposals in the insurance sector did not come as a surprise, the volume of changes, combined with the speed of consultation and implementation, will present challenges for all segments of the general insurance sector including underwriters, distributors and brokers.

This legal update tracks the current status of key regulatory changes that will impact the general insurance industry in Australia.

Financial Services Royal Commission Implementation Roadmap

Recommendation 2.4	Ending grandfathered commissions for financial advisers	Legislation to be consulted on and introduced by end-2019
Recommendation 4.2	Removing the exemptions for funeral expenses policies	
Recommendation 4.7	Application of unfair contract terms provision to insurance contract	
Recommendation 4.8	Removal of claims handling exemption for insurance	
Recommendation 4.1	No hawking of insurance products	Legislation to be consulted on and introduced by 30 June 2020
Recommendation 4.3	Deferred sales model for add-on insurance	
Recommendation 4.4	Cap on commissions paid to vehicle dealers for sale of add on insurance products	
Recommendation 4.5	Duty to take reasonable care not to make a misrepresentation to an insurer	
Recommendation 4.6	Limiting circumstances where insurers can avoid life insurance contracts	
Recommendation 4.2	Restricting use of the term 'insurer' and 'insurance'	
Recommendation 4.12	Extending the BEAR to APRA-regulated insurers	Legislation to be consulted on and introduced by end-2020

2019 Measures

The *Financial Sector Reform (Hayne Royal Commission Response – Protecting Consumers (2019 Measures)) Bill 2019* was introduced into the House of Representatives on 28 November 2019 and passed both houses of parliament on 5 February 2020.

Of relevance to general insurance, this legislation extends the law relating to unfair contract terms to insurance contracts and also extends consumer protections to funeral expense polices.

Unfair contract terms

The unfair contract terms regime contained in the *Australian Securities and Investments Commission Act 2001* (Cth) will be extended to include insurance contracts. Before the Financial Services Royal Commission, this reform had been recommended in a number of previous parliamentary and financial services inquiries. This change will take effect in August 2021.

The unfair contract regime in the ASIC Act operates to void the terms of consumer contracts or small business contracts if they are standard form contracts and the terms are declared by a Court to be unfair.

In the context of insurance contracts, unfairness will be determined based on consideration as to whether the term would cause imbalance in the rights and obligations between the insurer and insured under the policy, whether such terms are reasonably necessary to protect the legitimate interests of the insurer and whether such terms would cause financial or other determinant to the insured.

The existing unfair contract terms regime contains an exemption for the main subject matter of the contract. For insurance policies, the legislation provides that only terms that "describe what is being insured" will be exempt. This is a very narrow definition and potentially an insured could challenge exclusions or condition in the policy.

Funeral expense policies

One of the findings in the Financial Services Royal Commission was that many funeral expense policies offer limited value but may result in significant harm to vulnerable consumers. In recommendation 4.2 of the Final Report, it was recommended the existing exemption for funeral expenses policies from the definition of financial products be removed and further that consumer protection provisions should expressly cover these types of policies.

These changes have been implemented through various amendments to existing legislation which took effect on 18 February 2020.

These changes reflect the growing focus on consumer outcomes which is reinforced by the introduction of product design and development obligations and powers for ASIC to intervene in cases of significant consumer detriment.

2020 Measures

A raft of further changes is expected to be passed by parliament in 2020. Exposure draft legislation for a range of measures was released by the Australian Government in late 2019 and January 2020. The general insurance industry has been under pressure to prepare responses to the various proposals within very short consultation timeframes.

While there may yet be changes to the legislation actually introduced into parliament, a number of the measures are designed to satisfy the recommendations made in the Final Report including in respect of claims handling, add-on insurance, hawking of insurance products and the duty of disclosure.

Claims handling as a financial service

The Final Report recommended that the handling and settlement of claims, or potential insurance claims, should no longer be excluded from the definition of a "financial service".

The exposure draft legislation seeks to remove the exception in the definition of financial services and to also tailor the application of the existing financial services regime to the proposed new financial service of handling and settling insurance claims.

A wide-range of activities would be caught by the definition of "claims handling and settling settling services" including:

- making a recommendation or stating an opinion that could influence a decision whether to make an insurance claim;
- assisting another person to make an insurance claim;
- assessing whether an insurer is liable under an insurance product;
- making a decision to accept or reject all or part of an insurance claim;
- quantifying an insurer's liability under an insurance product;
- offering to settle all or part of an insurance claim; or
- satisfying a liability of an insurer under an insurance claim.

Persons involved in the handling and settling of insurance claims (including insurers, loss assessors, insurance fulfilment providers (who have the authority to reject all or part of a claim), insurance claims managers, insurance brokers) will generally be required to hold an AFSL or be authorised representative of an AFSL holder. As with other financial services, there will be an obligation to provide claims handling and settling services "efficiently, fairly and honesty" and failure to do so could result in civil penalty.

This measure could commence as early as 1 July 2020, although relevant entities will have the benefit of a transition period under 31 December 2020 to apply for a licence or to put authorisation arrangements in place.

However, even with a transition period, this change is likely to significantly increase compliance costs associated with claims management.

4 day deferral period

Add-on insurance

The Final Report tasked Treasury with developing a deferred sales model for the sale of any add-on insurance products.

The proposed legislation will apply to all insurance products which are sold with the offer or sale of a principal product or service by the provider of the principal product or a related party.

A deferred sales model will be introduced that prohibits the sale of add-on insurance products for at least four days after a consumer has acquired the principal product or service.

During the deferral period, certain prohibitions will apply to the sale of add-on insurance products by the principal provider and related third parties. After the deferral period ends and for a period of 6 weeks, sales will be permitted to consumers but communication with the consumer in forms other than writing will be restricted.

There were extensive submissions made to the Treasury arguing that a blanket deferral approach was not required in respect of all types of add-on insurance, particularly where the consumer would benefit from such a purchase and there was limited risk of high pressure selling. However, the only exemptions proposed at this stage are for comprehensive car insurance or products recommended by financial advisers.

Duty to take reasonable care not to make a misrepresentation

Hawking

The Final Report recommended that the hawking of insurance products should be prohibited.

The proposed legislation will introduce a prohibition on offers to sell or issue financial products to retail clients, including general insurance products, which are made in the course of, or because of, unsolicited contact.

Unsolicited contact is any contact which is not in response to a consumer request and which is made by telephone, in face-to-face meetings or by any other form which creates an expectation of an immediate response. If the contact is in response to a positive, clear and informed consumer request and relates to a financial product which the consumer has specifically requested, or which a reasonable person would consider to be within the scope of the request, the conduct will not be unsolicited contact.

The hawking prohibition will also extend to any agents or representatives of product issuers but will not apply to offers to sell or issue add-on insurance which are subject to the new add-on insurance rules.

These reforms are likely to invoke greater scrutiny of sales processes and may affect cross-selling opportunities.

Duty of disclosure

In relation to products sold to retail consumers, the Final Report recommended that the existing duty of disclosure should be replaced with a duty to take reasonable care not to make a misrepresentation to an insurer. This proposal is based closely on the approach taken in the UK.

The proposed law will apply to consumer insurance contracts with effect from 5 April 2021. The term "consumer insurance contracts" is a new concept in Australian insurance law and will cover those contracts of insurance, including general and life insurance contracts, which are obtained for the insureds' personal, domestic or household purposes.

The question as to whether an insured has fulfilled the new duty to take reasonable care not to make a misrepresentation to the insurer will vary depending on the facts of the particular case. There are a range of matters specified which may be taken into account including:

- the type of consumer insurance contract in question and its target market;
- explanatory material produced or authorized by the insurer;
- how clear and specific the questions asked by the insurer were;
- how clearly the insurer communicated the importance of answering the questions and the possible consequences of failing to do so;
- whether or not an agent involved was acting for the insured.

Where an insurer knew, or ought to have known, about particular characteristics or circumstances about an insured individual, these factors must be taken into account in determining whether the insured has taken reasonable care not to make a misrepresentation.

Under the proposed law, any fraudulent misrepresentation will be a breach of the new duty.

Where a breach of duty is established, the remedies available will depend on the nature of the consumer's representation. Generally, the insurer will be able to cancel a contract of general insurance in relation to the failure to comply with the duty to take reasonable care not to make a misrepresentation. The onus of proof will be on the insurer to show that the insured has failed to discharge the duty to take reasonable care.

For brokers who issue both wholesale and retail products to clients, care will need to be taken to ensure that clients properly understand the different disclosure obligations that will apply. The new duty of disclosure for consumer insurance contracts will not apply to commercial lines and for these policies, clients will still need to inform insurers of information which may be relevant to the underwriting of a risk.

New penalty framework

One of the first reforms to be introduced following the Royal Commission (and which was proceeding through the legislative process at the time the Final Report was issued) was a tougher penalty regime for breaches of corporations laws and the *Insurance Contracts Act 1984* (Cth).

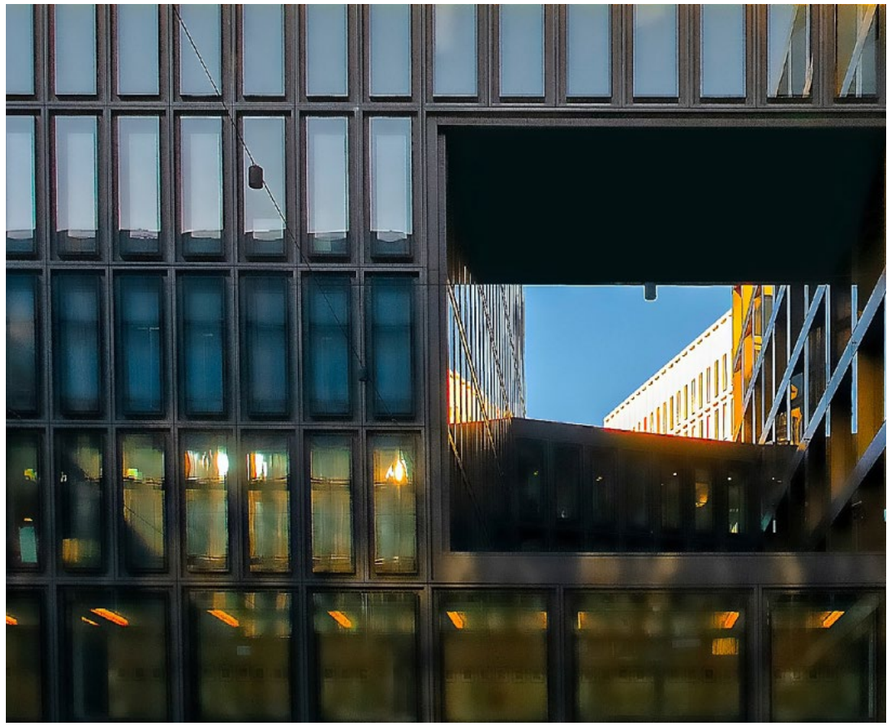
The *Treasury Laws Amendment (Strengthening Corporate and Financial Sectors Penalties) Bill* 2018 was passed on 18 February 2019 and most of the penalties introduced under the Act will apply to conduct engaged in after 13 March 2019.

For criminal offences, terms of imprisonment for individuals have been increased up to 15 years and pecuniary penalties may now be determined with reference to benefit derived, or detriment avoided, or, in the case of a body corporate, to the annual turnover of the company.

A key part of the new civil penalty framework is that penalties will now also apply to breaches of the general obligations of an Australian Financial Services Licence holder (**AFSL holder**).

Under section 912A of the Corporations Act AFSL holders are required to meet a number of core obligations including to provide financial services "efficiently, honestly and fairly". AFSL holders are also required to report "significant" breaches. Historically, there were no financial penalties associated with breach of these obligations.

All AFSL holders in the general insurance industry, including underwriters, brokers and distributors will be potentially subject to these new penalties.



Key civil penalties for AFSL holders

Individual	The greater of: (a) 5,000 penalty units (AU$1,050,000); or (b) the court can determine the benefit derived and detriment avoided because of the contravention – that amount multiplied by 3.
Body Corporate	The greater of: (a) 50,000 penalty units (AU$10.5 million); or (b) if the court can determine the benefit derived and detriment avoided because of the contravention – that amount multiplied by 3; or (c) 10% of the annual turnover of the body corporate for the 12 month period ending at the end of the month in which the body corporate contravened, or began to contravene, the civil penalty provision (up to an amount of 2.5 million penalty units – (AU$525 million).

Breach reporting regime

The Government has also prepared legislation to amend the Corporations Act to clarify and strengthen the breach reporting regime for AFSL holders. This will affect many insurers, distributors and brokers who hold such licences.

The proposed framework would generally require an AFSL holder to lodge a report with the Australian Securities and Investments Commission (**ASIC**) if there are reasonable grounds to believe that a reportable situation has arisen in relation to the financial services licensee. The time period for reporting is 30 days.

A "reportable situation" will arise where

(a) the AFSL holder or a representative of the AFSL holder has or breached, or is likely to breach, a core obligation; or

(b) the AFSL holder has commenced an investigation into whether the AFSL holder or a representative of the AFSL holder has breached a core obligation;
and the breach or likely breach is significant; or

(c) the licensee has engaged in conduct constituting gross negligence; or

(d) the financial services licensee or a representative of the financial services licensee has committed serious fraud.

Whether a breach is or is likely to be significant will depend on:

- the potential criminal or civil penalty arising from the breach;
- the number or frequency of similar previous breaches;
- the impact of the breach or likely breach on the AFSL holder's ability to provide financial services covered by the licence; and
- the extent to which the breach or likely breach indicates that the AFSL holder's arrangements to ensure compliance with those obligations are inadequate;

An AFSL holder will also be obliged to report the outcome of an investigation to ASIC where an investigation is undertaken into a breach or potential breach of a core obligation but the investigation discloses no reasonable grounds to believe that the ASFL holder or a representative of the AFSL holder has breached the core obligation.

Where personal advice is being provided to retail clients there are a number of additional obligations that apply including to carry out further investigations and, where an investigation identifies a customer has or will suffer loss or damage, to compensate the relevant customers. In these circumstances, other AFSL holders also have additional reporting obligations in so far as they become aware that a reportable situation has arisen in respect of another AFSL holder or its representatives.

Product Design and Distribution and Product Intervention

The *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019* (Cth) (**Product Design and Distribution Act**) amended the Corporations Act by inserting a new Part 7.8A – Design and distribution requirements relating to financial products for retail clients, and a new Part 7.9A – Product intervention orders.

Product Design and Distribution Obligations

Product design and distribution obligations will be imposed on "regulated persons" for certain products which have disclosure requirements under the Corporations Act within the *Australian Securities and Investments Commission Act 2001* (Cth) (**ASIC Act**).

The amendments are aimed at ensuring that financial products are targeted at an appropriate audience. The new obligations on issuers and distributors of products issued to retail clients will require the insurance industry to scrutinise products before they are offered for sale, to increase monitoring of the distribution process and to ensure that documentation is created to support the decision making and sales processes.

The term "regulated persons" is defined to include:

the issuer of a financial product
any person required to hold a financial services licence (or who is exempt from holding such a licence by a specified provision)
any authorised representative of such a licensee; and
sellers of financial products where the sale requires a disclosure document or Product Disclosure Statement (**PDS**)

Target market determination

Product design obligations on Product Issuers

Under the new legislation, the person who is responsible for preparing the disclosure document for the product (i.e. the product issuer) will now be required to:

- make a "target market determination" for a product;
- keep the target market determinations under review;
- keep records about decisions regarding target market determinations; and
- notify ASIC of significant dealings inconsistent with target market determination.

In December 2019, ASIC released a consultation paper (CP 325 Product design and distribution obligations). The proposed ASIC guidance states that what amounts to an appropriate target market determination can differ depending on:

- the type and characteristics of the financial product;
- the intended distribution approach; and
- the issuer's product governance framework.

Distribution obligations on Product Distributors

New distribution obligations will also be imposed on the person responsible for making offers, or giving advice or disclosure documents to potential investors (i.e. product distributors).

A product distributor will be prohibited from engaging in retail product distribution conduct unless a target market determination has been made, or engaging in retail product distribution conduct where a target market determination may no longer be appropriate.

In addition, the product distributor will be under an obligation to:

- take reasonable steps to ensure that retail product distribution conduct is consistent with the target market determination;
- collect and provide information specified by the product issuer and complaints related to the distribution of a product; and
- notify the product issuer of significant dealings inconsistent with the target market determination.

What is reasonable will depend on the scale of harm of the product if wrongly distributed, as well as the probability of it being wrongly distributed.

New Product Intervention Powers for ASIC

The new product intervention powers under the Product Design and Distribution Bill permits the Australian Securities and Investments Commission (**ASIC**) to proactively intervene to reduce harm to consumers before a breach occurs.

This may include regulating or banning potentially harmful financial and credit products where there is a risk of significant detriment to retail clients.

Where a product is determined by ASIC to cause significant detriment to consumers, ASIC will be able to issue a stop order and take other action that it considers appropriate.

Factors which will be relevant to ASIC's determination as to whether consumer detriment is "significant" for the purposes of this new power include: the nature and extent of the detriment (including any actual or potential financial loss to retail clients), and the impact of the detriment on retail clients.

In September 2019, ASIC issued its first product intervention orders banning certain short term lending products.

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