7 March 2016
Senator Edwards
Chair
Senate Economics Legislation Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

By Email: economics.sen@aph.gov.au

Dear Senator Edwards,

Inquiry into Corporations Amendment (Life Insurance Remuneration Arrangements) Bill 2016

Thank you for the opportunity to provide comments on the amendments included in the Corporations Amendment (Life Insurance Remuneration Arrangements) Bill 2016.

The Financial Services Council (FSC) has over 115 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, licensed trustee companies and public trustees. The industry is responsible for investing more than $2.6 trillion on behalf of 11.5 million Australians. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

The FSC supports the life insurance reforms which are designed to enhance advised life insurance and improve consumer outcomes. The FSC has worked alongside the Association of Financial Advisers, and Financial Planning Association to assist the Government in developing a package of reforms announced by the Minister for Small Business and Assistant Treasurer on 6 November 2015 (Life Insurance Reform Package). The Life Insurance Reform package seeks to address the issues in life insurance advice including reducing misaligned incentives to enhance quality of advice outcomes. These reforms are intended to commence 1 July 2016 and are important measures to address the issues raised in ASIC Report 413 (“ASIC Review”).

The FSC welcomes the opportunity to discuss its submission, please contact me on (02) 9299 3022.

Yours sincerely,

BIANCA RICHARDSON
SENIOR POLICY MANAGER
LIFE INSURANCE AND ADVICE

The Financial Services Council ("FSC") welcomes the opportunity to provide feedback to the Senate Economics Legislation Committee Inquiry on the Corporations Amendment (Life Insurance Remuneration Arrangements) Bill 2014 ("Bill").

The FSC made a submission on the Exposure Draft Legislation and Explanatory Memorandum for the Corporations Amendment (Life Insurance Remuneration Arrangements) Bill 2015 ("Exposure Draft Submission"). Whilst the FSC's Exposure Draft Submission provided feedback on some of the design aspects of the proposed amendments, the FSC supports the life insurance reforms which are designed to improve advised life insurance and enhance consumer outcomes.

The key reforms proposed in the Exposure Draft and now in the Bill seek to make important changes to reduce misaligned incentives and amend remuneration arrangements to better manage conflicts of interest in life insurance advice.

1. Background

ASIC Report 413 ("ASIC Review") found, as was re-iterated in the Trowbridge Review of Retail Life Insurance Advice, and the Financial System Inquiry, that remuneration arrangements allowing commissions of 120 per cent of the first year's premium create an incentive to offer advice that may not be in the best interests of the client (notwithstanding the legal requirements of the best interests duty). ASIC Review also found that 45% of cases reviewed failed to meet the required advice standards where high upfront commission was used, as well as there being a correlation between high upfront commissions and high lapse rates.

The Association of Financial Advisers ("AFA"), the Financial Planning Association ("FPA") and the Financial Services Council ("FSC") have together worked constructively seeking to address the issues raised in ASIC Review and put forward important changes (Life Insurance Reform Package) to improve outcomes for consumers.

The Bill gives effect to the Life Insurance Reform Package agreed by the industry and enables ASIC to determine acceptable benefits to be paid in relation to these products.

The FSC's Exposure Draft Submission provides feedback on the key aspects of the reform, which is included as an attachment to this submission. To address the concerns raised by ASIC in its report, the FSC believes the following measures are necessary:

1. Removal of high up front commissions, and introducing caps on upfront commission on life insurance products;
2. Extension of the responsibility period (clawback of adviser payments) from 1 year to 2 years;
3. An appropriate transition period;
4. Continued support of fee for service and level commission payment structures in respect of life insurance on an industry wide basis;
5. Appropriate and cost effective monitoring of these new arrangements to provide additional integrity around adviser behaviour; and

6. Reviewing the application of this proposed model, with a commitment to move to level commissions and fee for service remuneration arrangements if the proposed model is failing to achieve its objectives.

2. Key reforms proposed in the Bill

The Bill:

- Removes the conflicted remuneration exemption for certain life insurance products from the Corporations Act;
- Enables commissions to be paid for life insurance products where certain requirements are met including introducing certain types of allowable commissions and introducing 2 year clawback arrangements. The ASIC instrument will set out the acceptable benefits payable for life insurance products;
- Provides an appropriate transition to the commission changes (the ASIC Instrument will set maximum upfront and ongoing commission) - commission structures will gradually drop from existing rates of up to 120 per cent to maximum of 80 per cent (from 1 July 2016), and then 70 per cent of first year premium (from 1 July 2017) before landing at a maximum of 60 per cent commission on first year premium (from 1 July 2018);
- Introduces a 2 year clawback period will be introduced which is a 12 month extension from current industry common practice. Insurers generally require a 12 month clawback period which are designed to reduce the incentive for an adviser to replace a client's existing insurance within the clawback period (note – a clawback is only required where an adviser is remunerated on an upfront commission basis); and
- Enables alternative remuneration models to be used. Advisers are free to use alternative remuneration options and continue to use level commission or fee for service options.

Pursuant to the Life Insurance Reform Package, insurers will provide policy replacement (lapse reporting) data to ASIC which ASIC will use for its review in 2018 to determine whether the life insurance reforms have been effective in enhancing consumer outcomes.

Furthermore, the FSC is also developing a Life Insurance Code of Practice (Code of Practice) between life insurers and consumers which is expected to be in place by 1 July 2016. Whilst Code of Practice is still in development, the code will seek to set standards in relation to selling insurance, claims handling and assisting vulnerable customers.

3. Consumer Benefits of the Reforms

Reducing misaligned incentives

The removal of the exemption from conflicted remuneration, reducing high upfront commissions and allowing commissions where certain requirements are met, as well as the introduction of a two year clawback period are designed to reduce misaligned incentives and enhance consumer outcomes.

We believe that setting maximum caps of 60 per cent for upfront commissions and 20 per cent for ongoing commissions, in conjunction with an extended clawback period of 2 years (with a reduced clawback rate in year 2) will improve consumer outcomes.

Further, clawback or extended retention periods seek to mitigate any residual risk that may arise from allowing benefit arrangements to continue.

Reforms supported by existing obligations

The reforms are supported by conduct obligations introduced through the Future of Financial Advice reforms (FOFA) with the Best Interest Duty and related obligations requiring advisers to provide advice that is in their client's best interest and to prioritise the client's interests in a situation of conflict.

Advisers and Licensees have a responsibility to ensure they meet these obligations when providing personal life insurance advice to retail clients. ASIC is empowered to take appropriate enforcement action for failure to meet these obligations.

Exception reporting - addressing churning and poor quality advice

To further enhance consumer outcomes, life insurers have put forward an important integrity measure and will provide exception reporting to ASIC. The purpose of the exception reporting is designed to identify individuals with high lapse rates which, together with other information, may indicate a particular pattern which warrants further inquiry.

This will assist ASIC with monitoring and enforcement activities to identify problem advisers and to take action where advisers are 'churning' policies and providing poor advice.

We note that further investigation by ASIC will be needed to tell the difference between those advisers 'churning' policies and those advisers acting in the best interests of their clients.

Exception reporting will commence this year with insurers expecting to provide the first exception report to ASIC in September 2016 and on a 6 monthly basis thereafter. In addition to exception reporting insurers will continue to proactively report advisers to ASIC where concerns remain in relation to unnecessary or excessive switching.

This will enable ASIC to undertake a more targeted review to identify those advisers who are churning and providing poor quality advice. It is also envisaged that this process will assist ASIC with the 2018 review.

Review of reforms and enhanced consumer outcomes

ASIC will undertake a review in 2018, reviewing information on life insurance remuneration, lapse rates and clawback data. This review is important for determining whether the life insurance reforms have been effective in enhancing consumer outcomes. The Government has advised that if the 2018 review does not identify significant improvements in product churn and the quality of advice, the government will move to mandate level commissions as was recommended by the Financial System Inquiry.

4. Impact of Reforms

As was noted in our Exposure Draft submission, these reforms have been carefully designed to minimise the impact on small business and advisers. The current commission ratios were determined after extensive consultation with industry including the AFA and the FPA.

Commission structures will gradually drop from existing rates of up to 120 per cent to 80 per cent, and then 70 per cent of first year premium before landing at a maximum of 60 per cent commission on first year premium. At the same time, trail commissions will potentially double, from 10 per cent to 20 per cent, offsetting some of the initial impacts.

These reforms apply equally to all advisers, regardless of whether they are providing advice through an institutional, non-institutional, or a small independent licensee.

We note that the FSC **does not** "only represent the Banks and Insurance companies". The FSC has over 115 members across funds management businesses, superannuation funds, life insurers, financial advisory networks, licensed trustee companies and public trustees. Across life insurance and advice FSC members include a diverse range of members, including Financial Advisory Network (FAN) members which include both institutional and non-institutional Licensee members. Advisers licensed through FAN members of the FSC include approximately 44% of the 23,300 advisers providing personal advice to retail clients.

Importantly the amendments do not restrict advisers from choosing other remuneration models such as fee for service or level commission models. The FSC notes that advisers are always able to charge a fee for the services they provide. If commission payments permitted under the proposed reform package are not sufficient to cover the cost of advice services these businesses have the opportunity to recoup expenses via fees charged directly to the customer.

Several factors need to be considered when assessing the impacts of this package on advice businesses, including:

- The split of revenues in an advice business between investment advice and life insurance advice. Practices that offer holistic financial services may be better placed to absorb these changes compared to businesses that specialise on risk insurance.

- Whether the business is established. Businesses that have existing customers may have a large ongoing commission income stream that would make them better placed to absorb these changes.

- The value of advice businesses will grow over time as the recurring income grows due to the increased trail commission.

Readiness and system changes

These reforms are intended to come into effect 1 July 2016. As noted in our Exposure Draft submission, we reiterate that the industry continues to support the 1 July 2016 commencement date in relation to the reduction of commissions and the implementation of a clawback regime. This was agreed prior to the release of ASIC Consultation Paper 245. ASIC Consultation Paper 245 notes that regulations will not be provided to industry until sometime in April 2016. Furthermore the final form of the ASIC Instrument is also not yet known.

This timetable adds an additional delay to the process, with industry unable to assess some of the definitions that will be applied and what criteria ASIC will use to set the prescribed benefit amount, and how the clawback provisions will operate in practice.

This timetable gives industry a very limited time to establish all of the build requirements and approvals and implement process changes to ensure that changes are all in place by 1 July 2016.

ASIC Facilitative Period

The industry seeks a facilitative compliance approach by ASIC to the life insurance reforms for the first 12 months, which would be consistent with the stance taken by ASIC following the introduction of the FOFA reforms, as well as with ASIC's 'stance during the introduction of other major policy reforms.'[1] Aside from ASIC applying a consistent approach to major policy reform, the legislation and the ASIC instrument is likely to be finalised with very little time to enable industry to make the necessary system and process changes (which includes a range of changes to administrative functions, processes, procedures changing documentation, training staff and advising third parties of any changes) before the commencement of the reforms on 1 July 2016.

Industry seeks to comply with the spirit of the reforms commencing 1 July however there may be initial system errors implementing the precise detail or process mistakes that arise in the initial period which may result in technical breaches of the law.

The FSC does not consider that ASIC taking a facilitative approach to the life insurance remuneration amendments will impact ASIC from undertaking a robust 2018 review.

Exception reporting will commence this year and will enable ASIC to undertake targeted review of those advisers who may be engaging in unnecessary or excessive product replacement.

Where an adviser is engaging in churn and providing inappropriate advice, they will be in breach of existing *Corporations Act 2001* requirements including the obligation to act in the best interest of the client, the duty to prioritise the client's interest in a situation of conflict. ASIC is empowered, and will continue to be empowered during a 12 month facilitative period, to take appropriate enforcement action for failure to meet these obligations.

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[1] FoFA Background and implementation, ASIC. Source: http://www.asic.gov.au/regulatory-resources/financial-services/future-of-financial-advice-reforms/fofa-background-and-implementation/

5. Conclusion

A number of important reviews, including the ASIC Report 413 (ASIC Review), the Trowbridge Review of Retail Life Insurance Advice, and the Financial System Inquiry have recommended the need for changes to remuneration arrangements in the life insurance advice. The industry engaged in extensive consultation and careful consideration to agree on the Life Insurance Reform package in order to address the issues raised in the ASIC Review, namely to reduce misaligned incentives and improve consumer outcomes.

The reforms which include the Bill, the ASIC instrument and the ASIC 2018 Review, amongst other important initiatives, are aimed at achieving these objectives.

The industry would like to see improvements in quality of advice and removal of those advisers who are engaging in churn and replacing products that have no material benefit for consumers. The industry is taking further proactive measures, through the introduction of Exception Reporting, to assist ASIC identify advisers who may be engaging in unnecessary or excessive product replacement.

This proposal will assist ASIC to take enforcement action against those advisers responsible for churn, as well as assisting ASIC with the 2018 review.