Royal Commission Recommendation 4.5/4.6 – Duty to take reasonable care not to make a misrepresentation and limiting avoidance of life insurance contracts

FSC Submission

February 2020

FINANCIAL SERVICES COUNCIL

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FINANCIAL SERVICES COUNCIL

1. About the Financial Services Council

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing $3 trillion on behalf of more than 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

2. Introduction

The FSC welcomes the opportunity to provide comment on the consultations relating to recommendations 4.5 and 4.6 of the Financial Services Royal Commission (**FSRC**). These recommendations relate to the duty to take reasonable care not to make a misrepresentation to an insurer and limiting avoidance of life insurance contracts.

The FSC supports recommendation 4.5 that the duty of disclosure should be replaced with a duty to take reasonable care not to make a misrepresentation in the *Insurance Contracts Act 1984*. We believe that this change will result in better consumer protections. However, we note that the Exposure Draft (**ED**) draws heavily upon established UK legislation and as a result, the proposed legislation is unnecessarily complex and confusing.

The duty to take reasonable care not to make a misrepresentation is ultimately one which falls upon the consumer and as such the duty should be as simple and as easy to understand as possible. We outline three guiding principles which frame our recommendations which we believe will result in better consumer outcomes.

The FSC supports recommendation 4.6 which amends section 29(3) of the *Insurance Contracts Act 1984* so that an insurer may only avoid a contract of life insurance on the basis of non-disclosure or misrepresentation if it can show that it would not have entered into the contract on any terms. However, we recommend that the wording be clarified and additional clarity is provided in the explanatory memorandum (**EM**).

2.1. Recommendations

In relation to recommendation 4.5, the FSC recommends that the following be implemented to strengthen the proposed regime and avoid any unintended consequences.

Recommendation 1: The criteria of target market under section 20B(3)(a) in the ED should be removed as this does not consider the implications of DDO and only serves to complicate the proposed regime. It will be a factor that is caught by section 20B(2) if it is relevant.

Recommendation 2: The criteria of agent involvement under section 20B(3)(e) in the ED should be removed as this only serves to complicate the proposed regime and will be a factor that is caught by section 20B(2) if it is relevant. Alternatively, should these criteria still be considered appropriate, we recommend that the EM include a similar example as highlighted by the UK Law Commissions where an insured has used an agent and a higher level of care was required.

Recommendation 3: That the ED be amended in line with the *Consumer Insurance Act* and the current *Insurance Contracts Act* to include a “reasonable person” to retain both subjective and objective elements.

Recommendation 4: That section 20B(4) which considers the factors that the insurer reasonably ought to have known should be removed. This creates additional complexities in what should be a simple legislative framework.

Recommendation 5: That the test for “fraudulently” should be amended to “dishonestly”.

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We also recommend that the following changes be made for further clarification:

Recommendation 6: All variations of terms and conditions of an existing contract be captured as part of the application and transition provisions in subitem 34(3)(a) of the ED.

Recommendation 7: That the ED be amended to ensure that a life insured under a group insurance contract will be treated the same as an insured under a consumer insurance contract for the purposes of this part of the Act.

In relation to recommendation 4.6, the FSC recommends the following changes to provide further clarification:

Recommendation 8: That the ED be amended so that an insurer may only avoid a contract of life insurance on the basis of non-disclosure or misrepresentation if it can show that it would not have entered into *the* contract on any terms. The EM should include an additional example to clarify the intent of the current drafting.

Recommendation 9: All variations of terms and conditions of an existing contract be captured as part of the application and transition provisions in subitem 2(2) of the ED.

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3. Duty not to make a misrepresentation

Commissioner Hayne in his final report recommended that:

> *Part IV of the Insurance Contracts Act should be amended, for consumer insurance contracts, to replace the duty of disclosure with a duty to take reasonable care not to make a misrepresentation to an insurer (and to make any necessary consequential amendments to the remedial provisions contained in Division 3).*

(**Recommendation 4.5**)

The FSC supports amending the duty of disclosure to a duty to take reasonable care not to make a misrepresentation. We believe that the reasons referenced by Commissioner Hayne and to the UK Law Commission and the Scottish Law Commission (**UK Law Commissions**) in the 2009 report "Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation" remain generally relevant and will ultimately lead to better consumer protections.

We note the current ED has drawn significantly from the *Consumer Insurance (Disclosure and Representations) Act 2012* (UK) (**Consumer Insurance Act**) as recommended by Commissioner Hayne. However, while it draws on portions of the UK legislation, it does not contain significant portions which were designed to balance the rights of insurers and consumers.

The FSC agrees with Commissioner Hayne that a consumer should not have to guess the categories of information which an insurer considers to be "relevant in their decision of whether to insure a risk"[1] and it would be unfair to suggest so. The insurer should ask clear and specific questions so that the insurer can properly assess the risks and provide insurance.

Conversely, while the insurer is responsible for asking clear and specific questions and to ensure that that the insured is aware of their duty, the consumer must take reasonable care to answer the questions honestly and carefully.

We have recommended a number of minor changes to the ED which we believe will ensure that the needs of consumers and insurers are balanced and that the intention of Commissioner Hayne is fully implemented. We also note a number of areas which require further clarification.

3.1. Guiding principles

The FSC has developed three clear and simple principles which it believes should guide this legislation, these are:

1. Did the insurer clearly explain to the consumer what their duty was;

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[1] Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report* (2019), vol 1, 298 (FSRC Final Report).

2. Were the questions asked clear and specific (eg: not ambiguous or convoluted); and
3. Did the consumer answer the questions carefully and honestly, and to the best of their ability?

We believe that these principles ultimately go to the heart of Commissioner Hayne's recommendation.

The FSC submits that following these guiding principles will result in clearer and simpler legislation. The FSC considers that the proposed Australian laws should be amended to be as principles based as possible to ensure greater flexibility rather than attempting to deal exhaustively with every possible case.

3.2. Factors which the insurer may take into account

In line with the guiding principles, the FSC considers that a number of the criteria in section 20B(3) add unnecessary complexity. Noting that section 20B(2) states that an insured's duty to take reasonable care not to make a misrepresentation is determined "with regard to all the relevant circumstances", we would submit that section 20B(3) is used to outline guiding principles.

The following table matches the provisions of the ED with the guiding principles.

Principle	Provision	Section
Did the insurer clearly explain to the customer what their duty was?	Explanatory material or publicity produced or authorised by the insurer.	s 20B(3)(b)
	How clearly the insurer communicated the importance of answering those questions and the possible consequences of failing to do so.	s 20B(3)(d)
Were the questions asked clear and specific?	How clear, and how specific, any questions asked by the insurer were.	s 20B(3)(c)
Did the consumer answer the questions carefully and honestly?	…an insured has a duty to take reasonable care not to make a misrepresentation to the insurer before the relevant contract of insurance is entered into.	s 20B(1)

The FSC suggests that the addition of factors outside of the three main guiding principles is unnecessary and will complicate how the duty to take reasonable care not to make a misrepresentation is applied in practice. If additional factors were relevant to the individual circumstances, then these would be captured by section 20B(2).

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A. Target market of insurance contract

The ED envisages that the type of insurance contract in question and its target market would be a factor in determining whether an insured has taken reasonable care not to make a misrepresentation. The EM states that “whether the insured fell within the target market of the consumer contract may also be relevant in determining whether the insured fulfilled the new duty of disclosure”.

The introduction of the design and distribution obligations (**DDO**) in Part 7.8A of the *Corporations Act* requires issuers to design products that are likely to be consistent with the likely objectives, financial situation and the needs of the consumers for whom they are intended (ie: through a target market determination). It ensures that distributors must take “reasonable” steps so that distribution is in accordance with the target market determination. Furthermore, ASIC has a wide range of product intervention powers in respect to products which are offered to consumers who are not within the specified target market determination (**TMD**).

There may be specific circumstances in which a sale of a product occurs outside the target market (for example: an application from someone outside the general target market age range for the product). This should not result in a lowering of the standards in these circumstances.

In the context of DDO and following the guiding principles, the FSC believes that the additional criteria for target market complicates the framework and this would otherwise be caught under section 20B(2) if relevant.

Furthermore, the link with the DDO regime is not appropriate for products purchased before the DDO start date as these products were not subject to the requirements of the DDO regime, including the requirement to have a TMD on the product. If a TMD is subsequently developed for the product, it would be unreasonable to retrospectively examine whether an existing customer in the product is in this TMD which was written after the product was purchased. This issue would be addressed by removing the link with the DDO regime.

If the target market criteria is retained, we recommend that this should only apply to products purchased after the DDO regime commences.

FSC Recommendation 1: The criteria of target market under section 20B(3)(a) in the ED should be removed as this does not consider the implications of DDO and only serves to complicate the proposed regime. It will be a factor that is caught by section 20B(2) if it is relevant.

B. Agent acting for the insured

The ED also considers in section 20B(3)(e) whether or not an agent was acting for the insured as a factor in assessing the new duty. It is unclear in the current drafting how the use of an agent will impact on the standard of care which is required to be taken by a consumer. To avoid confusion, the FSC recommends the removal of this factor in addition to the reasons outlined above in the removal of target market.

Should Treasury consider that it is still appropriate to retain this criteria, further clarity should be provided in the EM through the use of examples. For example, the EM is unclear on how the appointment of an agent might impact the insured's duty to take reasonable care. Under the law of agency, if an agent acts for the insured, the insured is responsible for the agent's actions. If the EM contemplates that an insured could fulfil their duty to take reasonable care simply by engaging a financial adviser as their own agent, this would put insurers at risk of having no remedy if the adviser failed to pass to the insurer the information told to them by the insured. If these criteria are to be preserved, the EM should make clear that if an agent for the insured fails to take reasonable care to answer the questions honestly, the insured remains responsible for the agent's conduct, and the insurer will still be entitled to avail itself of remedies for breach of the duty. As noted in the report authored by the UK Law Commissions, "*a higher level of care might be expected if the insurance was only sold through specialist brokers who were able to guide the consumer through the process*."[2]

FSC Recommendation 2: The criteria of agent involvement under section 20B(3)(e) in the ED should be removed as this only serves to complicate the proposed regime and will be a factor that is caught by section 20B(2) if it is relevant. Alternatively, should these criteria still be considered appropriate, we recommend that the EM include a similar example as highlighted by the UK Law Commissions where an insured has used an agent and a higher level of care was required.

C. Reasonable person test

The FSC notes that the current provisions in the ED broadly reflect the UK legislation. However, one point of difference between the ED and the *Consumer Insurance Act* is the standard of care required in the UK legislation is based on the "reasonable consumer". The insertion of a reasonable person test would allow the law to retain both objective and subjective elements of the current law. Under the current disclosure regime there are both subjective (what the insured knows to be relevant to the insurer's decision to accept the risk) and objective (what a reasonable person in the circumstances could be expected to know would be relevant to the insurer's decision) elements. The new test should be structured in a similar way to provide clarity.

The FSC believes that it is important for insurers to ask clear, specific questions and for the applicant to answer these carefully and honestly. In doing so, it is important that applicants are held to the standard of care of that of a reasonable person. A subjective test allows for applicants to make misrepresentations on the basis that they assert that they took reasonable care. Such an outcome may allow applicants to be careless or reckless in the way that they provide their answers to the insurer. It would be a poor outcome if claims were paid in circumstances where clear misrepresentations were made for both insurers and those consumers whose premiums will increase to cover claims that would otherwise have not been paid.

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[2] UK Law Commission and Scottish Law Commission, *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation,* (Law Com No 319 and Scot Law Com No 219, 2009) para 5.18 (Consumer Insurance Law Review).

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We recommend that a new duty be included in section 20B as part of the test of whether the insured took reasonable care not to make a misrepresentation which states:

a) that the insured had the knowledge of a reasonable person in the circumstances; and
b) that the insured knew that a matter about which the insurer asked a clear and specific question was relevant to the insurer.

The FSC believes that is it important to provide additional objective guidance in a test which is otherwise more subjective than the previous regime.

FSC Recommendation 3: That the ED be amended in line with the *Consumer Insurance Act* and the current *Insurance Contracts Act* to include a "reasonable person" to retain both subjective and objective elements.

3.3. Particular characteristics of the insured

The FSC also strongly questions the inclusion of section 20B(4) which states that if an insurer was aware, or ought reasonably to have been aware, of any particular characteristics or circumstances of the insured, these are to be taken into account in determining whether an insured has taken reasonable care not to make a misrepresentation.

We note Commissioner Hayne stated in his final report that "the duty does not require an individual to surmise, or guess, what information might be important to an insurer."[3] In line with the guiding principles, the FSC believes that this provision is unnecessary and creates further confusion over the duty of the insured.

There is no question that if the insurer clearly knew of a circumstance that is relevant to the insured's ability to take reasonable care in answering the questions asked of them, then this should be taken into account. There should be no dilution of the duty if the applicant had previously disclosed a matter in a previous application, possibly many years beforehand or to a related party in an application for an entirely different product. Disclosures may also change over time due to a change in symptoms or an underlying condition so the inclusion of this criteria will only create ambiguity as to what a consumer needs to disclose to an insurer.

It is unclear in the EM where the line between when an insurer clearly knows something about the insured or when an insurer "ought reasonably to have been aware". For example, if a consumer fills in an online quote but two years later called up and purchased a policy, ought the insurer have reasonably ought to have been aware of the information previously filled in by the consumer online? This is further complicated by the number of mergers and acquisitions in the industry as data may be held across multiple legacy systems. Insurers do not, and will not, have IT solutions which can deliver this level of awareness.

We would submit that example 1.2 of the EM should be removed. Lesley should still be required to answer all questions in the online application carefully and honestly and should not be relieved of this duty because of an earlier conversation with a branch employee. At

[3] FSRC Final Report, 300.

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the time of the conversation, there was no application and recording her details may not have been contemplated by Lesley when she had the initial conversation. Recording Lesley's details prior to an application may also amount to a privacy breach.

At its most fundamental level, the insured should simply be required to answer all questions honestly and to the best of their ability. In turn, insurers should clearly explain to the customer what their duty is (such as through explanatory material) and the consequences of not answering questions correctly, and ask questions in a clear and specific manner.

FSC Recommendation 4: That section 20B(4) which considers the factors that the insurer reasonably ought to have known should be removed. This creates additional complexities in what should be a simple legislative framework. Furthermore, example 1.2 of the EM should be removed.

3.4. Fraudulently versus dishonestly

The FSC notes the test under section 20B(6) in the ED is that a misrepresentation must have been made "fraudulently", this is in comparison to the test under the *Consumer Insurance Act* where a misrepresentation must only have been made "dishonestly".

While it is clear that this drafting decision was made to align with the other provisions in the *Insurance Contracts Act*, we note that the proof for fraud is a higher bar than that of dishonesty. In order to establish fraud, one must typically demonstrate dishonesty and a necessary intent to profit from such an act.

The UK Law Commissions noted that "the insurer's task of proving that a misrepresentation was made deliberately or recklessly should not be unduly onerous or require an exceptionally high standard of proof."[4]

The FSC believes that this sets the bar too high that it is unlikely to serve any utility.

FSC Recommendation 5: That the test for "fraudulently" should be amended to "dishonestly".

3.5. Application and transition period

Subitem 34 of the ED provides further information on the application of the legislation and transitional provisions. These are reflected in the EM. Subitem 34(3)(a) outlines a variation of a policy to increase the sum insured or to provide one or more additional kinds of insurance cover.

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[4] Consumer Insurance Law Review, para 4.23.

The FSC submits that there are additional situations where the terms and conditions of a contract may be varied to benefit the insured, which include for example:

- Reducing the waiting period;
- Increasing the benefit period;
- Changing the scope of cover (eg: upgrading from a standard to a premium product);
- Changing occupation classification;
- Change in TPD definition (any to own);
- Change from smoker to non-smoker status; and
- Removal of amended terms (exclusions/loadings).

In each of the examples above insurers will be underwriting the variation to the policy and will therefore rely on the insured providing accurate information in order to determine whether the variation will be accepted. We consider the insured should be subject to the same duty in respect of the information provided to the insurer for any variations, and this should not be limited by the variations presently listed in the ED.

FSC Recommendation 6: All variations of terms and conditions of an existing contract be captured as part of the application and transition provisions in subitem 34(3)(a) of the ED.

3.6. Individually underwritten group insurance contracts

At the Treasury roundtable on 11 February 2020, it was confirmed that the new duty is intended to apply to life insureds under retail and group insurance contracts. However, as presently drafted, the definition of 'consumer insurance contract' in the ED does not extend to group insurance contracts. While s27AA(2) provides that the duty will apply to a life insured under a group insurance contract, the fact that a group insurance contract does not fall within the definition of 'consumer insurance contract' has other implications.

For example, the factors for consideration in s20B(3) only apply to consumer insurance contracts. This means a life insured under a group insurance contract will be under the same duty, but the insurer will not be directed to consider the same factors as it would for an insured under a consumer insurance contract. This will lead to an inconsistent approach under retail and group insurance contracts.

Treasury should therefore consider, for the purposes of the new duty, either expanding the definition of consumer insurance contract to include group insurance contracts, or including an additional section which confirms that if there has been a breach of the duty in respect of a group insurance contract by a life insured, that contract will be treated as a consumer insurance contract for the purposes of this Division of the Act

FSC Recommendation 7: That the ED be amended to ensure that a life insured under a group insurance contract will be treated the same as an insured under a consumer insurance contract for the purposes of this part of the Act.

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4. Limiting avoidance of life insurance contracts

Commissioner Hayne in his final report recommended that:

> *Section 29(3) of the Insurance Contracts Act should be amended so that an insurer may only avoid a contract of life insurance on the basis of non-disclosure or misrepresentation if it can show that it would not have entered into a contract on any terms.*

(**Recommendation 4.6**)

The FSC supports the implementation of recommendation 4.6 however recommends that further clarity be provided in either the ED or EM.

Commissioner Hayne was concerned that insurers could "avoid a contract of life insurance for non-disclosure or as a result of misrepresentation only if the insurer would not have entered into a contract with the insured *on any terms*"[5]. That is, where an insurer may still have offered a contract of life insurance but on different terms (eg: with an exclusion), an insurer should not be allowed to avoid the contract.

The FSC agrees with this however notes that the proposed wording is problematic. We would suggest that the ED be amended so that an insurer may only avoid a contract of life insurance under s 29(3) if it can show that it would not have entered into a contract for the specific type of policy which the insured had applied for on any terms ie: "*the* contract of life insurance with the insured on any terms". The use of the term "the contract" aligns with other provisions in the *Insurance Contracts Act*. This is also consistent with the comparable wording used in section 5 of the *Consumer Insurance Act*.

However, the FSC recommends that examples are provided in the EM to clarify the intent of Commissioner Hayne. We provide a suggestion below:

> *Jason purchased income protection insurance two years ago. When applying for the income protection insurance Jason made a non-fraudulent misrepresentation to the insurer, and had not taken reasonable care in his disclosure with regard to symptoms of ventricular tachycardia (an irregular heartbeat) he had previously experienced. The insurer's internal underwriting policy, which was consistently followed in practice, stated that applications for income protection cover under that type of policy which disclosed symptoms of ventricular tachycardia should be declined. The insurer may have accepted death cover however this was never applied for by Jason. As such, the insurer* ***can avoid*** *the income protection insurance contract.*

FSC Recommendation 8: That the ED be amended so that an insurer may only avoid a contract of life insurance on the basis of non-disclosure or misrepresentation if it can show that it would not have entered into *the* contract on any terms. The EM should include an additional example to clarify the intent of the current drafting.

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[5] FSRC Final Report, 301.

4.1. Application and transition period

Subitem 2 of the ED provides further information on the application of the legislation and transitional provisions. These are reflected in the EM. Subitem 2(2) outlines a variation of a policy to increase the sum insured or to provide one or more additional kinds of insurance cover.

As outlined in section 3.5 above, there are several other scenarios where the terms and conditions may be varied.

FSC Recommendation 9: All variations of terms and conditions of an existing contract be captured as part of the application and transition provisions in subitem 2(2) of the ED.