



**ASIC**

Australian Securities & Investments Commission

## REPORT 413

# Review of retail life insurance advice

October 2014

## About this report

This report presents the findings of ASIC's research into, and surveillance of, personal advice given to consumers about life insurance.

The purpose of the project was to understand the advice consumers are currently receiving about life insurance and to identify opportunities to promote advice that is in the best interests of consumers.

## About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

**Consultation papers:** seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

**Regulatory guides:** give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

**Information sheets:** provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

**Reports:** describe ASIC compliance or relief activity or the results of a research project.

## Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Examples in this report are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

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# Executive summary

- 1 ASIC has a focus on life insurance advice because it is of critical importance to the long-term financial wellbeing of Australian consumers. Life insurance is a key product through which consumers manage risk for themselves and their families.
- 2 Quality financial advice helps consumers identify their life insurance needs and find appropriate and affordable products that meet those needs.
- 3 This report reviews the advice consumers receive about life insurance. It builds on other work we have done focusing on the quality of retirement advice and advice about self-managed superannuation funds (SMSFs).<sup>1</sup>
- 4 Consumers purchase life insurance in one of three ways:
- (a) through an advice provider (adviser);<sup>2</sup>
  - (b) directly from an insurer; or
  - (c) through their superannuation fund and the group life cover offered by the fund.
- 5 This report focuses on the first distribution channel only—that is, distribution through personal advice. It presents the findings of our research into, and surveillance of, advice about life insurance.<sup>3</sup> Our purpose in this project was to better understand:
- (a) how life insurance is sold by advisers;
  - (b) how advisers are remunerated for that advice;
  - (c) the drivers behind product replacement advice to consumers; and
  - (d) the quality of the life insurance advice consumers receive.
- 6 Conducted between September 2013 and July 2014, our research project involved two phases:
- (a) industry roundtables and a survey of 12 insurers that manufacture and distribute life insurance products under personal advice models (phase 1); and
  - (b) a targeted surveillance of advisers who give personal advice to consumers on life insurance products, which involved a review of 202 advice files (phase 2)—our surveillance targeted advisers who sell a large amount of life insurance products.

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<sup>1</sup> See Report 279 *Shadow shopping study of retirement advice* (REP 279) and Report 337 *SMSFs: Improving the quality of advice given to investors* (REP 337).

<sup>2</sup> An advice provider is a person to whom the obligations in Div 2 of Pt 7.7A of the *Corporations Act 2001* (Corporations Act) apply when providing personal advice to a retail client. This is generally the individual who provides the personal advice. For ease of reference, we refer to advice providers as advisers in this report.

<sup>3</sup> In this report, ‘life insurance’ means ‘retail life insurance’: see paragraph 37 for how we define ‘life insurance’ in this report.

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This work builds on action we have taken to remove poor Australian financial services (AFS) licensees and advisers from the industry where we have found problems with life insurance advice. In these cases, we found evidence of poor life insurance advice that resulted in considerable detriment to consumers, including:

- (a) evidence that advisers failed to adequately consider their clients' personal circumstance and needs, leading to situations where consumers received inferior policy terms, paid more for cover, had health issues excluded and, in some cases, had claims denied where they previously had cover; and
- (b) evidence of unnecessary or excessive switching of clients between policies to maximise commission income, with a failure to consider or recommend insurance that reasonably correlated to clients' personal circumstances or objectives.<sup>4</sup>

## What we found

### Industry trends

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The most common policy type across the industry is a stepped premium policy. The premium on a stepped premium policy increases or 'steps up' each year according to risk factors such as the client's age.

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In phase 1, we found that life insurance policies are lapsing at high rates. For example, for stepped premium policies, we found that, in 2013, policy lapses doubled from approximately 7% in the first year to 14% in the second year. After the initial spike, lapse rates remain high (above 14%) for the next three years before tapering.<sup>5</sup>

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The drivers behind these high lapse rates include:

- (a) product innovation by insurers, such as changing actuarial assumptions at underwriting or the redesign of key policy features such as definitions and exclusions, which leads to the repricing of policies;
- (b) age-based premium increases affecting affordability; and
- (c) incentives for advisers to write new business or rewrite existing business to increase commission income.

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We also found a correlation between high lapse rates and upfront commission models.

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<sup>4</sup> For example, see Media Release (13-019MR) *ASIC cancels licences of national financial planning business* and ASIC advisory (12-60AD) *ASIC accepts permanent undertaking from Adelaide adviser*.

<sup>5</sup> A policy lapse is when a policy ceases due to non-payment or cancellation by the client. We exclude claims and a policy ceasing due to the insured person reaching a certain age (e.g. age 65) from our definition of a policy lapse. See paragraphs 110–111 for our definition of a policy lapse.

### **Advice quality**

- 12 We reviewed 202 advice files as part of phase 2. Files were selected for review from AFS licensees who were active in giving life insurance advice: see Section B for the methodology employed for this surveillance.
- 13 Our sample included advice given before and after the mandatory commencement date for the Future of Financial Advice (FOFA) reforms on 1 July 2013.<sup>6</sup>
- 14 We rated the advice by reference to the conduct obligations in the *Corporations Act 2001* (Corporations Act) (see Table 1) that were in force at the time the advice was given. These conduct obligations apply to personal advice and include the obligation to give appropriate advice, to act in the best interests of the client and to give priority to the interests of the client in the event of a conflict of interest. If the advice complied with the law, we rated the advice ‘a pass’. If the advice failed to meet the relevant legal standard, we rated the advice ‘a fail’.
- 15 We also commissioned an independent advice review where an external consultant reviewed a sample of files for quality checking and to ensure our ratings were sound and consistent: see Section B for further detail on this methodology.
- 16 We found that 63% of consumers received advice that met the standard for compliance with the law, while 37% of consumers received advice that failed to meet the relevant legal standard that applied when the advice was given.<sup>7</sup>
- 17 We found the quality of advice varied among the advice we rated as compliant. We found advice that clearly met the needs of the client through to files that were barely compliant with the legal threshold. We give some examples of this advice in this report.
- 18 We have found significant room for improvement among the advice we reviewed and we will be actively working with the advice industry to lift the standard of life insurance advice.
- 19 Of the advice that we rated a fail, we found serious failings with respect to compliance with the law.
- 20 We also found that the way an adviser was paid (e.g. under an upfront commission model compared to a hybrid, level or no commission model)

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<sup>6</sup> *Corporations Amendment (Future of Financial Advice) Act 2012* and *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012*.

<sup>7</sup> For example, s945A of the Corporations Act for pre-FOFA advice, or the requirements under s961B, 961G, 961H and 961J for post-FOFA advice, in addition to the switching requirements under s947D.

had a statistically significant bearing on the likelihood of their client receiving advice that did not comply with the law: see Figure 18.

21 Of the 202 files in our sample, we found that where the adviser was paid under an upfront commission model, the pass rate was 55% with a 45% fail rate. Where the adviser was paid under another commission structure, the pass rate was 93% with a 7% fail rate: see Figure 18.

22 Our findings in this review indicate that the impact of adviser conflicts of interest on the quality of life insurance advice is an industry-wide problem. Addressing this problem will require an industry-wide response.

23 This is because an individual insurer may change its remuneration arrangements to mitigate the effect of conflicts of interest among advisers selling their policies, but is likely to lose business to competitors. This is commonly referred to as the ‘first mover’ problem where the first mover is disadvantaged relative to their industry peers who pick up the business lost by the ‘first mover’.

24 The appendix to this report includes a checklist for advisers, AFS licensees, compliance consultants and insurers about relevant factors to consider in giving or assessing personal advice about life insurance. The checklist covers existing obligations as well as further considerations for giving best practice advice.

## **Recommendations**

25 We recommend that insurers:

- (a) address misaligned incentives in their distribution channels;
- (b) address lapse rates on an industry-wide and insurer-by-insurer basis (e.g. by considering measures to encourage product retention); and
- (c) review their remuneration arrangements to ensure that they support good-quality outcomes for consumers and better manage the conflicts of interest within those arrangements.

26 We recommend that AFS licensees:

- (a) ensure that remuneration structures support good-quality advice that prioritises the needs of the client ;
- (b) review their business models to provide incentives for strategic life insurance advice;

Note: Strategic life insurance advice includes advice on the type, level, structure and affordability of life insurance cover based on the client’s cash flow position and which prioritises the client’s insurance needs. Strategic advice can be stand alone or, where appropriate, provide the framework for product advice.

- (c) review the training and competency of advisers giving life insurance advice; and

- (d) increase their monitoring and supervision of advisers with a view to building ‘warning signs’ into file reviews and create incentives to reward quality, compliant advice.

27 Professional associations and training providers may wish to adopt the checklist in the appendix to this report when reviewing their adviser training and continuing professional development programs for their members.

### **Our further work**

- 28 Where the advice failed to comply with the law, we will consider enforcement action or other appropriate regulatory action with respect to the individual adviser or, depending on the conduct, the AFS licensee.
- 29 We will engage with AFS licensees, advisers and their professional associations about the issues they need to consider in giving compliant life insurance advice. The life insurance advice checklist in the appendix will form the basis for that engagement to lift the standard of life insurance advice.
- 30 We will update our consumer information to provide better guidance for consumers about their life insurance needs and important things to consider when seeking life insurance advice.
- 31 We hope that the findings in this report will contribute to a more informed discussion about the need for and access to appropriate life insurance products and personal advice that is in the long-term interests of Australian consumers.

## A Background

### Key points

The purpose of our project was to understand the life insurance advice consumers are currently receiving and to identify opportunities to promote advice that is in their best interests.

This section provides some context and background to our project, including an overview of:

- the life insurance industry in Australia; and
- the regulatory framework, including the FOFA reforms, which commenced on a mandatory basis on 1 July 2013 and introduced new conduct obligations for advisers who give personal advice about life insurance.

### Purpose of our project

- 32 Poor life insurance advice and sales practices have been an issue in ASIC investigations and surveillances over many years.
- 33 The Parliamentary Joint Committee on Corporations and Financial Services (PJC), in its inquiry into the Corporations Amendment (Future of Financial Advice) Bill 2011 and Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 (PJC Inquiry), made specific recommendations about the need to monitor the quality of advice about the sale of risk insurance.
- 34 The purpose of our project was to understand the life insurance advice consumers are currently receiving and to identify opportunities to promote advice that is in their best interests.

### The life insurance industry in Australia

- 35 There has been media and industry commentary about the sustainability of the life insurance industry in Australia over the past year or more, a debate generated by some key structural challenges facing the industry, including:
- (a) increasing claims arising from deteriorating economic conditions;
  - (b) profit write-downs by major insurance companies;
  - (c) downstream issues affecting profitability, such as increasing costs and increasing lapse rates; and

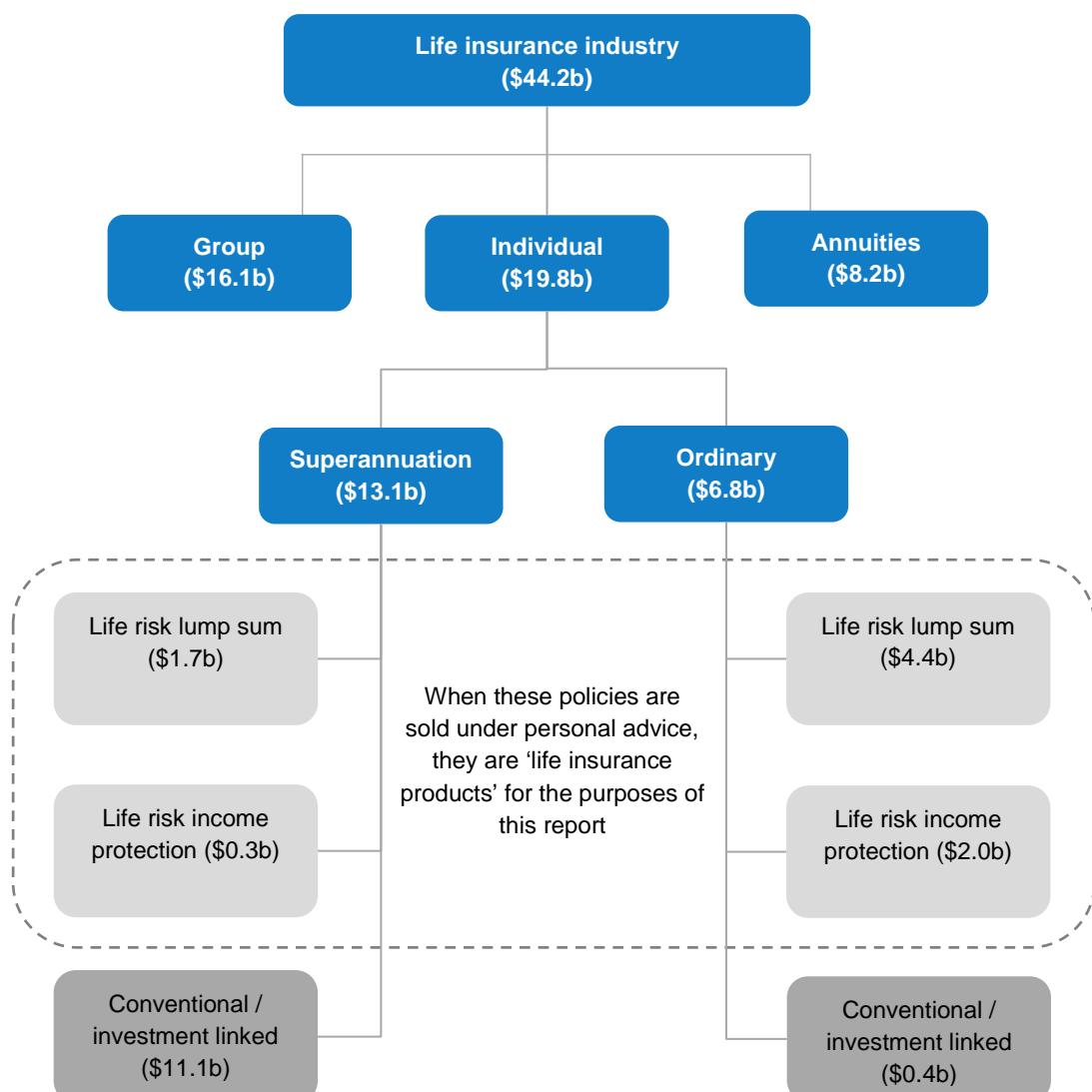
- (d) changing cost structures and risks, with changes to the distribution of life insurance products in Australia as many insurers move to a direct distribution model.<sup>8</sup>

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As at 30 June 2013, there were 28 life insurance companies in Australia.<sup>9</sup>

Figure 1 represents an aggregate overview of the life insurance industry in Australia and the different business lines and product categories of Australian insurers.

**Figure 1: The life insurance industry in Australia<sup>10</sup>**



Source: Plan for Life, Group Total Inflows, *Life insurance statistics*, March 2014.

<sup>8</sup> APRA, *Insight*, Issue 3, December 2013, p. 23.

<sup>9</sup> APRA, *Insight*, Issue 3, December 2013. This figure remains current at the date of publication.

<sup>10</sup> All values are total inflows of new and in force premiums as at March 2014. Values may not add up because of rounding.

- 37 For the purposes of this report, we define ‘life insurance’ as those lump sum and income stream products, such as life and total and permanent disability (TPD) insurance policies and trauma and income protection policies, sold to retail clients under personal advice. These policies may be held or purchased inside or outside the superannuation environment (excluding group life policies). These policies are represented in the light grey boxes in Figure 1.
- 38 The total premium value of individual life risk policies without an investment component is \$8.4 billion. This figure includes both policies sold under personal advice models, and policies sold directly or under general advice or no advice models. As at March 2014, the individual life risk policies sold under the combined models (personal, general, no advice) represented about 19% of the life risk insurance sector. While there is no comprehensive breakdown of the value of policies under advised sales channels compared to the other channels, for historical reasons advised channels remain dominant, although direct and online sales have seen significant growth over recent years.

Note: In Plan for Life’s data, the category of ‘ordinary’ life insurance includes life insurance purchased through an adviser and life insurance purchased through a direct channel under a general or no advice model. The data does not distinguish the value of those policies that relate to policies distributed through personal advice from those sold under a direct distribution model.

## The regulatory framework

- 39 As set out in Table 1, life insurers and advisers are subject to the statutory standards and requirements of:
- the Corporations Act;
  - the *Australian Securities and Investments Commission Act 2001* (ASIC Act);
  - the *Insurance Contracts Act 1984* (Insurance Contracts Act); and
  - the *Life Insurance Act 1995* and the Life Insurance Regulations 1995.

Life insurers are also regulated by the Australian Prudential Regulation Authority (APRA).

**Table 1: Regulatory framework for life insurers and advisers**

Legislation/regulation	Overview of requirements
Corporations Act: s763A, 766A, 912A, Pts 7.7, 7.7A and 7.9	<p>A retail life insurance product is a financial product. Insurers and advisers must hold an AFS licence, or be the representative of an AFS licensee, as they deal in a financial product (insurers) and provide financial product advice (advisers).</p> <p>AFS licensees must comply with various obligations under the Corporations Act and other financial services laws, including (but not limited to):</p> <ul style="list-style-type: none"> <li>• the general obligations in s912A to: <ul style="list-style-type: none"> <li>– provide financial services efficiently, honestly and fairly;</li> </ul> </li> </ul>

Legislation/regulation	Overview of requirements
	<ul style="list-style-type: none"> <li>– manage conflicts of interest;</li> <li>– ensure representatives provide services competently; and</li> <li>• the financial services disclosure obligations in Pt 7.7 if the licensee is the providing entity.</li> </ul> <p>Part 7.7A introduced new conduct obligations for the provision of personal financial product advice to retail clients, such as the best interests duty and related obligations.</p> <p>Part 7.9 includes the product disclosure obligations.</p>
ASIC Act: s12CA, 12CB, 12DA and 12DB	<p>The consumer protection provisions in the ASIC Act operate to protect consumers from misleading and deceptive conduct or unconscionable conduct by AFS licensees and representatives in the provision of financial services.</p>
Insurance Contracts Act: s13 and 29	<p>The Insurance Contracts Act regulates the content and operation of insurance contracts. It requires both the insurer and the insured to act towards the other, in respect of any matter arising under or in relation to the contract, with the utmost good faith.</p> <p>The Insurance Contracts Act also sets out what consumers must do when applying for an insurance policy, including their duty to disclose to the insurer all relevant information about the risks the insurer is accepting. Section 29(3) allows an insurer to avoid a policy within the first three years where the insured fails to comply with their duty of disclosure.</p> <p>The <i>Insurance Contracts Amendment Act 2013</i> amends the remedies available for insurers in cases of non-fraudulent non-disclosure under s29, so the insurer can alter the sum insured (s29(4) and (10)) or retrospectively vary the contract in such a way as to place the insurer in the position it would have been in if the non-disclosure or misrepresentation had not occurred (s29(6), (7), (8) and (9)).</p>
APRA	<p>Life insurers are also regulated by APRA, which supervises life insurers under the <i>Life Insurance Act 1995</i> and the <i>Life Insurance Regulations 1995</i>.</p>

## The FOFA reforms

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- The FOFA reforms introduced a suite of changes to the regulation of personal financial advice for consumers. These changes included:
- (a) a ban on conflicted remuneration (Divs 4 and 5 of Pt7.7A);
  - (b) new personal advice obligations, including:
    - (i) to act in the best interests of the client in relation to the advice (s961B);
    - (ii) to ensure that the advice provided is appropriate to the client (s961G);
    - (iii) to warn the client if the advice is based on incomplete or inaccurate information (s961H); and
    - (iv) to give priority to the interests of the client in the event of a conflict of interest (s961J);

- (c) a requirement to provide a fee disclosure statement to new clients (s962H); and
- (d) an extension of ASIC's licensing and banning powers (s913B, 915C and 920A).

**Life insurance: Exemption from the ban on conflicted remuneration**

- 41 The FOFA reforms did not extend the ban on conflicted remuneration to individual life insurance sales under personal advice. That is, commission payments for life risk insurance products (with the exceptions in paragraphs 42(a)–42(b)) are exempted from the ban on conflicted remuneration. Commission payments are the predominant remuneration structure in the industry (see paragraph 89 for a description of the different commission structures typically used in the life insurance sector). The Corporations Amendment (Streamlining Future of Financial Advice) Regulation 2014 does not impact on this exemption.
- 42 The exemption for life risk insurance is set out in s963B(1)(b) and reg 7.7A.12A of the Corporations Regulations 2001 (Corporations Regulations), which exclude monetary benefits given in relation to life risk insurance products, as defined by s764A(1)(e), unless they are given in relation to:
- (a) a group life risk policy inside superannuation (regardless of whether it is for a default or another type of superannuation fund); and
  - (b) an individual life insurance policy for the benefit of a member of a default fund.<sup>11</sup>

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<sup>11</sup> Sections 29SAC(1)(a)(i) and 29SAC(1)(a)(ii) of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) ban commission payments on MySuper products.

## B Project scope and methodology

### Key points

Conducted between September 2013 and July 2014, our research project involved two phases:

- industry roundtables and a survey of 12 insurers that manufacture and distribute life insurance products under personal advice models (phase 1); and
- a targeted surveillance of advisers who give personal advice to consumers on life insurance products (phase 2).

### Phase 1: Understanding the industry

- 43 Phase 1 of our project began with two industry roundtables with 12 life insurers (the insurers) to explain the scope of the project and to ensure that our questions were appropriately targeted so as to gather the essential information, while minimising the compliance burden on responding insurers. We wish to thank the insurers for their cooperation and assistance.
- 44 We then used our compulsory notice powers to gather information from the insurers currently writing life insurance policies under personal advice models. We excluded insurers in run-off arrangements and we also excluded life insurance sold directly to consumers under general or no advice models.
- 45 We asked the insurers questions about their current product book with a focus on a specific list of retail policy types. Our objective was to better understand at an aggregate industry level and at the individual insurer level:
- (a) the policies and policy combinations issued to clients under personal advice models;
  - (b) the policies currently in force for each policy type and how market share was changing over time;
  - (c) the policy life cycles;
  - (d) distribution arrangements and remuneration models;
  - (e) information about lapse rates for each policy type, premium type, distribution channel and remuneration model; and
  - (f) information about commission types and ‘clawback’ arrangements.
- Note: A commission or benefit that is paid to an adviser is recovered, or ‘clawed back’, by the insurer if the policy lapses within a certain period, usually within the first 12 months the policy is on foot.
- 46 Section C sets out our analysis of the data gathered.

## Phase 2: Assessing the quality of advice

- 47 Phase 2 involved a major surveillance of personal advice given to consumers about life insurance.
- 48 This was a targeted surveillance in so far as the sample of files selected for review was not a random sample of advice from randomly selected AFS licensees or authorised representatives. Rather, our objective was to identify the licensees and authorised representatives who were active in giving life insurance advice so as to test the quality of advice these licensees were giving.
- 49 To identify AFS licensees to include in our surveillance, we asked the insurers identified in phase 1 to tell us the three licensees or authorised representatives who had:
- (a) the highest number of new ‘in force’ policies written in the relevant period (2012 and 2013 financial years); and
  - (b) the highest number of policy lapses in the relevant period.
- 50 We asked for this information to identify AFS licensees who had recently given new and replacement product advice. The responses to the question in paragraph 49(b) were inconsistent due to differences in interpretation among the participating insurers; we did not select any licensee on the basis of the insurers’ response to this question. Nevertheless, our final sample included both advice to new clients and replacement product advice.
- 51 Of the pool of AFS licensees identified in the high selling category by insurers, we excluded licensees that had been the subject of recent regulatory action by ASIC. We then chose two large licensees and three medium licensees from the remaining pool. We added two small licensees to the sample so that our final sample included advice from a broad mix of licensees.

Note: The small licensees we selected were not chosen on the basis of known risk factors. To maximise efficiency, we used seven files that ASIC had previously obtained for different projects (in which the focus was not life insurance advice). The results from these licensees had a negligible impact on the overall results of this report.

## Conducting the file reviews

- 52 After we had identified the AFS licensees and authorised representatives who would be included in the sample, we used our compulsory notice powers to gather the following information:
- (a) the name of the authorised representative who provided the advice on the insurance and/or risk product;
  - (b) the client name;
  - (c) a description of the product name and/or type;

- (d) the name of the insurer who paid the commission to the licensee;
- (e) the date the commission was received by the licensee;
- (f) the amount of upfront commission received; and
- (g) the amount of ongoing commission received.

- 53 From this information, we requested client files for review based on:
- (a) the date the commission was paid (to identify pre-FOFA and post-FOFA advice);
  - (b) the amount of commission paid (to identify new advice that involved the giving of a Statement of Advice (SOA) because this was an advice review); and
  - (c) the types of life insurance products that were the subject of the advice to ensure that our policy sample was reasonably diverse, covering a suite of policy types (e.g. life, TPD, trauma and income protection insurance).
- 54 We looked at 243 files in total. Our reviews were the subject of two quality checks:
- (a) 101 files were reviewed a second time by analysts who were former financial planners with current Certified Financial Planner qualifications; and
  - (b) 20 files (five pre-FOFA and 15 post-FOFA files) were reviewed by an independent external consultant to ensure our ratings were sound and consistent.
- 55 To maintain the integrity of our sample and analysis, we excluded from our statistical analysis:
- (a) files from two advisers where we had specific intelligence that they were giving poor life insurance advice; and
  - (b) files that were inadequate or otherwise incomplete and this made it impossible to rate the advice for the purpose of this review without serving additional notices. We will be raising this issue individually with the relevant AFS licensees.
- 56 Our final sample of advice included 202 advice files from seven AFS licensees. It involved a random selection of advice from those licensees from 79 individual advisers and included a spread of pre-FOFA and post-FOFA advice: see Table 2.

**Table 2: Review of advice files—Pre-FOFA and post-FOFA**

<b>Advice type</b>	<b>Number of files</b>	<b>Percentage of files</b>
Pre-FOFA advice	94	47%
Post-FOFA advice	108	53%
<b>Total</b>	<b>202</b>	<b>100%</b>

- 57 The 202 files we reviewed included a broad range of advice types, including:
- (a) advice to new clients;
  - (b) product replacement advice to new or existing clients; and
  - (c) scaled life insurance advice.
- 58 ASIC analysts used an advice review template to standardise the assessment of the files. Most of the analysts were former financial planners with years of practical experience.
- 59 We rated the advice against the relevant legal obligations in force at the time the advice was given. If the advice complied with the law, we rated the advice ‘a pass’. If the advice failed to meet the relevant legal standard, we rated the advice ‘a fail’. As will be seen in our discussion of the case studies and in our life insurance advice checklist (see the appendix), we identified key areas for improvement to lift the quality of life insurance advice consumers receive.
- 60 We rated the pre-FOFA advice a pass if the advice was appropriate (i.e. it met the then test in s945A of the Corporations Act).
- 61 In rating the post-FOFA advice, we applied the new best interests duty (s961B), the appropriate advice test (s961G) and the client priority rules (s961J), and rated the advice a pass or a fail. Where there was some doubt as to the final rating, we gave advisers the benefit of the doubt given the law was new.
- 62 Section D sets out our detailed findings from phase 2.

## C Our findings on the industry

### Key points

This section sets out our findings from phase 1 in which we sought to better understand the life insurance policies sold under personal advice models.

For the 12 participating insurers in the survey, we found that:

- there were 2.6 million policies in force at 30 June 2013, representing a 5.8% increase over the previous year;
- life only and income protection policies are the most common policies;
- for the purposes of product design and pricing, insurers assume that policies written will remain in force for an average duration of 86 months (7.2 years);
- 58% of insurers distribute their policies through AFS licensees operating personal advice models;
- upfront commission arrangements are the dominant remuneration arrangement for advisers by a significant margin; and
- life insurance policies are lapsing at very high rates.

### Number and types of policies

63 We asked insurers what policy types and/or combinations they issued under personal advice models. Insurers sold:

- (a) life cover only;
- (b) life and TPD cover only;
- (c) life and trauma cover;
- (d) life, TPD and trauma cover;
- (e) TPD cover only;
- (f) TPD and trauma cover;
- (g) trauma cover only;<sup>12</sup>
- (h) income protection cover; and
- (i) income protection cover combinations.<sup>13</sup>

64 At 30 June 2013, the insurers had 2.6 million policies in force. This represents the total number of policies in force, not the lives insured, as many consumers will hold more than one policy type.

<sup>12</sup> Trauma insurance includes coverage for critical illness.

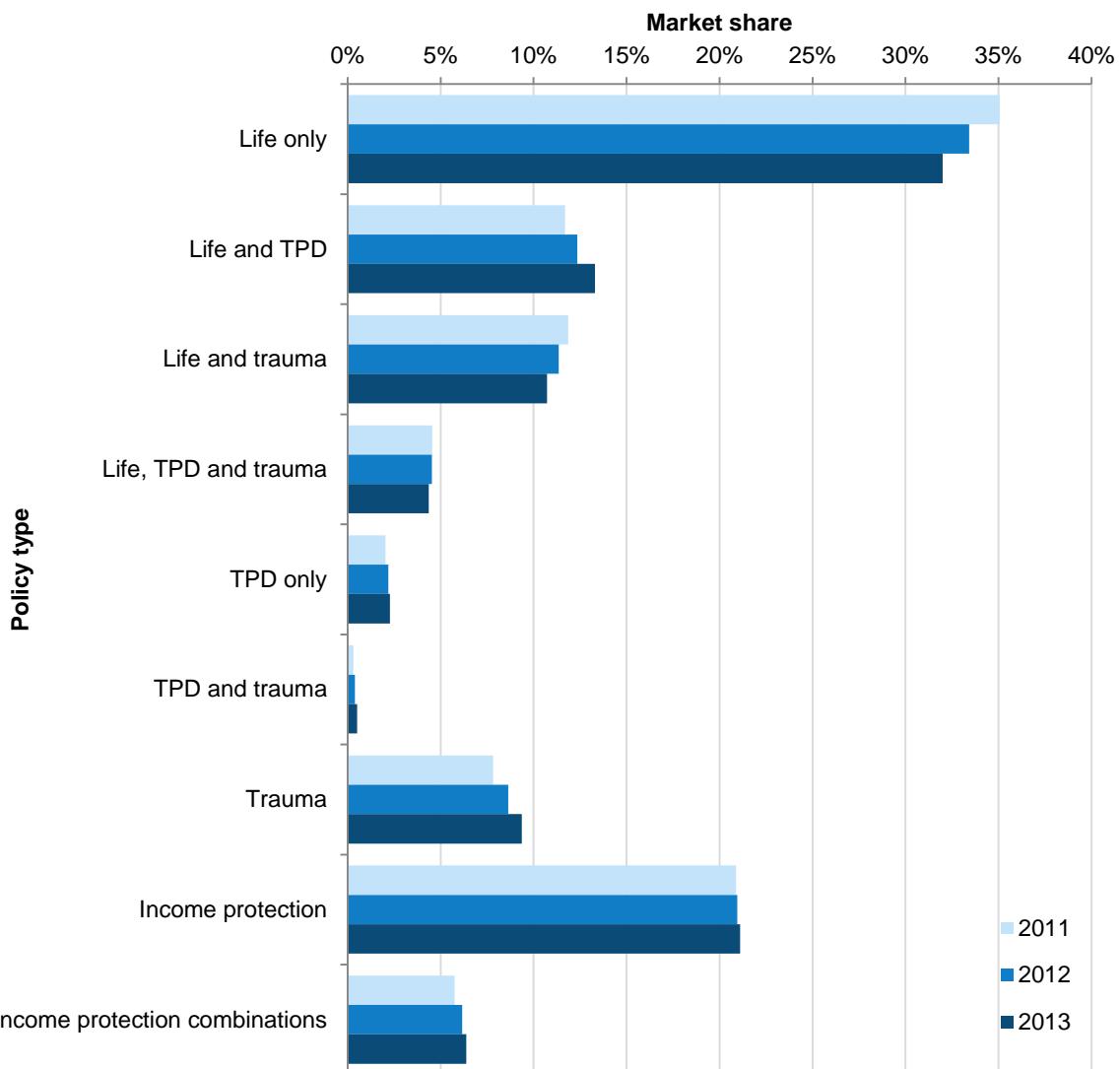
<sup>13</sup> A minority of insurers sold policies in other combinations (e.g. income protection and trauma; income protection and TPD; income protection, trauma and TPD). For consistency, we have grouped these policy combinations under the banner of income protection combinations.

- 65 The life insurance policies in force that were the subject of our survey grew at a rate of 4.5% in 2011–12 and 5.8% in 2012–13: see Table 3.

**Table 3: Life insurance policies in force (2011–13)**

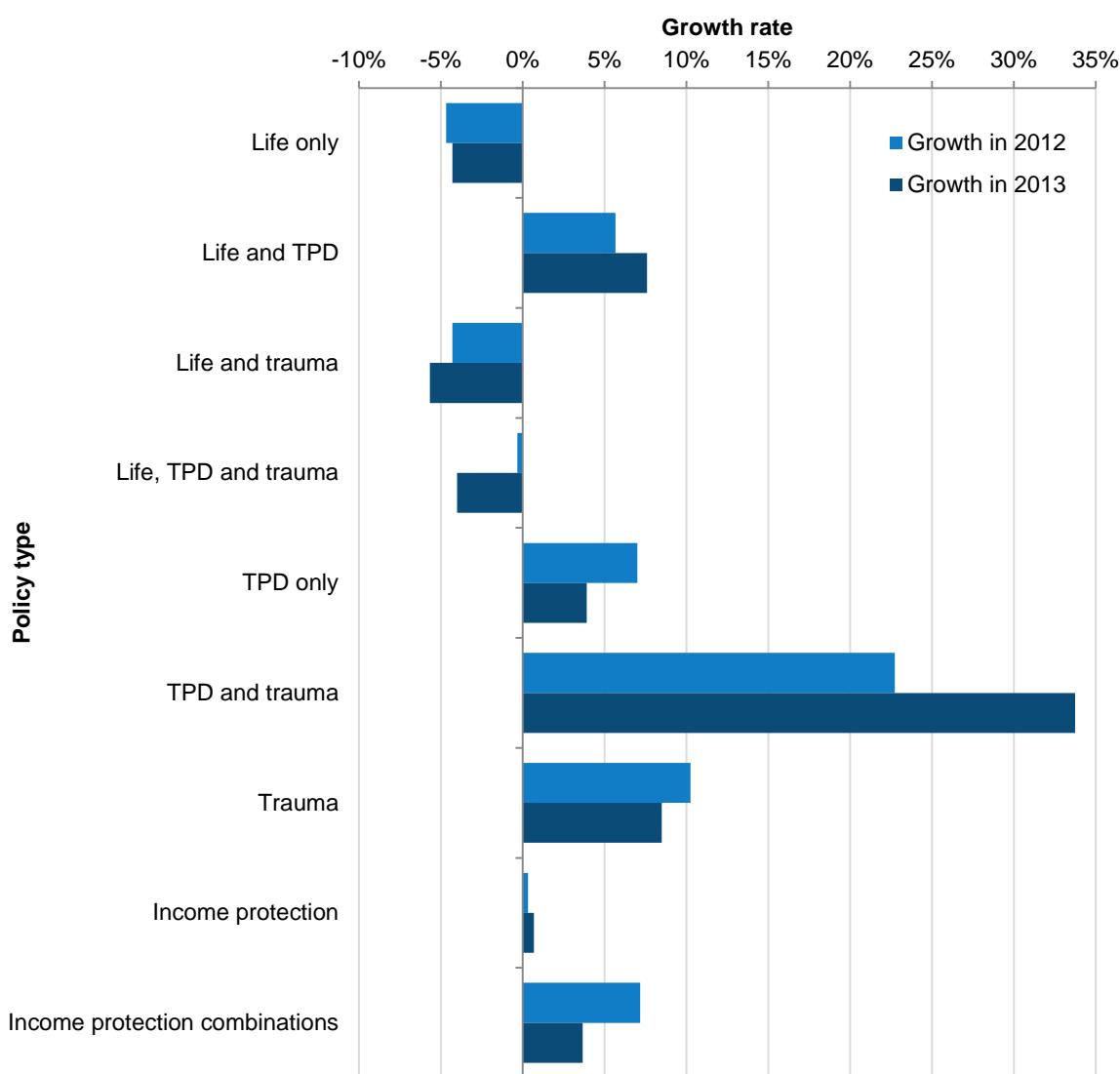
Year	Policies in force	Percentage growth
2010–11	2,357,047	N/A
2011–12	2,462,362	4.5%
2012–13	2,605,395	5.8%

- 66 Life only and income protection policies are the most common policies in force, comprising 32% and 21% respectively of the overall policies in force at 30 June 2013. Figure 2 shows the market share for each policy type as a proportion of the total number of policies in force.

**Figure 2: Market share of policy types (2011–13)**

- 67 While still dominant, the market share of stand-alone life policies declined across the survey period. Stand-alone trauma policies are increasing in market share, along with other policy combinations such as TPD and trauma, which has seen a 64% increase in market share in 2013, albeit off a low base.
- 68 The market share of other policy types or combinations has remained relatively stable. However, the growth in newer policy combinations suggests the market is moving away from stand-alone life or stand-alone TPD cover. Instead, those policy types form the nucleus in newly configured policy bundles comprising different policy combinations: see Figure 3.

**Figure 3: Annual percentage change in market shares of policy types (2012–13)**



### Product innovation and product bundling

- 69 There are sound commercial reasons for insurers to redesign policies and/or offer them in new policy combinations, including in response to advances in the identification of new medical conditions or advances in the treatment or

prognosis of existing medical conditions. An insurer may redesign policies with revised definitions and promote them to their distribution channels to win market share or attract a new segment of the market.

- 70 New policies on issue may benefit the insurer by replacing high-cost legacy policies, which may have been poorly designed or underwritten, or which had unsustainably broad definitions or conditions. Product innovation and redesign can therefore be a useful tool to manage claims exposures on a legacy book of policies.
- 71 Product innovations and new policy combinations may also evolve from regulatory changes.<sup>14</sup>
- 72 Product innovation and product bundling can be a positive for consumers. It may mean that they can:
  - (a) access new products with tailored cover; or
  - (b) access a broader class of products perhaps at lower cost (e.g. if an insurer applies multi-cover discounts on premiums).
- 73 Product innovation and reconfigured policy combinations may also be attractive to advisers where the cost, policy terms and definitions of new products may be more suitable to a client than an existing product.
- 74 However, product innovation and bundling can also lead to overinsurance, which may ultimately be unaffordable for consumers. Product innovation may also provide a rationale for advisers to rewrite insurance for existing clients in a way that delivers only marginal benefits to the client but at significant additional cost to them. The structure of incentives in the advice industry means that advisers have a clear financial incentive to write new business for clients with existing insurances.
- 75 Insurers also have commercial incentives to write more business, and product innovation and bundling is an important tool to gain or re-gain market share in a competitive environment.

## **Product design**

- 76 Life insurance products comprise ‘fixed’ and ‘moving’ parts. The fixed parts include the product’s key features and benefits, and the actuarial assumptions (such as the expected duration of the policies) that affect how the product is priced at the time of underwriting. The moving parts include those aspects of the policy customised to fit the client at the time of underwriting and include the sum insured, any add-on benefits, exclusions or loadings, and the premium type (stepped or level) chosen by the consumer.

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<sup>14</sup> For example, see the 2007 tax ruling (TR 2006/10) and 2014 amendments to the SIS Act and the Superannuation Guarantee (Administration) Regulations 1993.

77

The premium on a stepped premium policy typically increases each year with age and they are the most common premium type across the industry. Level premiums, by contrast, are fixed at the same level for the duration of the policy. The value of a stepped premium versus a level premium differs for different consumers and is a key factor for advisers to consider when weighing up the affordability of cover for a client and their ability to retain the cover over time.<sup>15</sup>

## Assumptions made about the duration of policies

78

We asked insurers about the assumptions they made about the duration of policies written over the survey period. These forward-looking assumptions tell us the average length of a policy, as anticipated by the insurers in the year the policy was underwritten. They also inform how insurers price policies at the commencement of the policy and price premium increases over time. They are significant commercial decisions that shape the value of the retail policy book at the time of underwriting and into the future.

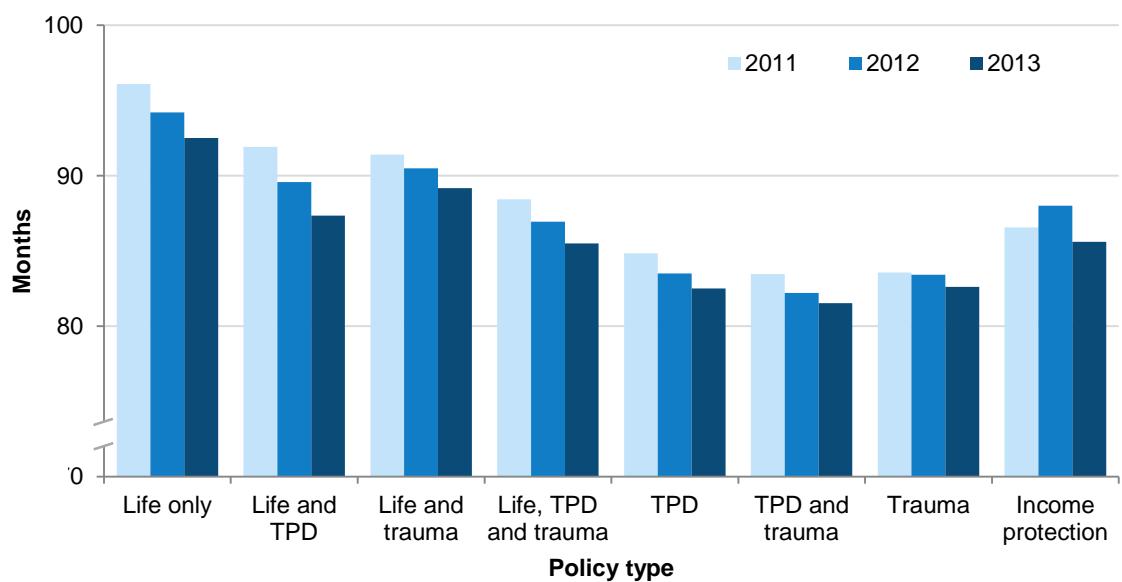
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There was a high degree of uniformity across the industry regarding assumed policy durations for stepped premium policies.

80

Life insurance policies, singly or in combination with TPD and/or trauma cover, had the longest assumed durations—between 86 and 93 months (between seven and eight years) on average: see Figure 4.

**Figure 4: Average assumed durations for stepped premium policies by policy type (2011–13)**



Note: This figure is based on 10 of the 12 insurers in our sample. Some insurers were omitted to maintain their anonymity or because their data could not be compared accurately with other insurers' data.

<sup>15</sup> Stepped premiums have been criticised for discouraging longevity in product holdings because of the step increases in premiums: see Ruth Liew, 'Suncorp argues for life changes', *Australian Financial Review*, 25 September 2013.

- 81 With some variation for different policy types, our data shows that, for the purposes of product design and pricing, insurers assumed that policies written in the relevant time period would remain in force for an average duration of 86 months (7.2 years).
- 82 However, with the exception of income protection policies, the data shows assumed durations for stepped premiums are decreasing.
- 83 Across the industry, insurers and their actuaries are revising downward the expected duration of policies. These revisions affect policy pricing—if a policy is assumed to be retained by the insured for a shorter duration, the opportunity for the insurer to recover the cost of establishing the policy must also be revised. This in turn affects the size of stepped premium increases because the premium must cover costs over a shorter policy duration.
- 84 By contrast, insurers are assuming that level premium policies will have significantly longer durations, at 109 months (9.1 years). However, the data for level premium policies shows the same trend with insurers incrementally revising the policy durations down across the survey period.
- 85 Assumptions made by insurers in the underwriting process have significant commercial effects over time. Our analysis of this data suggests that insurers are changing key actuarial assumptions about product duration, in an effort to ‘catch up’ to changes in the market (e.g. increasing lapse rates).

## Distribution models and costs

- 86 Insurers use a number of channels to distribute life insurance policies to consumers. These include:
- (a) retail personal advice models operated by the insurer or under the AFS licence of a related corporate entity;
  - (b) retail personal advice models operated by another AFS licensee; and
  - (c) direct distribution models (i.e. a no advice model such as online distribution channels, including comparison websites).
- 87 More than half of the insurers in our sample (58%) distribute their policies through AFS licensees operating personal advice models. Of the remaining 42%, the majority reported that their policies were distributed by AFS licensees where the advice model was not known by the insurer. One insurer distributed its policies under a mix of advice models, including via their own salaried employees.

## Remuneration arrangements

88 For life insurance distributed under personal advice models, advisers are typically paid under commission arrangements. To identify the spectrum of remuneration arrangements in the market, we asked insurers how they paid their advice channels so we could understand:

- (a) the most common remuneration arrangements in the market; and
- (b) the extent to which those arrangements differed, depending on:
  - (i) whether advice was given (personal, general or no advice); and
  - (ii) whether the advice was given under the insurer's own AFS licence or by another licensee under its own licence.

89 We asked for this information across the survey period to understand the extent to which remuneration arrangements may have changed over time.

### Categories of remuneration arrangements

90 We also asked insurers to categorise their remuneration arrangements. The following labels are commonly understood and applied in the industry:<sup>16</sup>

- (a) *Upfront commission*—This is generally an upfront commission of 100% to 130% of the new business premium and an ongoing commission of around 10% of renewal premiums.
- (b) *Hybrid commission*—This is generally an upfront commission of 70% of the new business premium and an ongoing commission of around 20% of renewal premiums.
- (c) *Level commission*—This is generally a flat rate upfront commission of around 30% on the new business premium and an ongoing commission of around 30% of renewal premiums.
- (d) *No commission*—This includes fee-for-service remuneration arrangements, where typically the adviser would rebate any commission paid by an insurer back to the client and the client would pay a fee for service, as negotiated between the adviser and the client, which would vary depending on the nature, scope and complexity of the advice provided to the client.
- (e) *Salaried employee*—In this case, remuneration is not by commission.

### Clawback arrangements

91 We also asked insurers about the circumstances in which they claw back commissions paid to advisers. A commission or benefit that is paid to an

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<sup>16</sup> For example, typically advisers are paid by an upfront commission and an ongoing commission, or trail, set at different levels depending on the type of arrangement chosen by the adviser.

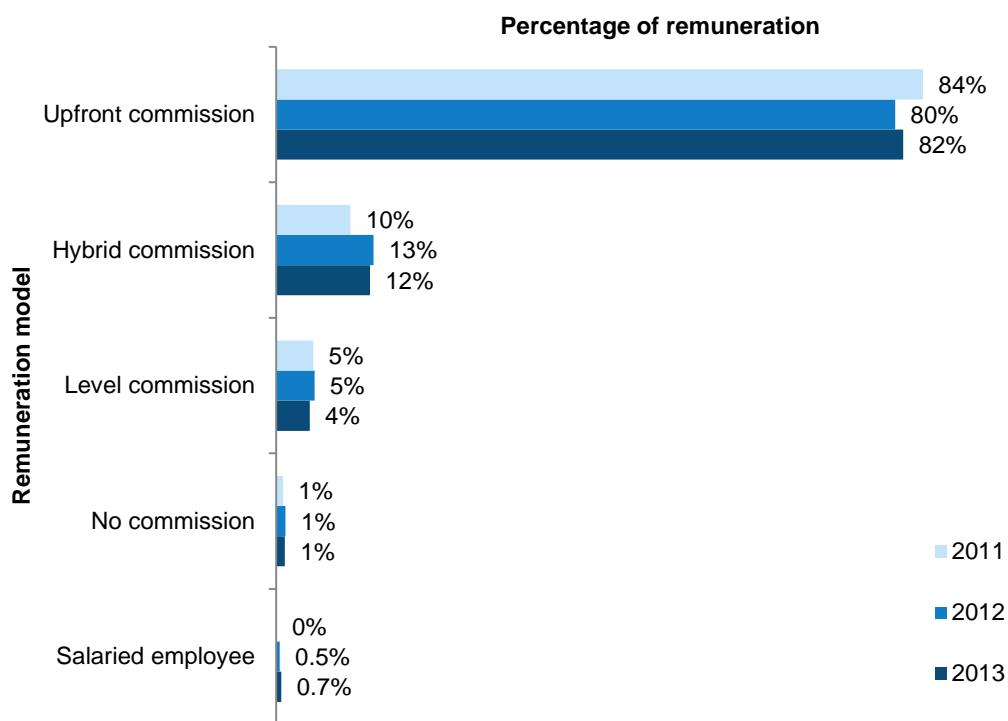
adviser is recovered, or ‘clawed back’, by the insurer if the policy lapses within a certain period, usually within the first 12 months the policy is on foot.

- 92 Clawback arrangements are designed to provide a disincentive to advisers to rewrite insurance cover for existing clients during the ‘clawback period’: see paragraphs 122–128.

## **Commission arrangements**

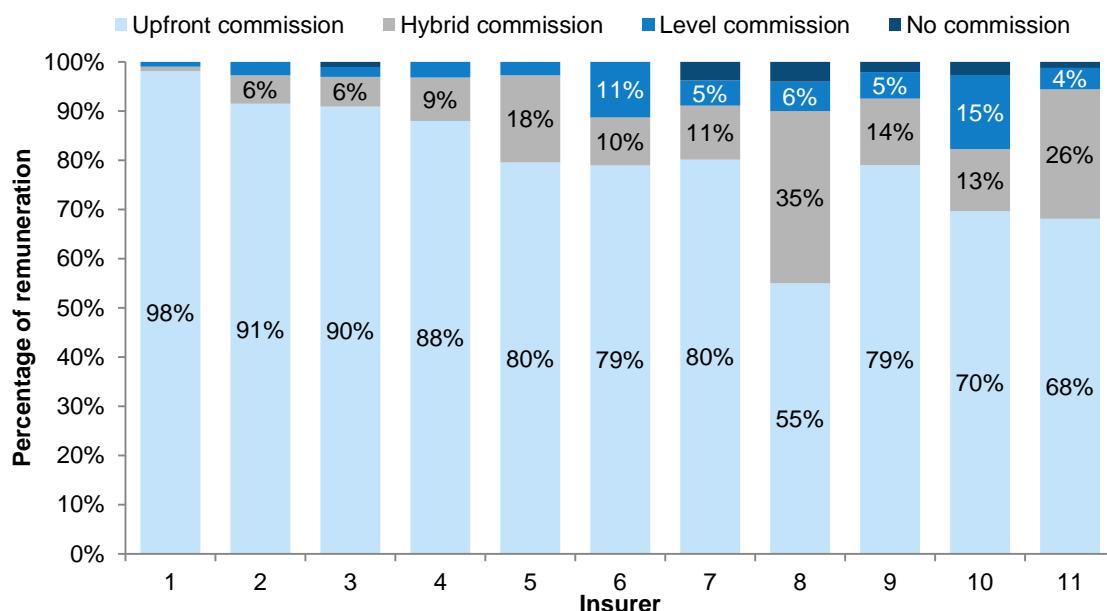
- 93 Typically, advisers who are paid by commission choose which commission model they wish to be paid under in the insurance application form and the commission is paid when the policy is in force.
- 94 Commission remuneration arrangements pay advisers for product sales (upfront) and ongoing commissions on receipt of each year’s annual premium. Commission remuneration arrangements mean that the advice cost is built into the product (described as a commission).
- 95 The value of the commission to the adviser directly relates to the value of the business to the insurer. This is because insurers calculate the commission as a percentage of the annual premium paid by the client. The total premium on the policy (or policies) the client purchases is affected by:
- (a) any new or voluntary increases on the insured benefits or sum insured; and
  - (b) any loadings (for age or existing medical conditions) or any additional features or benefits that may apply to the policy.
- 96 Under commission arrangements, there is no necessary relationship between the cost or complexity of the advice and the remuneration received by the adviser. The consumer pays the premium to the insurer. The insurer pays the commission to the AFS licensee. Each insurer applies its own formula for each commission type in their remuneration schedule.
- 97 The amount of commission an adviser receives varies according to the terms of their agreement with their AFS licensee. For example, a licensee may split the commission earned on a fixed formula basis with the adviser, passing on 85% to the adviser and retaining the balance of 15% of the commission. In other cases, the licensee may charge a fixed flat annual fee to the adviser and pass on 100% of the commission earned to the adviser.
- 98 Advisers must disclose their remuneration arrangements in the SOA. However, it may not always be clear to the client exactly how they are paying for the advice. While the commissions are disclosed in the SOA, it may appear to the client that the payment to the adviser comes from the insurer and that they do not pay for the advice. Indeed, many SOAs leave the section relating to the ‘advice fee’ blank or state N/A (not applicable).

- Ultimately, the consumer pays through their premium for the commission to be paid to an adviser.
- 99 Advisers can rebate (or ‘dial down’) the commission they would receive, which reduces the premium a client pays by reducing the remuneration the adviser will receive. Most insurers enable advisers to discount the premiums by any whole percentage point up to a maximum of 30%. We found this to be uncommon.
- 100 There is some variation among insurers in how they structure their remuneration arrangements. Remuneration schedules include the commission payments for each commission type, what premium discounts may apply and in what circumstances (e.g. multi-policy discounts), and the circumstances where commissions paid will be ‘clawed back’ by the insurer in the event of a policy lapse within the first year.
- 101 Along with policy terms and claims experience, the remuneration arrangements on offer by different insurers can have a significant bearing on which insurer a given adviser may be more likely to recommend to their clients.
- 102 Upfront commission models that pay on average 110% of a new business premium to an adviser (with an ongoing commission of around 10%) represent an incentive for advisers to:
- (a) write new business;
  - (b) increase the sum insured or the level of cover the client holds because the commission is calculated on the premium, which is based on the sum insured, so generally the higher the premium paid, the more revenue is earned by the adviser; and
  - (c) give product replacement advice to clients with existing insurance arrangements, resulting in the adviser earning a new upfront commission on the replacement policy, provided any clawback period has expired on the current policy.
- 103 Upfront commission arrangements are the dominant remuneration arrangement by a significant margin, at 82% of the industry. Figure 5 shows the distribution of remuneration models across the industry and how that distribution has changed across the survey period.
- 104 The average is very high—for some insurers, more than 90% of their advice channels are paid under an upfront commission model. A minority of insurers appear to be developing their hybrid distribution channels.
- 105 While there is some variation among insurers, the general trend is that remuneration arrangements are relatively stable. The vast majority of advisers choose to be remunerated under upfront commission models.

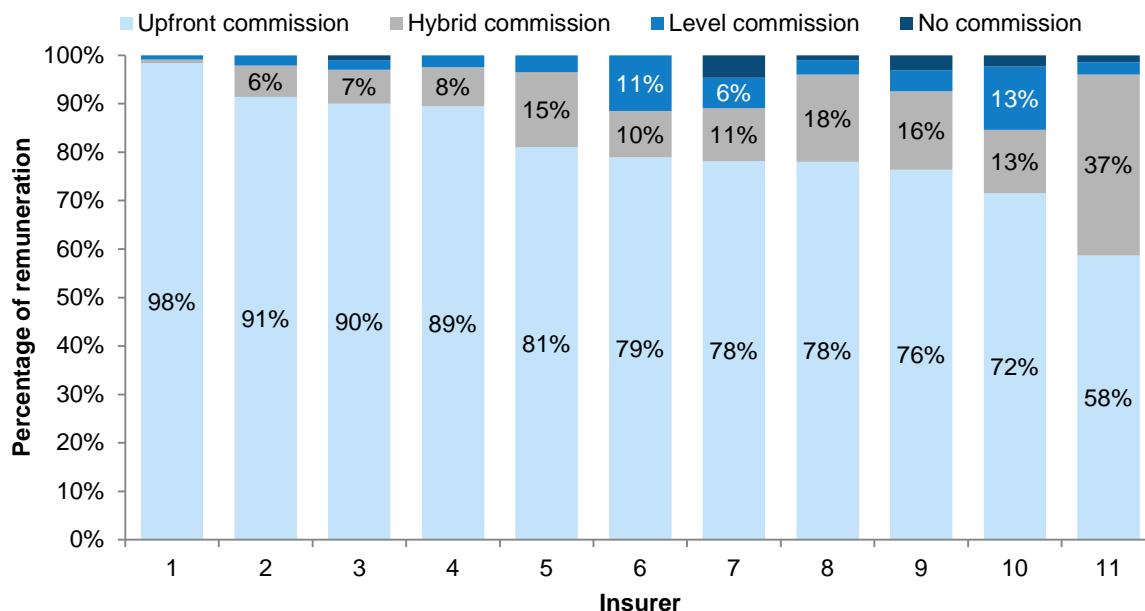
**Figure 5: Remuneration models—Averages (2011–13)**

106

Figure 6 and Figure 7 show the breakdown of remuneration model by insurer in 2012 and 2013.

**Figure 6: Breakdown of remuneration model by insurer (2012)**

Note: This figure is based on 11 of the 12 insurers in our sample. We omitted data from insurers only in circumstances where it was necessary to maintain their anonymity or because their data could not be accurately compared with other insurers' data.

**Figure 7: Breakdown of remuneration model by insurer (2013)**

Note: This figure is based on 11 of the 12 insurers in our sample. We omitted data from insurers only in circumstances where it was necessary to maintain their anonymity or because their data could not be accurately compared with other insurers' data.

## Relationship between product design and lapse rates

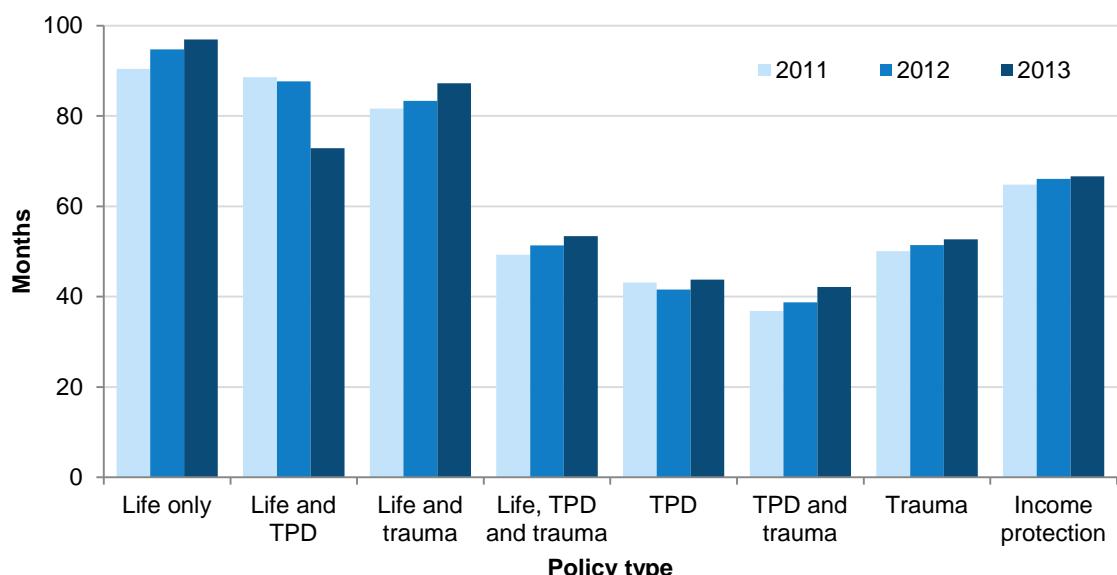
107 To understand the relationship between the assumptions built into product design and policy lapse rates, we asked insurers:

- (a) how many policies were in force for each policy type and distribution channel;
- (b) for each policy type, the average duration (expressed in months) of the policies that ceased for any reason for each year in the survey period; and
- (c) the lapse rate (expressed as a percentage) for each policy type for both stepped and level premiums for each year across the survey period.

108 The data about actual durations gives us a snapshot of average durations at a moment in time: see Figure 8. For example, life only policies that ceased in 2013 for any reason were, on average, in force for 97 months, or just over eight years.

Note: The figures for actual durations (Figure 8) are backward looking in time and cannot be compared to figures for assumed durations (Figure 4), which are forward looking projections as to the assumptions made at the time of underwriting.

109 The actual duration data also shows that, across 2011–13, life policies remained in force for longer before ceasing for any reason. Regardless of the reason that a policy ceases, policies are, on average and excepting life and TPD, remaining in force for longer.

**Figure 8: Average actual duration for stepped premium policies by policy type (2011–13)**

Note: 11 of the 12 respondents provided data for this question. The data from one insurer could not be compared accurately with the other data.

### Lapse rates

- 110 For the purposes of this project, we defined a policy lapse as when a policy ceases due to non-payment or cancellation by the client.<sup>17</sup>
- 111 We do not consider the following examples to be policy lapses and asked insurers to exclude these policy events from their responses:
- (a) a claim on a policy;
  - (b) a policy ceasing due to the insured person reaching a certain age (e.g. age 65);
  - (c) a change in ownership of a policy from individual ownership to SMSF ownership, with the same underlying insured person and risk;
  - (d) a policy being unconditionally reinstated on payment of an outstanding premium, after non-payment has occurred for a period of time;
  - (e) a policy owner electing to discontinue one of the benefits the policy commenced with (e.g. the original policy had life, TPD and trauma cover, but the policy owner chooses to discontinue the trauma cover, while continuing with the life and TPD cover); and
  - (f) one person under a policy that covers multiple people ceasing to be insured, but the policy remaining in force for the other person or people.

<sup>17</sup> We asked insurers to apply our definition to calculate lapse rates. For commercial reasons, many insurers calculate the lapse rate by reference to the value of the premium that lapsed (e.g. \$5,000 or \$50,000 premium lapsed). Calculating the lapse rate in this way is relevant to the application of each insurer's clawback arrangements.

112

Our objective was to better understand:

- (a) what types of policies were lapsing and when those policies were lapsing to identify any trends in lapse rates; and
- (b) the overall lapse rate profile, to identify any factors that may affect the lapse rate, such as consumer price sensitivity to premium increases or the effect of incentives on adviser behaviour.

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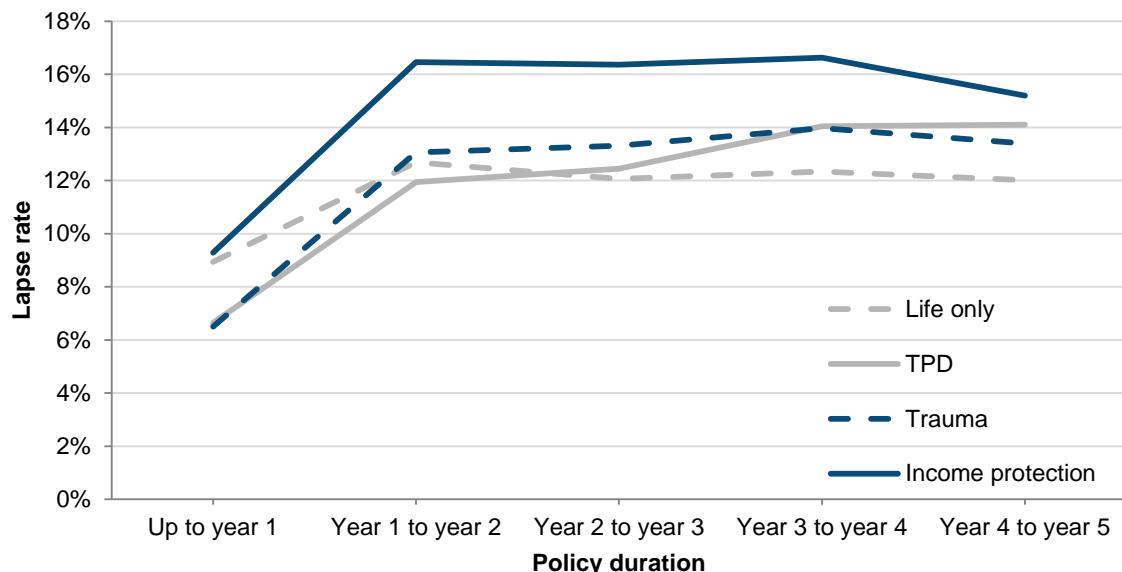
For this reason, we asked insurers to tell us their lapse rate (expressed as a percentage) for each policy type across the three-year survey (June 2011 to June 2013) period for both stepped and level premium types. We also asked insurers to tell us the period in which a policy lapsed—that is, before the end of the first year, from year 1 to year 2, year 2 to year 3, and so on up to year 5.

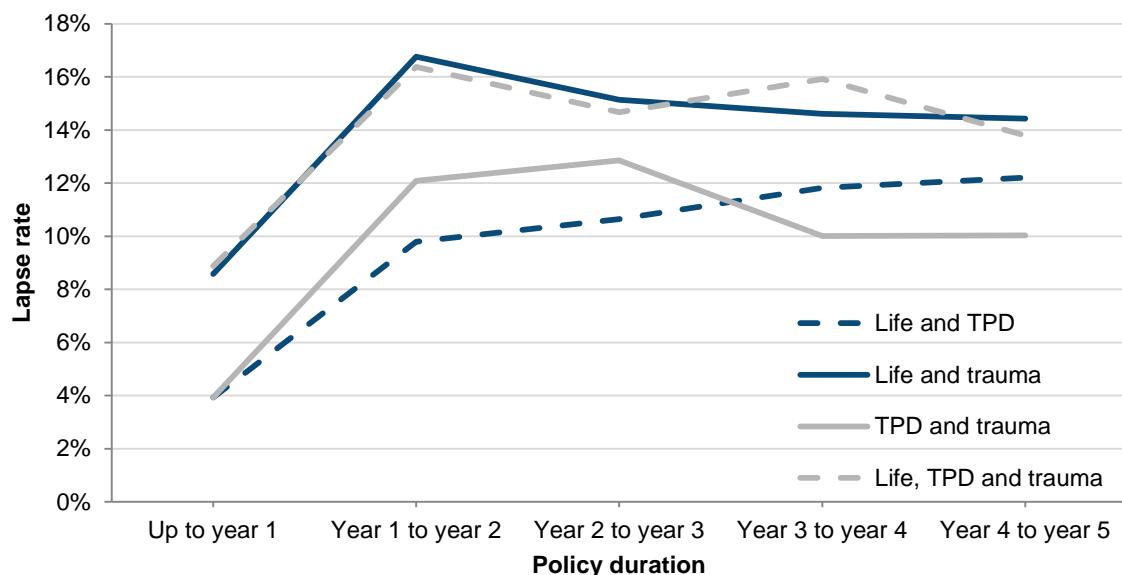
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Regardless of the policy type, lapse rates are lowest in the first year of the policy, and increase sharply from the first to the second year: see Figure 9 and Figure 10. For example, during the move from the first to the second year:

- (a) lapse rates for income protection policies increased from 9% to 16.4% (see Figure 9); and
- (b) lapse rates for ‘life and TPD’ policies more than doubled from 4% to 10% (see Figure 10).

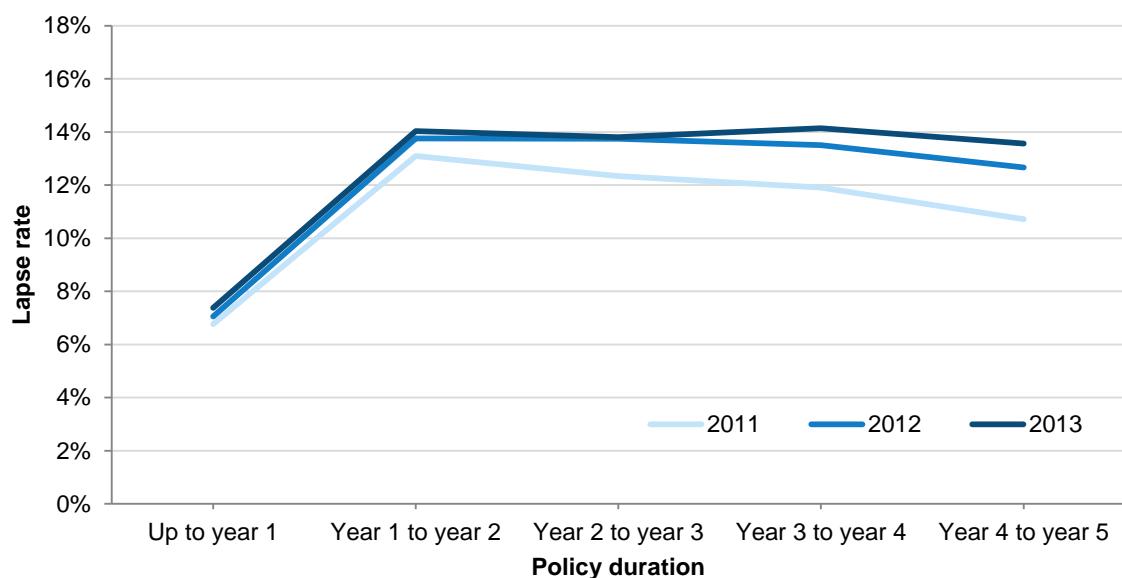
**Figure 9: Lapse rate by policy type—Stand-alone policies**



**Figure 10: Lapse rate by policy type—Combination policies**

115

For stepped premium policies that lapsed in 2013, policy lapses doubled from approximately 7% for policies that had been held for less than a year to 14% for policies that had been held for between one year and two years: see Figure 11. We found that these lapse rates remained persistently high regardless of the policy duration (i.e. the length of time the policy had been held before lapsing). This contrasts to the data for policy lapses in 2011, when the lapse rate begins to taper after the initial spike after year 1. Across the three-year time period, the data suggests that the profile of lapse rates is changing. Lapse rates are increasing sharply after year 1 and remaining persistently high for stepped premium policies.

**Figure 11: Aggregate lapse rates for stepped premium policies**

116 Stepped premium policies lapsed at a much higher rate than level premium policies. Consumer price sensitivity to stepped premium price increases is likely to be a contributing factor in the difference between the lapse rates for stepped and level premium policies.

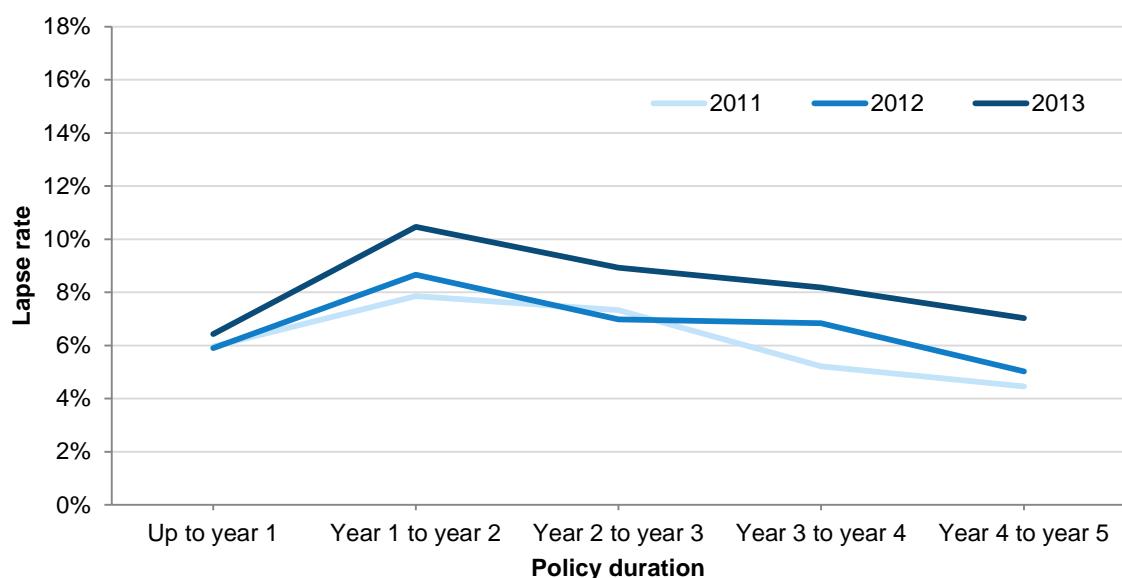
Note: Research by Investment Trends indicates that the price of premiums was the reason 38% of people cancelled their life insurance—19% said they could no longer afford the insurance and 19% said that the premiums increased too much. This research also identified the fact that a significant driver in consumer switching is price sensitivity to premium increases—33% of respondents in the Investment Trends research said that lower premiums would make them more likely to change their life insurance provider and, of consumers who did switch provider in the last two years, their reasons for switching life insurers were premiums increasing too much (27%), and finding a provider with cheaper premiums (21%).<sup>18</sup>

117 Level premium policy lapse rates show a similar spike after the first year; however, after this spike the lapse rates begin to taper down significantly: see Figure 12.

118 This suggests that once the policies have been in force for the first few years, consumers seem more likely to retain the policies over time and they are therefore relatively less likely to lapse compared to stepped premium policies.

119 Level premium policies are more likely to suit consumers who take them out at a younger age and intend holding the policy for a long time. It is only after a long period of time that the value of the initial high premium of a level policy when compared to a stepped premium policy is realised.

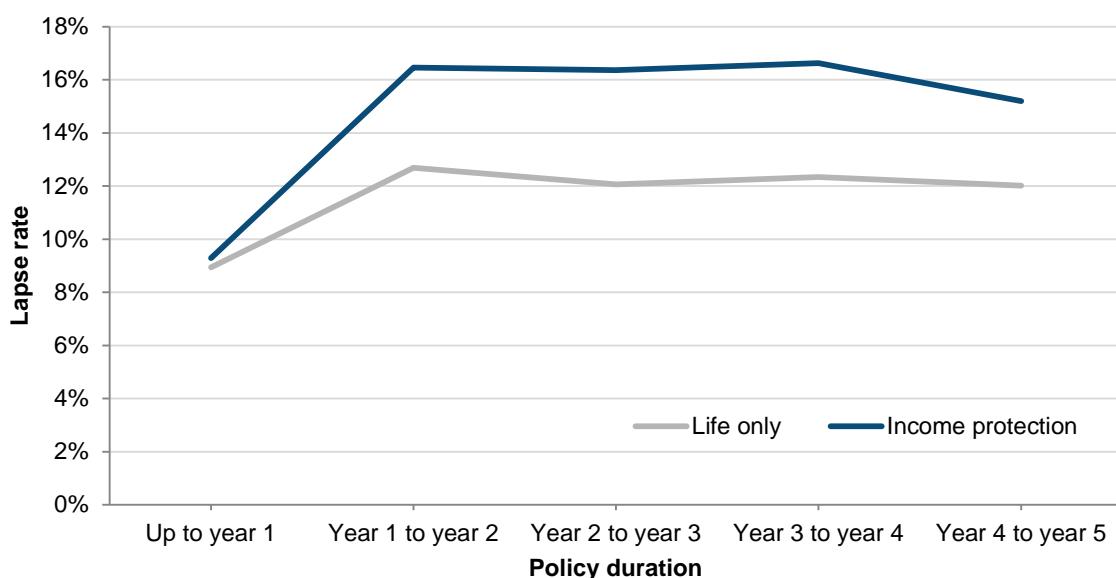
**Figure 12: Aggregate lapse rates for level premium policies**



<sup>18</sup> See Investment Trends, *Investor product needs report*, November 2013, I-352, I-350, I-351.

120 Stand-alone life insurance and income protection policies represent more than 50% of the market share for life insurance in Australia: see Figure 2. However, these policy types experienced lapse rates of 12%–16% in the second year the policies are in force, with the lapse rates remaining high year after year: see Figure 13.

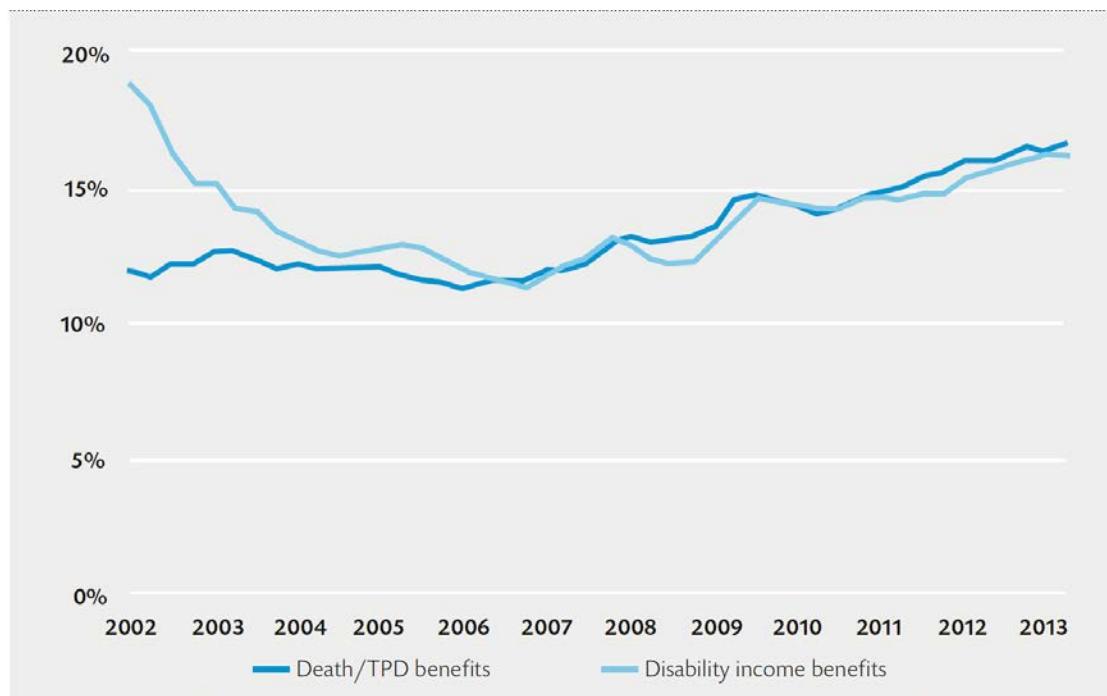
**Figure 13: Lapse rates for life only and income protection insurance**



121 The lapse rates for life insurance policies covered by our survey are consistent with the upward industry trend of lapse rates that APRA has reported (see Figure 14):

Overall, annual lapse rates for both lump sum (death/TPD) and disability income benefits have increased from 11%–12% per annum when they were at their lowest level in 2006 to 16%–17% per annum in 2013.<sup>19</sup>

<sup>19</sup> APRA, *Insight*, Issue 3, 2013, p. 39, Figure 5. Note that APRA calculates lapse rates by premium, not policy number.

**Figure 14: Lapse rates for individual term life insurance**

Source: Plan For Life, *Life insurance statistics*, June 2013, as cited in APRA, *Insight*, Issue 3, 2013, p. 39.

### Lapse rates and commission clawback

- 122 Regardless of the policy type or premium type, our data shows a sharp increase in lapse rates after policies have been in force for more than 12 months. These lapse rates then remain persistently high over time.
- 123 The 12-month period is significant for two reasons:
- (a) for stepped premium policies, the policy renewal anniversary is the point at which the first stepped premium increase will apply; and
  - (b) it is the point at which the clawback period expires for adviser commissions.
- 124 The uniformity of the sharp increase in lapse rates after the expiry of the clawback period suggests that the incentive for advisers to write new business increases once the clawback period ends.
- 125 Some insurers taper their clawback arrangements so that 100% of the commission is clawed back if the policy lapses within the first six months, 50% if the policy lapses at nine months, and so on.
- 126 Some individual insurers include in their remuneration schedules specific measures designed to address high lapse rates among certain advisers or affecting certain classes of policies. Such measures include:
- (a) the application of longer clawback periods to some clusters of policies or advisers;

- (b) the exclusion of level premium policies from their clawback arrangements;
- (c) the application of specific clawback mechanisms to policies that are being rewritten with the same insurer within a certain timeframe (e.g. five years);
- (d) restricting an adviser to level commission where that adviser's lapse rate exceeds a certain threshold; or
- (e) restricting advisers to certain commission models subject to the age of the insured at application.

127 While there was some common ground among these measures, there was also significant diversity among approaches, including approaches to the tapering of clawback periods. Commercial decisions about remuneration arrangements at the individual insurer level are limited in their broader industry impact. Where an adviser chooses their remuneration arrangement, they have an incentive to write new business or rewrite existing business with an insurer or insurers whose remuneration model is most attractive to them.

128 Clawback arrangements are designed to provide a disincentive to advisers to rewrite existing insurance cover for clients during the clawback period—that is, to address the conflicts of interest inherent in a remuneration model that gives advisers the incentive to write new business or rewrite existing business. However, they generally have no application beyond the first year of the policy and are therefore a blunt instrument to address structural issues with remuneration arrangements.

### **Lapse rates and average policy durations**

129 Our analysis of the insurer data shows that, at an aggregate level, policy durations are increasing over time: see Figure 8. That is, at an aggregate level, policies are being held for longer before a claim or other event occurs (such as the insured reaching an age limit causing the policy to cease).

130 This may appear inconsistent with our findings that the assumed duration of policies is decreasing and lapse rates are increasing. This is explained in part by the fact that the average duration of a policy is arrived at by calculating how long a policy has been held before ceasing for any reason (i.e. a backward-looking measure), while assumed durations are a forward-looking measure made by actuaries at the time of policy design.

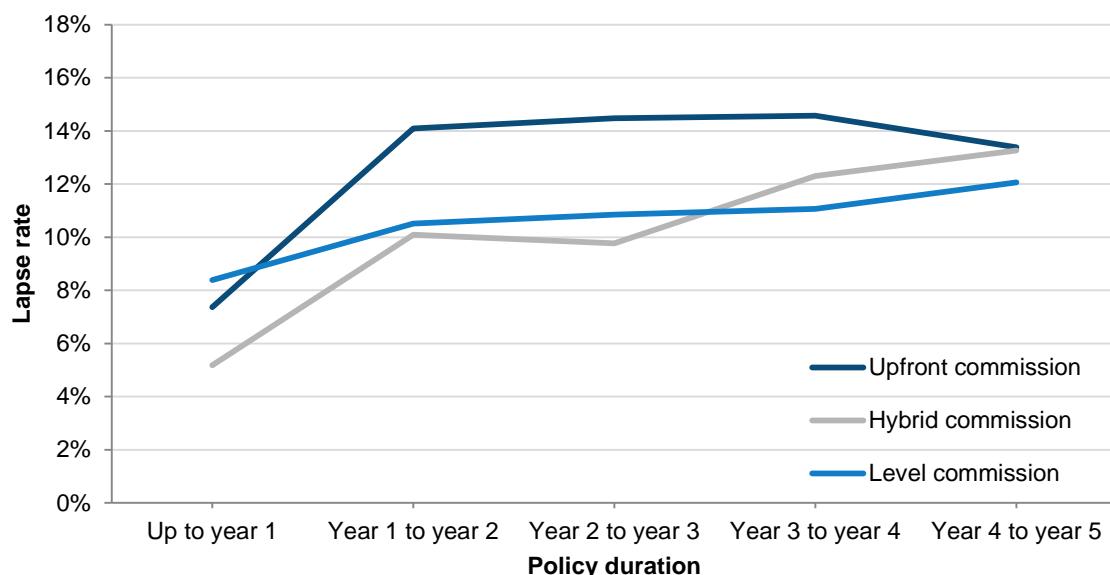
131 Another relevant issue is the application of different definitions. Our definition of actual duration includes a broader group of policies than our definition of lapse rate, which explicitly excludes claims or a policy ceasing due to the insured reaching an age limit: see paragraphs 110–111. This means that the two data sets cannot be directly compared.

- 132 Policies in the actual duration data set include policies that may have recently lapsed, including policies that end because the insured has met an age limit (such as reaching age 65). Such policies may also have been held by the insured for a long period of time. Demographic factors such as the ageing of the population may also be contributing to the overall increase in actual policy durations across the survey period.
- 133 A detailed analysis of these variables would require further data and analysis and is beyond the scope of this report. However, in commenting on claims experience, APRA recently expressed concerns that there may be an anti-selection effect in certain policy cohorts, where less healthy lives will be more inclined to retain their policies over time and more healthy lives less so (particularly in the face of rising premiums).<sup>20</sup>

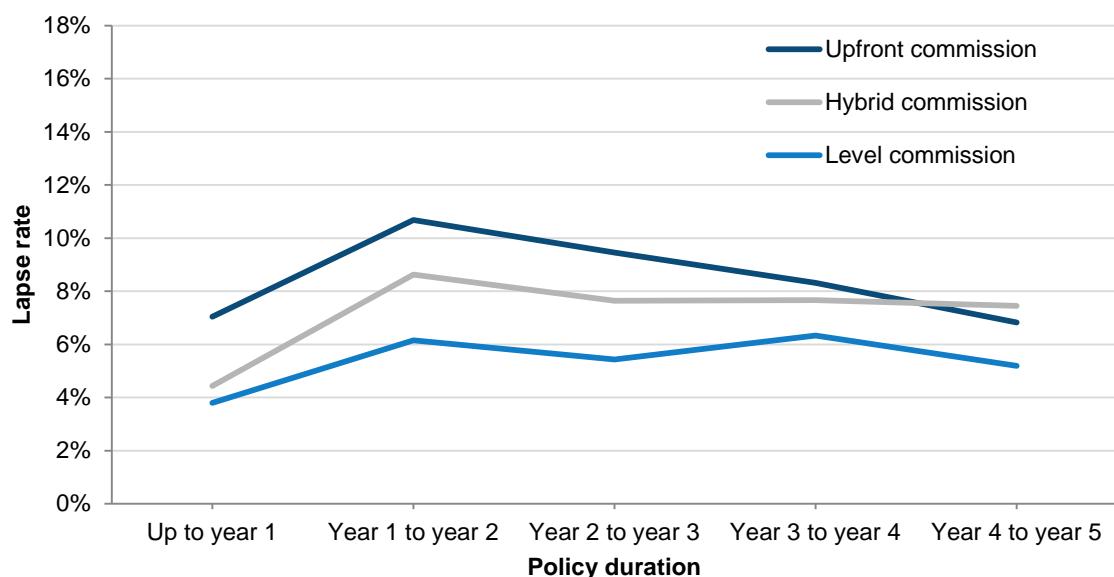
### Lapse rates and remuneration models

- 134 In addition to asking insurers about lapse rates by policy and premium type, we also asked about lapse rates by remuneration model for both stepped and level premium policies.
- 135 Figure 15 and Figure 16 show the lapse rates for stepped and level premium policies respectively, by the three different commission arrangements—upfront, hybrid and level. We excluded no commission and salaried employment arrangements because the percentage of insurers' distribution channels that were remunerated in this way was extremely small, at less than 2%: see Figure 5.

**Figure 15: Lapse rates by remuneration arrangement for stepped premium policies**



<sup>20</sup> APRA, *Insight*, Issue 3, 2013, p. 37.

**Figure 16: Lapse rates by remuneration arrangement for level premium policies**

- 136 Upfront commission models had significantly higher lapse rates relative to hybrid or level commission models. For stepped premium policies, upfront commission models had a lapse rate of around 7% in the first year of the policy, which doubled to 14% in the second year: see Figure 15. These lapse rates remained persistently high, at around 14% for the following years.
- 137 For stepped premium policies, lapse rates for hybrid commission arrangements increased at a similarly sharp gradient from around 5% in the first year of the policy to around 10% in the second year, and then tapered before increasing again from the third year to meet the lapse rate for upfront commission models.
- 138 This contrasts to the lapse rates for stepped premium policies where the adviser is remunerated under a level commission model. For these policies, the lapse rates increased from just over 8% to just over 10% in the second year of the policy and remained relatively steady over time. That is, lapse rates for level commission models had a much flatter curve than either upfront commission or hybrid commission models.
- 139 Consistent with the lapse rate by policy type (see Figure 9 and Figure 10) and premium type (see Figure 11 and Figure 12), lapse rates by remuneration model also spike after the clawback period expires (i.e. in the second year of the policy).
- 140 This spike in lapse rates in the second year that a policy is in force was also in evidence for level premium policies: see Figure 16. Upfront commission models had the highest lapse rates, followed by hybrid and level premium models, although the lapse rates tapered off much more quickly for level premium policies. This tapering of lapse rates for level premium policies is

consistent with the fact that the benefit of these policies is only realised when the policies are held over a longer time period.

## **Analysis and observations on lapse rates**

141

We make the following observations:

- (a) actual durations of policies that ceased for any reason during the survey period are, on average, remaining on foot for longer;
- (b) for new policies written over the survey period, insurers are progressively revising downward their assumptions about the duration of those policies (see Figure 4);
- (c) lapse rates are increasing across the board, and this increase is occurring across policy and premium types;
- (d) lapse rates increase sharply for all policy and premium types after the clawback period expires;<sup>21</sup>
- (e) stepped premium policies lapse at a higher rate than level premium policies; and
- (f) upfront commission remuneration models lapse at a higher rate than other remuneration models and, for stepped premium policies, they remain persistently high over time.

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We consider that insurers are revising down their assumed policy durations over time in an effort to bridge the gap between:

- (a) the assumed policy durations insurers had historically built into their pricing assumptions at the time of underwriting; and
- (b) their actual policy retention experience.

That is, insurers are revising down their assumed policy durations to factor increasing lapse rates into policy design.

143

Increasing lapse rates are of significant concern to the industry and are a consequence of a number of different factors, including:

- (a) product innovation and product pricing and repricing for stepped premium policies;
- (b) age-based premium increases affecting affordability; and
- (c) incentives for advisers to write new business or rewrite existing business to increase commission income.

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The revenue gained by insurers winning new business is affected by the high costs involved in winning that business.

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<sup>21</sup> All the insurers in our sample had clawback arrangements that expired after 12 months, noting that some insurers had staggered clawback arrangements as described in paragraph 125.

- 145 Remuneration arrangements that pay high upfront commissions to advisers are important to insurers to win new business. However, those very same remuneration arrangements are contributing to high lapse rates where insurers lose existing business to competitors offering high upfront commissions.
- 146 It seems that high upfront commissions are contributing to poor commercial outcomes for insurers.
- 147 Insurers are losing existing business at a point in the policy life cycle where they have no prospect of recovering high upfront costs (where the clawback period has expired on the policy). At the same time, insurers are incurring new upfront costs to win new business to replace the business lost to competitors.
- 148 High upfront commissions give advisers an incentive to write new business. The more premiums they write, the more they earn. There is no incentive to provide advice that does not result in a product sale or to provide advice to a client that they retain an existing policy unless the advice is to purchase additional covers or increase the sum insured.
- 149 Our analysis suggests that the interests of insurers, advisers and their clients are in conflict. These conflicts have the following implications:
- (a) if one insurer introduces initiatives to better align remuneration arrangements with other objectives (e.g. product retention), they risk losing market share—the ‘first mover’ problem;
  - (b) insurers may relax their clawback arrangements (e.g. reducing their clawback periods from two years to one year) to win new business from competitors or to avoid further loss of market share (in the case of insurers who may have tried alternative strategies). This waters down the effectiveness of clawback arrangements as a disincentive for advisers who can shop around for the most attractive remuneration arrangement; and
  - (c) consumers do not understand how these conflicts of interest may affect the quality of the advice they receive.
- 150 The short-term effectiveness of clawback periods also represents a challenge to industry because their very effectiveness suggests that commission incentives for advisers *are* operating in such a way as to distort and/or influence the behaviour of advisers. This has real commercial effects on insurers, on the price of life insurance products and on the quality of advice consumers receive, as set out in Section D.

## D Our findings on the quality of advice

### Key points

In phase 2, we conducted a targeted surveillance of advisers who give personal advice to consumers on life insurance products.

Of the 202 files reviewed, 63% were rated a pass while 37% were rated a fail—that is, they did not comply with the law.

We identified a number of factors that affect the quality of advice, including:

- adviser incentives;
- inappropriate scaling of advice;
- lack of strategic life insurance advice;
- weak rationales for product replacement advice; and
- failure to consider the relationship between life insurance and superannuation.

We also identified some key warning signs of poor advice, including:

- high clawback rates; and
- high volumes of replacement product advice, product bundling and upselling.

## Overview of our findings

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While many consumers (63%) received personal advice about life insurance that complied with the law, more than one-third (37%) received life insurance advice that failed to comply with the law: see Table 4. (Table 5 and Table 6 show the failure and pass rates for pre-FOFA and post-FOFA advice.) This finding from our initial file reviews (which included a detailed process of internal quality checks) was affirmed in our external benchmarking exercise.

**Table 4: Overall quality of personal advice files**

Quality of advice	Number of files	Percentage of files
Pass	127	63%
Fail	75	37%
<b>Total</b>	<b>202</b>	<b>100%</b>

**Table 5: Pre-FOFA advice**

Quality of advice	Number of files	Percentage of files
Pass	55	59%
Fail	39	41%
<b>Total</b>	<b>94</b>	<b>100%</b>

**Table 6: Post-FOFA advice**

Quality of advice	Number of files	Percentage of files
Pass	72	67%
Fail	36	33%
<b>Total</b>	<b>108</b>	<b>100%</b>

152 Given the importance of quality life insurance advice to consumers, and that the sample involved AFS licensees for whom life insurance advice is a key part of their business, it is of major concern to ASIC that more than one-third of the advice given by advisers failed to meet the relevant legal standards.

### Obligation to give priority to the client's interests

153 The client priority rule means that an adviser must not recommend a product to create extra revenue for themselves where additional benefits for the client cannot be demonstrated. Such a conflict of interest cannot be managed; it must be avoided: see Regulatory Guide 175 *Financial product advisers—Conduct and disclosure* (RG 175) at RG 175.367–RG 175.382.

154 Our surveillance results indicate that many advisers giving post-FOFA advice may prioritise their own interests in earning commission income ahead of the interests of the client in getting good quality advice.

155 Where we have found significant breaches of the law in our advice reviews, we will take enforcement action. We will take further regulatory action as appropriate to ensure advisers give compliant life insurance advice to their clients: see paragraphs 28–31 for details on our further work.

### Factors that affect the quality of advice

156 From our surveillance we identified the following factors that affect the quality of advice:

- (a) adviser incentives;
- (b) inappropriate scaling of advice;

- (c) lack of strategic life insurance advice;
- (d) weak rationales for product replacement advice; and
- (e) failure to consider the relationship between life insurance and superannuation.

## Adviser incentives

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Our findings confirm that adviser incentives affect the quality of advice consumers receive. The data from insurers indicates that, on average, 82% of advisers are remunerated under upfront commission models: see Figure 5. However, our analysis shows that upfront commission models are correlated to advice that failed to comply with the law.

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In 80% of the files in our sample, advisers were remunerated under upfront commission models. However, 96% of the poor advice was given by advisers paid under upfront commission models: see Figure 17. This suggests that where an adviser is paid under an upfront commission model it has a statistically significant bearing on the likelihood of that adviser giving advice that did not comply with the law.

**Figure 17: Relationship between upfront commissions and advice that failed in our sample**



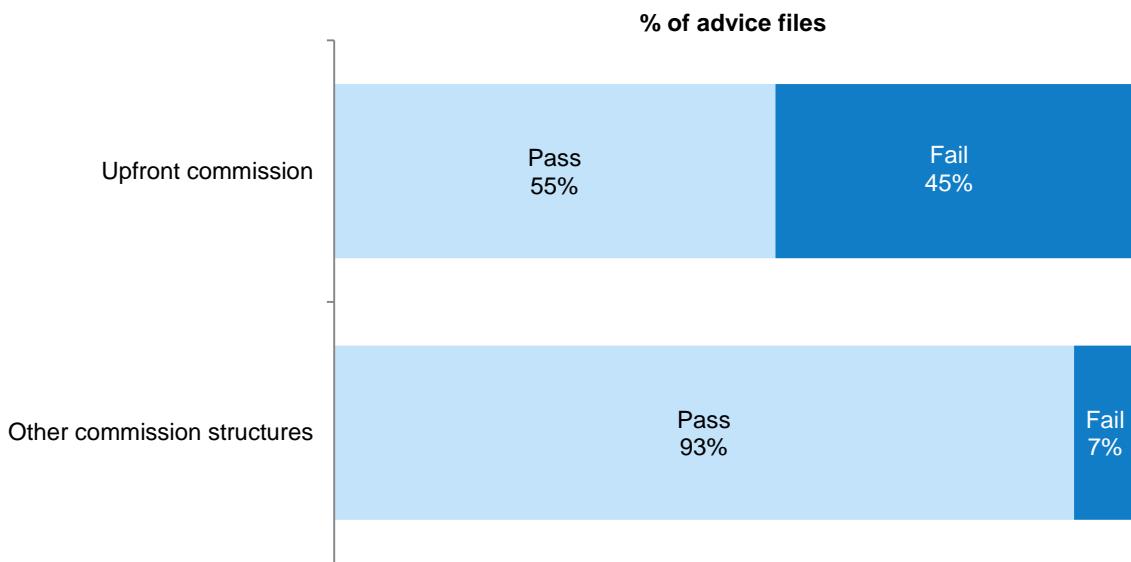
159

The chance of getting advice that rated a pass was significantly higher where the adviser was paid under a commission structure other than upfront commissions: see Figure 18.

160

Our analysis of data from the insurers and data from our file reviews demonstrates that there is a material relationship between:

- (a) high lapse rates and upfront commission models (see paragraphs 134–140 and Figure 15)—upfront commission models had significantly higher lapse rates relative to hybrid or level commission models; and
- (b) advice that failed to comply with the law and upfront commission models.

**Figure 18: Percentage of advice rated a pass or fail by commission structure in our sample**

- 161 A remuneration arrangement tied to a product sale creates an incentive for the adviser to make a sale, rather than provide non-product-specific advice or strategic advice for which the adviser may not be paid.
- 162 Among the advice that failed, we found files that were poorly documented and where the needs analyses were poor.
- 163 In the case of pre-FOFA advice, there was no reasonable basis for much of the advice. In the case of post-FOFA advice, the advice did not comply with the best interests duty and related obligations and failed to leave the client in a ‘better position’.
- 164 The case studies that follow are all drawn from files we reviewed in the course of this surveillance. Identifying information has been removed. Where we quote the commission paid to the adviser, we refer to the upfront commission the adviser would have earned less any payment to their AFS licensee. We exclude any ongoing commissions the adviser may have earned from the analysis. As noted in paragraph 90, advisers paid under upfront commission models typically also receive ongoing commissions of 10% of the renewal premium.

#### **Case study 1: Post-FOFA advice that failed to comply with the law**

<b>Personal circumstances</b>	Michelle is 50 and married. She is employed full time and earns \$56,800 per annum. There was no information about Michelle’s spouse or dependants on her file.
<b>Assets</b>	Michelle jointly owns a home valued at \$800,000 and an investment property valued at \$500,000. She has a cash account of \$10,000, but she has no other cash savings or investments. Michelle’s superannuation balance is \$80,000.
<b>Debts</b>	Michelle has mortgages totalling \$600,000 on her home and investment property.

<b>Insurance</b>	Michelle has life and TPD cover of \$406,000 and trauma cover of \$100,000. Her current annual premium is \$1,676, with \$502 paid from her superannuation benefits and the balance of \$1,174 from her personal cash flow.
<b>Reason for seeking advice</b>	Michelle wants her life cover to be paid from her superannuation benefits and not from her personal cash flow.
<b>Advice</b>	The adviser recommended that Michelle increase her insurance and take out life cover of \$588,100, TPD cover of \$578,100, trauma cover of \$667,469, and income protection cover of \$3,879 per month, with a 30-day waiting period and a benefit payment period to age 65.  The new total annual premium was \$10,772, of which \$5,353 was paid from Michelle's superannuation benefits and the balance of \$5,419 from her personal cash flow.
<b>Commission</b>	The commission was 110% or \$11,849. This was a gross figure less fees payable to the AFS licensee.
<b>Commentary</b>	<p>The advice to Michelle failed to comply with the law:</p> <ul style="list-style-type: none"> <li>• The \$5,353 annual premium for the life, TPD and income protection policies that Michelle will pay from her superannuation benefits exceeds Michelle's superannuation guarantee contributions of \$5,254 per annum.</li> <li>• Although the assets are jointly owned, the adviser did not identify her spouse's personal details (age and employment status or income). Without this information, the adviser cannot demonstrate why the insurance recommendations are appropriate and in Michelle's best interests.</li> <li>• The adviser did not consider retaining her existing life insurance cover in her superannuation where the premium is cost effective.</li> <li>• The \$5,419 annual premium for the trauma policy that Michelle will pay from her personal cash flow represents 9.5% of Michelle's gross income. This is a large financial commitment, particularly when it is unclear from the file how necessary and appropriate this insurance cover is for Michelle.</li> <li>• The advice did not address Michelle's stated objective, which is to reduce the impact of her existing premium on her current personal cash flow.</li> </ul>

- 165 Our findings from this surveillance suggest that dependence on upfront commission remuneration arrangements has a material effect on the type of advice an AFS licensee's business will give, and increases the possibility that the business may give advice that does not comply with the law.
- 166 The practice of only paying remuneration on a product sale works against the provision of balanced, strategic risk advice to clients.
- 167 These risks must be actively managed by AFS licensees who must consider:
- (a) declining to provide advice if they cannot do so in compliance with the best interests duty and related obligations;
  - (b) structuring remuneration arrangements so they receive some remuneration from clients for advice where there is no product sale;
  - (c) structuring remuneration arrangements to minimise the effect of conflicts of interest and create financial incentives for advisers to meet compliance obligations;

- (d) ensuring they provide appropriate levels of training to improve adviser competence; and
- (e) performing regular file audits.

### Inappropriate scaling of advice

- 168 All personal advice is ‘scaled’ or ‘limited in scope’ to some extent—advice is either less or more comprehensive in scope along a continuous spectrum.
- 169 Regardless of whether an adviser is giving advice on a particular topic, such as insurance, or a broader suite of advice topics, the obligation to comply with the best interests duty and related obligations remains unchanged.
- 170 We found examples where advisers failed to exercise sufficient prudence and judgement in the scope of their inquiries into the client’s relevant circumstances. In some cases, advisers failed to ask the most rudimentary questions of their clients or their inquiries were unduly limited when a product recommendation was made.
- 171 When a consumer is seeking advice about life insurance, a prudent adviser would make sufficient inquiries to establish what the client was seeking to insure. For example, does the client want to secure their spouse or family in the event of death or to cover debt or business expenses should they fall ill?
- 172 We reviewed files where the client requested a particular sum insured and there was no documentation on the file relating to how that sum insured may meet the client’s needs or objectives. It is the role of an adviser to engage with the client about the relative value and cost of insurance at a particular sum insured and to help the client arrive at the right type of cover and sum insured that is appropriate and affordable to them over time. This is the ‘value add’ of personal advice to a client.

### Case study 2: Post-FOFA advice that complied with the law

<b>Personal circumstances</b>	Stephen is 56 and married. He is a self-employed management consultant and works full time. There was no information on his file about his income, spouse or any dependants.
<b>Assets</b>	There was no information on Stephen’s file about his assets.
<b>Debts</b>	There was no information on Stephen’s file about his liabilities.
<b>Insurance</b>	Stephen has held life, TPD and trauma insurance since 1996. His sum insured was \$190,000. Stephen has held income protection insurance since 2010. His insured monthly benefit was \$11,576, with a 30-day waiting period and a benefit payment period to age 65. Stephen’s premium was \$17,513 per annum.
<b>Reason for seeking advice</b>	Stephen wanted a review of his insurance cover because his premium was too expensive. He was comfortable with the level of life, TPD and trauma cover, but wanted his income protection cover increased to \$12,000 per month.

<b>Advice</b>	<p>The adviser compared Stephen's current insurer with three other insurers before recommending Stephen take out:</p> <ul style="list-style-type: none"> <li>• \$190,000 life insurance and TPD (any occupation);</li> <li>• \$190,000 trauma cover with a TPD rider (any occupation); and</li> <li>• income protection insurance with an insured monthly benefit of \$12,500, with a 30-day waiting period and a benefit payment period to age 65.</li> </ul> <p>The annual premium for the recommended policies was \$14,867, an annual saving of \$2,646 or 15%.</p> <p>The new insurer had the most competitive premium and had improved trauma policy definitions compared to the existing policy.</p>
<b>Commission</b>	<p>The commission was 121% of the premium or \$18,199.08. This is a gross figure that is reduced by the adviser's arrangement with their AFS licensee. In this case, the SOA stated the adviser would earn 93% of the gross commission or \$16,925.44.</p>
<b>Commentary</b>	<p>The advice to Stephen was compliant with the law. The adviser had achieved the client's stated objectives of maintaining the same insurance type and cover, with an increase in income protection to reflect current earnings with a cheaper premium.</p> <p><i>What would have made this advice high quality advice?</i></p> <p>High quality advice to Stephen would have included the adviser:</p> <ul style="list-style-type: none"> <li>• making further inquiries about Stephen's relevant circumstances, needs and objectives to ensure the type and amount of cover recommended were suitable. In the absence of those inquiries, Stephen may be overinsured or underinsured;</li> <li>• making further inquiries to assess whether Stephen needed the trauma cover, or whether a longer waiting period and/or a shorter benefit payment period would have been suitable; and</li> <li>• canvassing whether the life and TPD cover could have been held inside superannuation for tax effectiveness and exploring the advantages and disadvantages of this strategy.</li> </ul>

- 173 Advisers should employ their expertise to ask questions to ascertain the client's true position and test whether the subject matter of the advice as identified by the client is appropriate and in the best interests of that client, given their relevant personal circumstances.
- 174 Failure to ask questions of the client, and therefore determine with the client the scope of the advice, means that the adviser does not have sufficient information on which to base their advice.
- 175 To scale advice appropriately is to apply the professional judgement of the adviser to the client's circumstances. Advisers should ask questions to make sure that:
- (a) the information they have about existing clients' relevant circumstances is up to date; and
  - (b) they have enough information about new clients' relevant circumstances on which to base their advice.

- 176 Scaling advice does not mean an adviser can walk away from their obligations to give appropriate advice that is in the best interests of their clients. Regardless of whether the advice is scaled narrowly or broadly, the obligations remain the same. For example:
- (a) a generic warning from the adviser in the SOA that the advice is based on incomplete or inaccurate information does not affect the obligation on the adviser to act in the best interests of their clients and to make reasonable inquiries to obtain complete and accurate information; and
  - (b) a needs analysis is not a tool to upsell clients more insurance than they could reasonably afford, with product recommendations for add-on policies of negligible benefit to the client but at significant additional cost to them.
- 177 In our file reviews, we found advice that recommended increasing the total package of insurance cover (life, TPD, trauma and income protection) that was not in the best interests of the clients, but which increased the premium, and therefore the commission income, for the adviser.

### **Case study 3: Pre-FOFA advice that failed to comply with the law**

<b>Personal circumstances</b>	Phuoc is 56, self-employed and earned \$100,000 the previous year. Khanh is 55 and earns \$40,000 per annum. There was no detail about dependants on the file beyond a note about child maintenance costs of \$150 per week.
<b>Assets</b>	Phuoc and Khanh own a home valued at \$430,000. Phuoc has a superannuation balance of \$183,677. Khanh has a superannuation balance of \$58,229. The SOA listed their combined assets as \$1.34 million.
<b>Debts</b>	Phuoc and Khanh have: <ul style="list-style-type: none"> <li>• a home loan of \$280,000;</li> <li>• a personal loan of \$17,000 (at an interest rate of 10%); and</li> <li>• two credit cards with a debt of \$14,000 (at an interest rate of 17%) and \$8,000 (at an interest rate of 17%).</li> </ul>
<b>Insurance</b>	Phuoc had \$400,000 of life insurance inside his superannuation at an annual premium of \$1,079.75. Khanh had \$350,000 of life insurance inside her superannuation at an annual premium of \$576.17. Phuoc also had an income protection policy with a benefit of \$3,500 per month, with a 30-day waiting period and a benefit payment period of 12 months.
<b>Reason for seeking advice</b>	Phuoc and Khanh stated they would like to: <ul style="list-style-type: none"> <li>• consolidate their personal debts;</li> <li>• set up an SMSF to purchase property; and</li> <li>• review their levels of insurance.</li> </ul> <p>The SOA stated that the adviser did not complete a full needs analysis because arranging the insurance cover was 'time critical'.</p>

<b>Advice</b>	<p>The adviser recommended that Phuoc take out two insurance policies with a new insurer. The policies would be held inside the new superannuation fund, which was yet to be established:</p> <ul style="list-style-type: none"> <li>• \$500,000 of life insurance with an annual premium of \$2,291.52; and</li> <li>• \$7,875 of income protection per month with an annual premium of \$4,304.84.</li> </ul> <p>The adviser recommended Khanh take out two policies inside her superannuation:</p> <ul style="list-style-type: none"> <li>• \$500,000 of life insurance cover, with an annual premium of \$2,489; and</li> <li>• \$2,500 of income protection per month with an annual premium of \$3,070.30.</li> </ul> <p>The adviser referred Phuoc and Khanh to an accountant to set up an SMSF and to transfer their existing superannuation balances to the new fund.</p>
<b>Commission</b>	<p>The commission was 115% upfront or \$11,909.47 (for all four insurance policies recommended) less any payments to the AFS licensee.</p>
<b>Commentary</b>	<p>The advice to Phuoc and Khanh failed to comply with the law:</p> <ul style="list-style-type: none"> <li>• The SOA stated that the adviser prioritised the need to arrange the insurance because Phuoc did not have any income protection insurance and that the need was 'time critical'. Phuoc and Khanh currently held insurance and Phuoc had income protection cover, so the rationale supporting the scoping of the advice to insurance only as a 'time critical' issue had no basis.</li> <li>• Given the other client objective was to pay off their debt as soon as possible and given the size of the debt and the age of the clients, the debt should have been identified as a priority.</li> <li>• The adviser did not complete a full needs analysis and limited the scope of the advice to insurance where there was no reasonable basis to do so.</li> <li>• The SOA stated that the combined debt level was the justification for increasing both Phuoc and Khanh's life insurance cover. However, the recommended insurance was significantly more expensive than the couple's existing insurance and did not provide much more cover. Phuoc was paying approximately 220% more in life insurance premium for only 25% more cover.</li> <li>• The adviser failed to consider Phuoc and Khanh's existing provider, although it appears to have been cheaper than the recommended cover.</li> <li>• The SOA did not explore the option of making a partial rollover of funds into the new SMSF, while maintaining a balance in the existing fund to retain the existing insurance. The adviser also did not explore retaining the existing insurance cover until the cover being applied for in the SMSF had been underwritten and accepted.</li> <li>• The strategy to fund their insurance through their superannuation will have a dramatic impact on their superannuation balances.</li> <li>• The adviser did refer the clients to an accountant to establish their SMSF, but scoped retirement out of the advice, explaining that the couple could review their strategies 'when they are ready'. Given Phuoc and Khanh's age and debt levels, strategies for retirement should have been identified as a priority for the couple and not scoped out of the advice.</li> </ul>

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The needs analysis is the fundamental building block of the financial advice process. It is a threshold issue for advisers. Consumers cannot get good advice without it. Done well, it enables the adviser to understand the client, their financial situation, needs, objectives and values, and forms the basis of the advice engagement process.

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However, the needs analysis is only the first step in identifying client needs and objectives. The further step in the advice process is the prioritising of

these needs and objectives against what is appropriate and achievable at the time the advice is given.

### Lack of strategic life insurance advice

- 180 It is the process of identification and prioritisation of needs and objectives that is the most important aspect of financial advice for consumers. It is a key reason why consumers look for financial advice.
- 181 A recurring theme in this surveillance was the failure of advisers to give strategic risk advice to their clients. Strategic life insurance advice includes advice on the type, level, structure and affordability of life insurance cover based on the client's cash flow position and which prioritises their insurance needs. Strategic advice can be stand alone or, where appropriate, provide the framework for product advice.
- 182 For example, we found many files where the adviser failed to add any meaningful value to their clients by:
- (a) helping them set an appropriate sum insured, balancing the competing priorities of underinsurance versus affordability;
  - (b) testing the value of optional extras against the client's ability to sustain the insurance over time by prioritising the essential and the non-essential; or
  - (c) helping the client evaluate the merits of stepped versus level premiums relative to the amount of time the client may expect to hold insurance—for example, until debts are repaid, children are adults or the client transitions to retirement.

### Setting an appropriate sum insured

- 183 There is currently a discussion about underinsurance in Australia. Life insurers, advisers, commentators and policy makers are actively engaged in the process of identifying insurance needs and the extent to which they are being met relative to the level of cover consumers hold.
- 184 The *Financial System Inquiry: Interim report* stated that:
- Superannuation funds now play an important role in providing life insurance to members through group insurance policies. Latest estimates indicate more than 90 per cent of the working age population now has some life insurance.
- Introducing default insurance into many superannuation funds has extended the number of people holding life insurance; however, submissions question the adequacy of this coverage. Some submissions put forward the view that underinsurance for life and disability is significant, requiring policy measures to close the 'underinsurance gap'.<sup>22</sup>

<sup>22</sup> *Financial System Inquiry: Interim report*, Commonwealth of Australia, July 2014, section 3:78–3:79 (see also notes 50 and 51). See also Rice Warner, *Underinsurance in Australia*, Rice Warner, Sydney, 2013. Rice Warner estimates that current life insurance cover is 64% of the amount needed, with disability insurance much lower again. As income protection insurance is

- 185 An indicator of the level of underinsurance is typically a measure of the desired level of insurance (or the level of insurance need) relative to the actual level of personal insurance already held.<sup>23</sup>
- 186 Different industry participants employ a range of heuristics (rules of thumb) to provide some guidance about appropriate levels of insurance for consumers based on typical client personas (e.g. working adults with dependants and high levels of debt). This is also a common approach taken by life insurance calculators, which tend to model insurance needs as a multiple of the insured person's annual income. However, at the individual level, underinsurance must be balanced against affordability.
- 187 In our file reviews, we found that the complexity of the client's personal circumstances was not taken into account and that many advisers responded with generic advice.

#### **Case study 4: Pre-FOFA advice that failed to comply with the law**

<b>Personal circumstances</b>	June is 62, single and earns \$40,000 per annum. June is the guarantor on her adult son Matthew's home loan of \$300,000. Matthew earns \$50,000 per annum. June and Matthew have set up an SMSF together—with a combined value of \$120,000.
<b>Assets</b>	June owns her home valued at \$450,000. Matthew's home is valued at \$450,000.
<b>Debts</b>	June has no debt. Matthew has a \$300,000 mortgage.
<b>Insurance</b>	There was no evidence on the file that either June or Matthew have existing life insurance.
<b>Reason for seeking advice</b>	June and Matthew want insurance as security against sickness and injury.
<b>Advice</b>	The adviser recommended June take out \$400,000 of life insurance cover. In the application process a 75% health loading was applied, which increased June's premium from \$5,829 to \$10,260 per annum.  The adviser recommended Matthew take out \$500,000 of life cover, \$300,000 of TPD cover and income protection of \$3,500 per month. There is no information on the file about Matthew's premium.  The policies were to be held in their SMSF.
<b>Commission</b>	The commission was 115%–123% of the premium. The SOA stated the client accepted the insurance terms at an annual premium of \$10,260. Based on the minimum commission payable of 115%, the adviser would earn \$11,790 less the adviser's payment to their AFS licence. This file was silent on that payment.

only available to a limited range of people in certain types of employment, it is not possible to judge the level of underinsurance.

<sup>23</sup> See KPMG, *Underinsurance: Disability protection gap in Australia*, January 2014, and Rice Warner, *ibid.*, pp. 9–10.

<b>Commentary</b>	<p>This advice to June failed to comply with the law:</p> <ul style="list-style-type: none"> <li>• There was no reasonable basis for this advice or any explanation on the file as to why June, single with no debt or dependants, would need \$400,000 of life insurance cover. If June were to die, it is reasonable to assume Matthew would inherit her unencumbered home valued at \$450,000.</li> <li>• The advice to June did not address the stated objectives of the need for insurance to address sickness and injury.</li> <li>• The premium was unaffordable even before the 75% health loading was applied. The premiums exceed 100% of June's superannuation guarantee contributions on an annual income of \$40,000 and would erode June's very modest superannuation savings as she approaches retirement.</li> </ul>
188	Unfortunately, in our advice surveillance, this kind of advice was not isolated. We found a number of cases where the advice recommended a sum insured and therefore a premium that seemed significantly in excess of the client's ability to afford or retain the insurance over a period of time. There was no evidence of any evaluation of the client's other priorities to found a reasonable basis for the advice.
189	Advice that recommends a client obtain insurance at a sum insured that is unlikely to be affordable for that client at that level of premium over time is likely to leave the client uninsured when the policy lapses or is cancelled, precisely because it is unaffordable. Such advice may leave the client with greater cover but at a premium that is unsustainable.
190	Cost was a major trigger for clients to seek advice about their insurance and a key trigger for consumers to drop their insurance over time, as they struggled to continue making premium payments as stepped premium increases became unaffordable.
191	Our analysis of the insurer data in Section C, Investment Trends research on consumer behaviour (see paragraph 116) and the findings of our advice surveillance suggest that rising premiums increase the likelihood of the client discontinuing the policy. Where the client sought further advice, we found advisers were responding to this issue with product replacement advice that simply recommended a cheaper policy.
192	The sum insured and the affordability of the premium are interdependent issues and go to the heart of the provision of appropriate personal advice that complies with the best interests duty and related obligations.
193	We found that absent or inadequate cash flow analysis or evidence of any active engagement with the client in setting the sum insured and premium often led to template advice that simply set the sum insured at a multiple of the client's income or a benchmark level and compared policies set at that level of cover.

- 194 In many cases, we found that when clients explicitly expressed concerns about affordability, they were not given strategic advice that considered options such as:
- (a) setting an appropriate sum insured, informed by how long the client, given their relevant circumstances, wants or needs to maintain insurance cover (for a limited period such as when debts are paid off or until retirement);
  - (b) what type of policy is appropriate and affordable;
  - (c) alternative strategies for managing affordability for that client, including prioritising the essential and the non-essential; and
  - (d) whether insurances should be reviewed (increased or decreased at appropriate intervals) and what those intervals should be for the particular client.
- 195 Our concerns about the lack of strategic advice were amplified where we saw affordability issues addressed by:
- (a) writing new cover with a different insurer at the same level of cover without any consideration of alternative approaches, such as retaining the same policy at a lower level of cover; or
  - (b) writing the same level of cover but changing the source of the payments from direct cash flow to superannuation, without any adequate consideration of the impact of this strategy over the long term on the retirement savings of the client given their other relevant circumstances.
- 196 It was rare to find advisers who recommended clients hold an existing policy or marginally decrease the level of cover or suite of insurance, regardless of whether this advice would have been in the best interests of their clients. The stakes can be very high for the insured and all too often we saw advice that failed to consider these important issues or provide any strategic value to the client in making these decisions.
- 197 The upfront commission payments advisers receive for life insurance advice is significant, and significantly above estimates of the cost of a comprehensive financial plan. In 2010, we published Report 224 *Access to financial advice in Australia* (REP 224). In that report, AFS licensees reported an estimate of the cost of providing comprehensive financial advice to a client in the range of \$2,500–\$3,500: see paragraph 171 of REP 224. Even allowing for inflation, this cost is significantly below the remuneration we found advisers were receiving for life insurance advice in our surveillance.
- 198 As noted in paragraph 96, under commission remuneration arrangements, there is no relationship between the cost or complexity of the advice and the remuneration received by the adviser.

- 199 Consumers are paying a significant amount of money for life insurance advice. They pay this cost indirectly as the cost is built into the premium. This cost is considerably above the general industry benchmark for comprehensive financial advice. For the prices they paid, consumers should be entitled to expect diligent and thorough life insurance advice that considers their insurance needs and objectives in a strategic way that is in their best interests.
- 200 The failure of advisers to do so is particularly concerning and suggests that, for too many consumers, the advice they are receiving is poor value for money.

### **Record keeping**

- 201 For advice given after 1 July 2013, there is an onus on an adviser who is relying on the best interests duty ‘safe harbour’ to satisfy their obligations under s961B(2) to show they have complied with the best interests duty.
- 202 As noted in the methodology section (see paragraph 55), in the course of this surveillance we found files that were inadequate or otherwise incomplete, which made it impossible to rate the advice for the purpose of this project. We excluded those files from our overall results. We will be raising this issue individually with the relevant AFS licensees.
- 203 However, in future surveillances, where we find that the record keeping is so poor or inadequate that we cannot satisfy ourselves whether the relevant legal obligations are met, it is likely that we will need to talk to clients to assess whether an adviser has complied with their obligations. It is less likely that we will need to do this if the file contains thorough records of the information relied on and action taken by the adviser that demonstrates that the advice was in the client’s best interests.
- 204 Access to client records is essential for AFS licensees to enable them to:
- (a) deal with client complaints or disputes; and
  - (b) supervise their advisers when giving client advice and review adviser conduct whenever they need to do so.

### **Weak rationales for product replacement advice**

- 205 We saw product replacement advice that met the client’s objective to find a cheaper policy. This is a reasonable basis for a product switch for many clients who wish to retain insurance in the face of immediate cost pressures.
- 206 However, because of the impact of stepped premium price increases, this strategy would need to be repeated every couple of years because the initial savings would evaporate for the client within a year or two as the premium increases overtake the savings from the cheaper product.

- 207 We found that many files lacked any strategic consideration of the issues bringing the client to the adviser in the first instance—issues such as the effect of stepped premium increases on product affordability.
- 208 There is a tension between a client's insurance need, which may be to hold cover over the long term, and the immediate cost pressures they face as they try to maintain their insurance as their premiums rise.
- 209 While it is not the responsibility of advisers to resolve this tension, there are real risks that advisers need to adequately consider when advising clients to switch their insurance for premium savings. These include the risk that future insurance cover will only be provided at higher cost or on less favourable terms than a previous policy.
- 210 The nature of life insurance presents particular risks for consumers when they receive and act on advice to replace existing insurance products. There are also significant risks for advisers in giving replacement product advice. Two recent cases bear out both the catastrophic risks to the client and the responsibility of the adviser in ensuring that the product replacement advice was appropriate.<sup>24</sup>
- 211 The operation of s29(3) of the Insurance Contracts Act represents a significant risk to consumers where product replacement advice is given. It means that an insurer can avoid a policy within three years if the insured person fails to comply with the duty of disclosure, (s21 of the Insurance Contracts Act). It requires the insured person, before the contract is entered into, to disclose every matter that is known to the insured person that:
- (a) they know to be relevant to the decision of the insurer whether to accept the risk and, if so, on what terms; or
  - (b) a reasonable person in the circumstances could be expected to know to be so relevant.
- 212 In the cases of *Commonwealth Financial Planning Ltd v Couper* [2013] NSWCA 444 and *Swansson v Harrison & Ors* [2014] VSC 118, the existing

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<sup>24</sup> In *Commonwealth Financial Planning Ltd v Couper* [2013] NSWCA 444, the NSW Court of Appeal upheld a NSW District Court finding that an authorised representative of Commonwealth Financial Planning had negligently engaged in misleading or deceptive conduct by failing to warn about the effect of s29(3) of the Insurance Contracts Act when advising a client to change life insurance policies. In this case, the insurer avoided the client's claim based on non-disclosure of his health history. The client would have been covered under the previous policy, which he had held since 2003.

In a similar case—*Swansson v Harrison & Ors* [2014] VSC 118—the Victorian Supreme Court found that an authorised representative of Synchronised Business Services was negligent with respect to what a ‘reasonably prudent advice provider’ would have done. At issue was the failure of the adviser to make any further inquiry of the client about a current medical issue before cancelling their existing policy. The independent insurance expert in this case held that: ‘A reasonably prudent broker would have rung [the client] to check on his stomach condition before cancelling the first policy. This is because of the precious asset (being continuity of cover) that stood to be lost if there has been some development in respect of that stomach condition’ (at 180). The second insurer subsequently avoided the replacement policy on the basis of non-disclosure in reliance on s29(3) of the Insurance Contracts Act. In this case, the court also found the client contributed to the negligence and the damages awarded to the client were reduced by 50%.

We would also note that each year the Financial Ombudsman Service (FOS) resolves a significant number of life insurance and advice-related disputes: see the FOS annual review.

life insurance policy was of significant value to the client. In both cases, the three-year period during which the insurer could have avoided the existing policy had lapsed, so the existing cover represented a significant asset to the clients when subsequently diagnosed with terminal illnesses. Avoidance of the replacement policies was a catastrophic financial event for both clients.

- 213      These cases underscore the importance of the role of the adviser in recommending a client switch to a new product and in exercising due care and diligence when completing an insurance application and assisting the client through the underwriting process.
- 214      Quality life insurance advice should be robust and rigorous in duly considering the adverse implications of a product switch. The potential effect of s29(3) of the Insurance Contracts Act should be considered by the adviser when the client has a current policy in force that cannot be avoided by their existing insurer based on this provision.<sup>25</sup>
- 215      Personal advice should include personal warnings to the client. In our reviews, we saw too many generic warnings that were insufficient to engage the client in understanding their disclosure obligations or other key aspects of the advice.

### **Stepped versus level premium options**

- 216      Most life insurance products sold under advice recommended stepped premium policies. In some cases, SOAs modelled the effect of stepped and level premiums over time and we found examples where this was done well, in ways that were concrete and realistic for the client.
- 217      In other cases, we found limited consideration of the merits of different premium options or any engaged discussion with the client about how long they intended to hold the cover, and therefore the effect of stepped premium increases on the premium (and the client's cash flow) across that timeframe.

### **Compliance with the product replacement disclosure obligations**

- 218      Of the files in our sample, 67% involved product replacement advice. Of this advice, we found that 63% of the produce replacement advice met the expected disclosure requirements in s947D, while 37% failed to meet these requirements.

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<sup>25</sup> The *Insurance Contracts Amendment Act 2013* amends the remedies available for insurers in cases of non-fraudulent non-disclosure under s29 to avoid or to vary the contract of insurance in such a way as to place the insurer in the position in which the insurer would have been if the duty of disclosure had been complied with or the misrepresentation had not been made, s29 (4)-(10).

## Failure to consider the relationship between life insurance and superannuation

- 219 Australia's compulsory superannuation system with mandatory default life and TPD insurance means that most working Australians generally hold some life and disability insurance inside their superannuation.
- 220 While group life insurance inside superannuation was not a focus of this project, the insurance a consumer holds inside their superannuation is an important and relevant consideration for advisers giving life insurance advice that complies with the best interests duty and related obligations.
- 221 Considering the merits of holding cover inside and outside superannuation is an important part of strategic life insurance advice. This is because:
- (a) generally, group life insurance cover is cheaper than a retail policy;<sup>26</sup>
  - (b) many consumers may benefit from automatic acceptance arrangements, which mean they have a certain level of cover regardless of any underlying health issues; and
  - (c) consumers can generally 'dial up or down' their levels of life or TPD cover inside their superannuation and some funds offer additional policy types such as income protection.<sup>27</sup>
- 222 Life insurance is a part of consumers' default superannuation arrangements. The question of where to hold life insurance, inside or outside superannuation, is an important consideration for consumers seeking personal advice depending on:
- (a) what they are insuring (e.g. life, income or illness);
  - (b) their existing superannuation arrangements; and
  - (c) their personal needs and circumstances, including health status.
- 223 Life insurance and superannuation is also an area of advice where we found many advisers fall short in giving their clients appropriate advice.
- 224 Of the files we reviewed, 33% related to insurance held both inside and outside of superannuation, 22% related to insurance held solely inside superannuation and 39% related to insurance held outside superannuation: see Table 7. In a very small number of files, it was unclear where the insurance was held.

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<sup>26</sup> Although we note that Rice Warner has recently reported that the price differentials between retail and group segments had significantly reduced during the prior eight months to April 2014: see Rice Warner, *The gap between group and retail risk offers continues to narrow*, 6 August 2014.

<sup>27</sup> Since 1 July 2014, trauma insurance cannot be offered inside superannuation.

**Table 7: Breakdown of advice sample—Insurance held inside/outside superannuation**

Where is the life insurance held?	Pre-FOFA		Post-FOFA		Total	
	No.	%	No.	%	No.	%
Combination inside and outside superannuation	30	32%	36	33%	66	33%
Inside superannuation	15	16%	29	27%	44	22%
Outside superannuation	38	40%	42	39%	80	39%
Unclear	11	12%	1	1%	12	6%
<b>Total</b>	<b>94</b>	<b>100%</b>	<b>108</b>	<b>100%</b>	<b>202</b>	<b>100%</b>

- 225 Whether to hold insurance inside or outside the superannuation environment or in combination can be an important issue affecting:
- (a) the cost, amount and type of cover available;
  - (b) the level of underwriting and/or tax effectiveness of different insurance arrangements; and
  - (c) the impact of different policy terms and definitions where trustees must ensure that any insurance payout meets a condition of release under the *Superannuation Industry (Supervision) Act 1993* (SIS Act) before releasing those funds to the member.
- 226 Recent changes to the regulation of insurance and superannuation<sup>28</sup> mean that, since 1 July 2014, insurance cover offered inside superannuation funds must have policy wording that aligns with SIS Act conditions of release. Insurances that do not meet these requirements cannot be offered within the superannuation environment.
- 227 These changes introduce a more restrictive definition of permanent incapacity, so ‘own occupation’ cover is prohibited for any new insurance cover issued to a member after 1 July 2014. Similarly, trauma insurance will not meet a condition of release and therefore will not be available inside superannuation.
- 228 Personal advice about life insurance and superannuation requires strategic advice and the application of expertise and due diligence to ensure the insurance is appropriate and will meet the needs of the client and their beneficiaries in the event of a claim. Personal advice about life insurance and superannuation should include advice about:
- (a) relevant taxation issues;

<sup>28</sup> The 2014 amendments to the SIS Act and the Superannuation Guarantee (Administration) Regulations 1993 have changed a number of insurance and superannuation-related policy settings. The changes include requirements on trustees of SMSFs to have an investment strategy that addresses the insurance needs of each member of the fund.

- (b) binding or non-binding death benefit nominations and the need to update those nominations as circumstances change; and
- (c) the merit of making concessional or non-concessional contributions to the client's superannuation fund to mitigate the effect of insurance premiums on retirement benefits.

229 Many of the advice files in our surveillance that recommended clients hold their insurance inside superannuation failed to adequately consider these issues.

### **Paying the insurance premium from the client's superannuation**

230 In many files, we found that advisers were recommending policy bundles and a sum insured for each policy type resulting in an aggregate premium that was unaffordable to the client. The recommended strategy to manage this was to pay the insurance premium from the client's superannuation guarantee contributions.

#### **Case study 5: Post-FOFA advice that failed to comply with the law**

<b>Personal circumstances</b>	Amon is 52, employed full time and earns \$80,000 per annum. His spouse Fatima is not in paid employment and they have no financial dependants.
<b>Assets</b>	Amon and Fatima rent, own a car valued at \$10,000 and have \$2,500 in the bank. Amon has a superannuation balance of \$62,000.
<b>Debts</b>	Amon has a debt of \$26,000.
<b>Insurance</b>	Amon had \$250,000 of life insurance and \$225,000 of TPD insurance, and an income protection policy with a monthly benefit of \$5,000 per month, a 30-day waiting period and a two-year benefit payment period.
<b>Reason for seeking advice</b>	Amon's short-term financial goals are to repay his debt of \$26,000 and save. His longer term goals are to retire at 65 and live comfortably.
<b>Advice</b>	The adviser recommends that Amon switch to a new superannuation fund, with \$100,000 of life and TPD cover and an income protection policy with a monthly benefit of \$5,000 per month, a 30-day waiting period and a five-year benefit payment period.  The new premium was \$11,068 per annum.
<b>Commission</b>	The commission was 115% or \$11,667 (reduced in this case by a payment of \$7,817 to the AFS licensee).  The adviser would earn other fees, including a percentage of the superannuation rollover and implementation fees on the superannuation and an ongoing advice fee.
<b>Commentary</b>	The advice to Amon failed to comply with the law: <ul style="list-style-type: none"> <li>• The advice did not address Amon's stated objectives.</li> <li>• The advice reduced Amon's life and TPD cover to \$100,000 and, although there was an increase in the benefit period of his income protection policy, there was a premium increase.</li> </ul>

	<ul style="list-style-type: none"> <li>• The annual insurance premiums of \$11,068 exceed Amon's superannuation guarantee contributions of \$7,400 per annum.</li> <li>• The premiums will significantly erode Amon's superannuation balance of \$62,000 between now and his retirement at age 65.</li> <li>• The adviser failed to adequately consider the affordability or sustainability of paying the insurance premium from Amon's superannuation benefits, particularly given his stated objective to save for retirement. Further, the adviser failed to consider any alternative strategies such as: <ul style="list-style-type: none"> <li>– salary sacrificing part or all of the insurance premium;</li> <li>– balancing the insurance objective against the retirement savings objective (the advice sacrificed one for the other);</li> <li>– whether Amon should self-insure in part or in whole; and</li> <li>– what other resources may be available to Amon in the event of a serious accident or illness.</li> </ul> </li> </ul>
231	Appropriate advice that complies with the best interests duty and related obligations should actively consider the long-term effects of insurance costs on clients' superannuation savings.
232	For many clients, paying for insurance from superannuation is an entirely viable and appropriate strategy. However, the true costs and effects of this approach should be discussed with clients. Among our file reviews, we found a number of cases where the cost of the insurance was consuming a significant percentage of those superannuation savings and, in the worst cases, more than 100% of a client's annual superannuation guarantee contributions without any justification.
233	We also found limited consideration of a contribution strategy to supplement retirement savings depleted by the cost of insurance premiums or consideration of the risk that a client may exceed the contributions caps for example and hence be exposed to tax liabilities.
234	Some advisers recommended clients retain existing default insurance arrangements inside superannuation, while also recommending the client purchase new insurance outside superannuation. In many cases, we found very little rationale on the file as to why this was a suitable option for the client. In many of the other poorly rated files, the adviser did not even consider the existing product as an option.
235	In many cases, consumers had the option to increase their life insurance cover in their default superannuation fund at a low cost and obtain additional insurance cover inside that fund. In our file reviews, we found that such advice was rarely given to clients.
236	Advisers cannot earn commission for recommending a client purchase insurance or increase cover <ul style="list-style-type: none"> <li>(a) under a group life risk policy inside superannuation; or</li> </ul>

- (b) under an individual life insurance policy provided for the benefit of a member of a default fund.

This would again suggest that commission payments generate a conflict of interest between the needs of consumers and advisers.

- 237 Where the adviser was recommending a product switch, inadequate consideration of existing insurance arrangements made it difficult for the adviser to found a reasonable basis for the advice or, for post-FOFA advice, to meet the client priority rule (s961J) where the adviser had a clear conflict of interest.
- 238 Adviser remuneration arrangements where the adviser is not paid for certain types of advice present a barrier to those advisers complying with their legal obligations.
- 239 We expect an adviser to decline to provide the advice if they cannot consider or recommend a client's existing insurance or superannuation arrangements—for example, if the products are not on their AFS licensee's approved product list.

*Disclosure about of the costs or benefits of paying for insurance from superannuation*

- 240 Many SOAs included generic warnings to clients, such as 'following this recommendation may affect your retirement savings'.
- 241 We also found explanations in SOAs such as 'client doesn't place much importance on his super as such and is willing to use it to fund his premiums'. We found it surprising that people did not put much weight on their superannuation.
- 242 Repeatedly, we found advisers failed to meaningfully explain or model the effect of a strategy to pay their insurance premium from their client's retirement savings over time.
- 243 In making the recommendation to pay for the insurance from superannuation, some SOAs included statements to the effect that paying the insurance premium from superannuation savings would not affect personal cash flow, or would have a lesser financial impact on the clients.
- 244 In our view, such statements materially misrepresented the client's situation. Clients are paying the premium regardless, although the experience of that effect is deferred because the payments are being made from their superannuation guarantee contributions or balance.
- 245 Very few files included any comparison projection of the clients' superannuation benefits with and without insurance premium payments. We would expect advisers to make such comparisons so as to enable the client to

clearly understand the effect on final retirement benefits, including how much longer they may need to work as a result.

### Case study 6: Post-FOFA advice that failed to comply with the law

<b>Personal circumstances</b>	Kevin is aged 54, employed full time and earns \$75,000 per annum. Tricia is aged 53 and is not in paid employment.
<b>Assets</b>	Kevin and Tricia rent, and their assets consist of a term deposit of \$10,000, an investment property valued at \$350,000 and Kevin's superannuation of \$57,000. They earn annual rental income of \$14,000 on the investment property.
<b>Debts</b>	Kevin and Tricia have a mortgage on their investment property of \$190,000.
<b>Insurance</b>	Held since 2011, their insurance included: <ul style="list-style-type: none"> <li>• Kevin: \$533,540 of life cover, \$533,540 of accidental death cover and \$106,708 of trauma insurance with an annual premium of \$3,747.44; and</li> <li>• Tricia: \$266,512 of life cover with an annual premium of \$1,389.60.</li> </ul>
<b>Reason for seeking advice</b>	Kevin and Tricia sought advice for their annual insurance review and expressed concern about premium increases and how they could manage this cost now and in the long term, as they wanted to retain the cover for at least another 10 years.
<b>Advice</b>	The adviser recommended that Kevin and Tricia retain the same type and amounts of insurance, but switch to a new insurer. To help them in managing the cost of their premiums, they would move to a level premium structure and pay for Kevin's insurance premium through his superannuation benefits (although this was already the case). <p>Their combined new annual premiums totalled \$8,535, an increase of \$3,398 per annum compared to their current stepped premiums.</p> <p>The adviser recommended the new insurer because they can pay for some of the premiums through Kevin's superannuation, gain multi-policy discounts and obtain 'true' level premiums to age 65.</p>
<b>Commission</b>	The commission was 115% or \$9,774.19 (less a 25% fee payable to a referral source). The SOA was silent on any fees payable to the AFS licensee.
<b>Commentary</b>	The advice to Kevin and Tricia failed to comply with the law: <ul style="list-style-type: none"> <li>• The insurance premium will erode approximately 80% of Kevin's superannuation guarantee contributions as Kevin approaches retirement.</li> <li>• The advice did not consider the costs versus the benefits of such a strategy and any steps Kevin may take to ameliorate the impact on his retirement savings.</li> <li>• The adviser did not demonstrate the benefit of level versus stepped premiums for Kevin and Tricia. It is not clear from the client file or SOA that a level premium was the most cost-effective option for these clients over a 12-year period until they reach age 65.</li> <li>• No consideration was given to retaining stepped premiums in exchange for a reduced sum insured at each policy anniversary, despite this feature being noted as a gained benefit when switching to the new insurer. Such an option may have been a suitable alternative solution for Kevin and Tricia, as well as reducing the effect on Kevin's final retirement balance.</li> <li>• Given their financial and cash flow position, the advice should have considered the need for Tricia's life cover because it is likely that Kevin would continue working in the event of Tricia's premature death.</li> </ul>

- 246 Some of the life insurance and superannuation advice in our review simply failed on basic competency grounds—that is, the advice failed to consider issues such as:
- (a) the option to salary sacrifice into superannuation to top up balances reduced by the insurance premium;
  - (b) information or advice about the importance of nominating beneficiaries for benefits and reviewing those nominations where client circumstances change (e.g. divorce); and
  - (c) the merits of any ‘own occupation’ definitions for that particular client.

### **Insurance and SMSFs**

- 247 Insurance advice to clients in or establishing SMSFs did not feature significantly in this advice surveillance. In Report 337 *SMSFs: Improving the quality of advice given to investors* (REP 337), we identified a number of areas where insurance advice to these consumers could be improved. Problem areas included:
- (a) discussing insurance after, and not before, an SMSF had been established;
  - (b) inappropriately excluding insurance from the scope of the advice;
  - (c) keeping some money in an APRA-regulated fund for insurance purposes without discussing the advantages and disadvantages of this approach; and
  - (d) some small pockets of overinsurance.

- 248 Legislative changes, discussed at paragraph 226, require trustees of SMSFs to have an investment strategy that addresses the insurance needs of each member of the fund. This means that advisers giving advice to SMSF trustees must consider whether it is appropriate for each member to have their insurance inside or outside superannuation (or in a combination) or to hold no insurance at all.

## **Warning signs of poor advice**

- 249 In the course of our research project, we identified some key warning signs for poor advice: see Table 8. These signs may operate singly or in concert with other indicators to guide insurers and AFS licensees about where poor advice and/or adviser misconduct is likely to be found.

**Table 8: Warning signs of poor advice**

Warning sign	Commentary
High clawback rates	<p>High clawback rates per adviser may be a warning sign about the quality of the advice that the adviser is giving to their clients. Clawbacks can be a telling indicator that advisers are rewriting business to earn commission income and providing product replacement advice that is not in the best interests of their clients.</p> <p>AFS licensees should monitor clawback rates and policy lapses across their advisers.</p>
High volumes of new business with 'no underwriting issues'	<p>Advisers may write new business in online applications or under certain limits to avoid triggering any compliance concerns—to 'fly under the radar'. This may be a warning sign that the automatic underwriting process is being abused.</p> <p>Automatic underwriting means that advisers can ensure questions are answered in such a way so as not to raise any warning signs. This abuse of the automatic underwriting process can cause significant detriment to clients and expose AFS licensees to compensation claims from clients.</p> <p>Insurers should have robust systems in place to review new business and ensure that automatic underwriting is not being abused.</p>
Poor or inadequate needs analysis	<p>Failure by an adviser to ask the most rudimentary questions about the client's relevant circumstances may be a warning sign that the advice is not in the best interests of the client.</p> <p>Advisers who fail to perform and record an appropriate needs analysis of their clients present a significant risk to an AFS licensee's business. An appropriately detailed needs analysis is also important to ensuring that scaled advice is delivered appropriately.</p> <p>AFS licensees should actively review the quality of the needs analysis.</p>
High volumes of replacement product advice, product bundling and upselling	<p>AFS licensees should actively monitor files for advice to clients that recommends the client hold multiple policies where the recommendation suggests that the clients may be overinsured relative to their insurance needs and income.</p> <p>Where the business model is dependent on the incentives to advisers to write new business, AFS licensees should actively monitor representatives writing high volumes of new business, particularly replacement business written after the expiry of the clawback period on the previous policy.</p>
Competency <sup>29</sup>	<p>File reviews should consider the following warning signs that the adviser is not competent to provide the advice:</p> <ul style="list-style-type: none"> <li>• inadequate inquiries into the client's relevant personal circumstances;</li> <li>• poor record keeping and inadequate documentation on the file to found a basis for the advice; and</li> <li>• poor consideration of related issues of strategic importance for clients, such as the need for clients to nominate beneficiaries (and update nominations) for death benefits in superannuation.</li> </ul>

<sup>29</sup> See our submission to the *Financial System Inquiry: Interim report*, August 2014, p. 39, where we stated our support for the need to raise the minimum education and competency standards for advisers who give personal advice and our recent submission to the *PJC Inquiry into proposals to lift the professional, ethical and education standards in the financial services industry*, September 2014, p.4.

Warning sign	Commentary
Insurance paid for using a high percentage of the client's superannuation guarantee contributions	<p>Life insurance advice recommending a client pay insurance premiums using a significant percentage of their superannuation guarantee contribution may be a warning sign that the advice is not in the best interests of the client.</p> <p>AFS licensees should review files to ensure that the effect of this strategy is modelled to show the loss of retirement income over time and the extent to which the advice considers contribution strategies as appropriate to the client's circumstances.</p>
Poor record keeping	<p>Record keeping is essential to prove compliance with s961B(2) and to enable licensees to comply with their obligations to monitor and supervise their representatives. Poor record keeping should be a key warning sign to an AFS licensee that the advice may not be compliant.</p>
Poor compliance with disclosure obligations and use of generic warnings	<p>Generic warnings and non-specific information about strategy may be a warning sign that the advice may not be in the best interests of the client.</p> <p>AFS licensees should review files to ensure that the SOA includes relevant information about the basis on which the advice was given. This includes:</p> <ul style="list-style-type: none"> <li>• a clear and specific explanation to the client about the rationale for and implications of a recommended strategy;</li> <li>• the pros and cons of a strategy to pay for insurance inside or outside superannuation; and</li> <li>• consideration of the importance of the duty of disclosure where a client is given switching advice.</li> </ul>

## The challenge for insurers and advisers

- 250 There is no doubt that the findings in this report represent a significant challenge to the insurance industry, advisers, regulators and consumers.
- 251 Insurers should:
- (a) review their remuneration arrangements to ensure that consumer interests are prioritised and that conflicts of interest are better managed; and
  - (b) develop simpler products that may better balance affordability issues against insurance needs.
- 252 Advisers should:
- (a) review and amend, as appropriate, business models to address structural barriers to the provision of compliant life insurance advice; and
  - (b) when presented with a conflict of interest, act according to what a reasonable adviser without a conflict would do.
- 253 Advisers are in the business of giving personal advice in most situations. The value of personal advice is that it:
- (a) is tailored to the client and their relevant personal circumstances;

- (b) considers the client's insurance needs and balances those needs against their other priorities;
- (c) does not rely on generic calculations to reach a sum insured or fail to make inquiries of the client to test or challenge their assumptions; and
- (d) leaves the client in a better position.

- 254 Observations drawn from our surveillance, recent case law and industry experience give us an opportunity to reflect on the value that life insurance advice should give to consumers.
- 255 Advisers can help consumers in making key strategic decisions such as setting, and as personal needs change, revising their sum insured. Such strategic advice can help the client balance the competing priorities of insurance needs against cost.
- 256 Unlike the direct market, consumers who retain the services of an adviser should have the benefit of the adviser's expertise and judgement.
- 257 Competent advisers know, or ought to know, the importance of exercising particular diligence when recommending a client switch their insurance product because of the remedies available to an insurer where the insured person fails to comply with their duty of disclosure.
- 258 Advisers can help clients 'triage' their insurance needs by prioritising the essential and the non-essential and explain the costs, benefits and value of different options to the client to help them make an informed decision as to their insurance needs and priorities.
- 259 Advisers can give essential assistance to clients when a claim is made, reducing the need for lawyers to advocate for their clients where a claim may be denied or only partially paid by the insurer.

### **Giving high quality advice**

- 260 There is both a need and a demand for quality life insurance advice. We include the following examples from our surveillance so as to illustrate how advisers, who are already giving compliant advice to their clients, may lift the quality of that advice.

#### **Case study 7: Pre-FOFA advice that complied with the law**

<b>Personal circumstances</b>	Indira is 54, self-employed and earns \$250,000 per annum. Sandeep is 50 and earns \$100,000 per annum. Indira and Sandeep have two children aged 11 and 7. Their living expenses are unknown beyond education fees of \$20,000 per annum and Indira had some minor health issues which have been resolved.
<b>Assets</b>	Jointly held assets include their home valued at \$1.8 million. They have a combined superannuation balance of \$120,000 with no other cash or investments/savings.

<b>Debts</b>	Indira and Sandeep have a \$580,000 mortgage.
<b>Insurance</b>	Indira and Sandeep had no insurance outside superannuation. It is unclear if there was any insurance inside superannuation.
<b>Reason for seeking advice</b>	Indira had been a client since 2007 and wanted wealth accumulation advice. The adviser specialises in personal life insurance only, and so refers clients for wealth accumulation advice. Indira had declined to implement previous insurance recommendations. She was now looking for insurance to cover debt and provide income to her family in the event of sickness, accident or death.
<b>Advice</b>	<p>The adviser conducted a needs analysis and considered Indira's objective to cover her income, debt reduction and education costs for her children until age 24, and to provide replacement income of \$50,000 per annum for Sandeep for 20 years. The adviser took into account Indira's superannuation balance of \$60,000 as a realisable asset in the needs analysis. The adviser compared four insurers and recommended Indira take out:</p> <ul style="list-style-type: none"> <li>• life insurance of \$2 million and TPD cover of \$1 million for any occupation (inside superannuation);</li> <li>• stand-alone TPD cover of \$1 million (own occupation) outside superannuation;</li> <li>• \$500,000 of trauma cover in her own name; and</li> <li>• income protection of \$15,625 per month, with a 30-day waiting period and a benefit payment period to age 65.</li> </ul> <p>The premium was stepped and the total payable in year 1 was \$23,305.</p> <p>No insurance recommendations were made for Sandeep.</p>
<b>Commission</b>	The commission was 110% or \$25,635.69 (less any fees payable to the AFS licensee).
<b>Commentary</b>	<p>The advice to Indira and Sandeep was compliant with the law. The adviser had:</p> <ul style="list-style-type: none"> <li>• made reasonable inquiries about the client's financial and health circumstances;</li> <li>• compared four different insurers before making a recommendation;</li> <li>• explained and documented the basis for the recommended sum insured relative to Indira's personal circumstances; and</li> <li>• told the client that income protection premiums are tax deductible.</li> </ul> <p><i>What would have made this advice high quality advice?</i></p> <p>High quality advice to Indira and Sandeep would have addressed key strategic considerations such as:</p> <ul style="list-style-type: none"> <li>• the affordability of the premium over time as there was no evidence on the file that this issue was considered;</li> <li>• the advantages and disadvantages of holding insurance inside superannuation;</li> <li>• the insurance needs of Sandeep as the SOA was silent on this issue; and</li> <li>• existing insurance Indira and Sandeep may have had inside their superannuation.</li> </ul>

#### Case study 8: Post-FOFA advice that complied with the law

<b>Personal circumstances</b>	Eric is 55, single and self-employed earning \$100,000 per annum. He is in good health. There was no other information on the file about his personal circumstances or any dependants.
<b>Assets</b>	Eric has \$43,000 in superannuation. There was no other information on the file about assets.

<b>Debts</b>	There was no information on the file about debt.
<b>Insurance</b>	<p>Eric had the following cover in place:</p> <ul style="list-style-type: none"> <li>• life insurance of \$515,000 held inside superannuation;</li> <li>• income protection insurance of \$6,180 per month, with a 30-day waiting period and a benefit payment to age 65, also held inside superannuation; and</li> <li>• life and trauma insurance of \$82,400 held in Eric's personal name.</li> </ul> <p>Eric's existing annual premiums were \$8,213 with insurer A.</p>
<b>Reason for seeking advice</b>	<p>The adviser contacted Eric to discuss his upcoming annual premium renewal with insurer A, review his circumstances and make sure Eric was satisfied with his current levels of cover.</p> <p>The adviser offered Eric a full needs analysis, but Eric declined and stated he would like to maintain his existing cover, but he was concerned with the increasing premium cost.</p>
<b>Advice</b>	<p>The adviser recommended that Eric switch to insurer B, maintain the existing type and amounts of cover, and hold all his insurance inside superannuation with the exception of the trauma insurance.</p> <p>Eric's existing annual premiums were \$8,213 and would be reduced to \$6,757 with insurer B. This represented a 17.7% premium saving.</p>
<b>Commission</b>	The commission was 105% or \$7,955.14. The SOA stated that the adviser would receive 100% of the commission, with no payment to the AFS licensee.
<b>Commentary</b>	<p>The advice to Eric was compliant with the law:</p> <ul style="list-style-type: none"> <li>• The client file and SOA demonstrated the client's instructions to maintain the amount of existing insurance cover but seek a cheaper premium.</li> <li>• The SOA documented the client's instructions, including a warning about the limitations and risks of this approach. The client's objective of obtaining a premium saving for comparable cover was achieved.</li> </ul> <p><i>What would have made this advice high quality advice?</i></p> <p>The adviser has been advising this client since 2008. The client expressed affordability concerns in 2011 and again in 2013. The adviser did not adequately consider alternatives to Eric's affordability concerns and alternative solutions other than switching insurers and using superannuation to pay for premiums: see the appendix to this report for the life insurance advice checklist.</p> <p>High quality advice to Eric would have:</p> <ul style="list-style-type: none"> <li>• canvassed with Eric a range of alternatives to deal with his affordability concerns balanced against his insurance needs;</li> <li>• considered the advantages and disadvantages of holding his insurance inside superannuation. Instead, the SOA stated that unless Eric makes contributions to his superannuation account, funding insurance premiums through his superannuation will have a detrimental effect on his retirement outcome;</li> <li>• explored with Eric that, given his age, modest superannuation savings and the fact the premium payments represented 12% of his current superannuation balance that the trade-off of being insured versus his retirement savings should not be ignored; and</li> <li>• compared the existing insurer A with more than a single alternative, the recommended insurer B.</li> </ul>

## Appendix: Life insurance advice checklist

The checklist in Table 9 sets out a list of factors to consider when giving life insurance advice. The checklist covers existing obligations under the Corporations Act, as well as further considerations for giving good or best practice advice. We recommend reading the checklist alongside ASIC's guidance in RG 175.

**Table 9: Issues to consider when giving life insurance advice**

Issue	Considerations
What are the client's objectives?	<p>Good life insurance advice should ensure a client's objectives are specific, measurable and prioritised: see RG 175.218(c). Objectives may include:</p> <ul style="list-style-type: none"> <li>• debt reduction/repayment;</li> <li>• emergency/cash funds;</li> <li>• medical expenses or home renovation expenses;</li> <li>• education or business-related expenses; and</li> <li>• a lump sum amount to produce a level of regular income for financial dependants for a period of time.</li> </ul> <p>Note: This is not an exhaustive list.</p> <p>Good advice should be able to identify further client objectives relevant to insurance, such as:</p> <ul style="list-style-type: none"> <li>• nominating a beneficiary on the policy; or</li> <li>• seeking legal advice on a will.</li> </ul> <p>Good advice should also use a client's objectives to define the scope of the advice.</p>
What are the client's financial situation and needs?	<p>Good advice is founded on a solid strategy that requires identification of the client's relevant personal and financial situation and needs. The adviser should identify, discuss and document the client's:</p> <ul style="list-style-type: none"> <li>• financial position (income, expenses, assets and liabilities);</li> <li>• personal circumstances (age, relationship status and family circumstances);</li> <li>• foreseen changes to their personal or financial position (inheritance, home renovations, divorce, new baby, sale of business);</li> <li>• existing insurance arrangements (including insurance held inside their superannuation fund);</li> <li>• health status (including any hereditary or genetic conditions that may affect their ability to obtain insurance);</li> <li>• insurance needs (life, disability, illness or income) and the relative priority of these needs; and</li> <li>• willingness and capacity to pay insurance premiums and over what time period.</li> </ul> <p>Good advice should explore with the client alternatives that may be available if the client wishes to self-insure in part or in whole, and an insured event arises. Such 'self-insurance strategies' may include:</p> <ul style="list-style-type: none"> <li>• the client's leave entitlements, employee benefits and liquid assets;</li> <li>• the client's ability to rely on extended family support or to downsize their home to access capital;</li> <li>• returning to work or increasing working hours; and</li> <li>• any entitlements the client has to social security and/or workers or transport accident compensation arrangements.</li> </ul>

Issue	Considerations
Providing balanced scaled advice	<p>When providing scaled advice, good advice will respond to the client's stated objectives and implicit needs. For example, a client may state they wish to obtain cheaper insurance and the adviser and client agree to scope the advice to this issue. Good advice should include further considerations relevant to obtaining life insurance, including:</p> <ul style="list-style-type: none"> <li>• the costs and benefits of holding existing levels of cover and the client's priorities regarding their insurance;</li> <li>• the coverage of any replacement insurance product;</li> <li>• how long the client wants to hold the insurance and of what type;</li> <li>• alternative options, including revising down the sum insured or modifying the selection of optional extras; and</li> <li>• the merits and hazards of switching policies as a strategy to manage affordability (such as s29(3) of the Insurance Contracts Act).</li> </ul> <p>Good advice should also consider:</p> <ul style="list-style-type: none"> <li>• giving clear and specific warnings to the client about the cost impact of their insurances relative to their income, debt, insurance needs or retirement goals; and</li> <li>• giving practical guidance to the client about self-insurance strategies (see the list above on self-insurance strategies).</li> </ul>
Making a recommendation to retain a current insurance product	<p>An adviser must:</p> <ul style="list-style-type: none"> <li>• conduct a reasonable investigation into the financial products that might achieve the client's objective and meet the client's needs that would reasonably be considered relevant to the subject matter of the advice (s961B(2)(e)(i)); and</li> <li>• assess the information gathered in the investigation (s961B(2)(e)(ii)).</li> </ul> <p>Good advice should consider the client's existing insurance arrangements and consider whether the best solution for the client may be to retain their existing insurer but modify the type or amount of cover. An adviser may consider:</p> <ul style="list-style-type: none"> <li>• the amount of leave the client may have, including sick leave, annual leave and long-service leave; and</li> <li>• any alternatives that may be available if the client wishes to employ self-insurance strategies (see the list above on self-insurance strategies).</li> </ul> <p>In some cases, it is unlikely that a product recommendation will be appropriate. For example, a client nearing retirement may have accrued long-service leave, more than a year of annual leave and be a member a defined benefit superannuation fund that will pay out a defined lifetime benefit if the client ceases work permanently (even before retirement age). To achieve such a client's objectives of having sufficient income if temporarily disabled, a product recommendation is unlikely to be appropriate.</p>
Making a recommendation to replace an insurance product	<p>Replacement product advice must be appropriate to the client. Good replacement product advice should carefully consider important risks to the insured in switching policies. This is particularly important where an adviser recommends a switch to a cheaper premium because such a strategy can have significant risks for a client.</p> <p>In addition to documenting the client's objectives, financial situation and needs, good replacement product advice should:</p> <ul style="list-style-type: none"> <li>• consider and address affordability issues in the strategy for achieving the client's objectives. This may include self-insurance strategies (see the list above on self-insurance strategies);</li> <li>• carefully consider how long the client wants to hold insurance, along with careful consideration of the client's current and any foreseeable future health challenges;</li> <li>• clearly describe the long-term impact of a recommendation to pay the premium from the</li> </ul>

Issue	Considerations
	<p>client's superannuation benefits and consider options to ameliorate the impact on future retirement income as appropriate to that client's personal circumstances; and</p> <ul style="list-style-type: none"> <li>• carefully consider the operation of s29(3) of the Insurance Contracts Act. This provision represents a significant risk to consumers where product replacement advice is given because it allows an insurer to avoid a contract of insurance within three years of commencement where the client failed to comply with the duty of disclosure.</li> </ul> <p>The operation of this provision is particularly important for a client who has held an existing policy for more than three years and for whom the insurance represents a significant asset. Poor replacement product advice may risk the client losing the important protection of an existing insurance policy.</p> <p>Courts have recently held advisers liable for compensation to clients for misleading and deceptive conduct, and negligence, when switching clients from one insurance policy to another. The advice should clearly explain</p> <ul style="list-style-type: none"> <li>• why the new product is better than the old product;</li> <li>• what specific features are better and what has been lost. Where the rationale is 'better policy terms', those improved policy terms should be spelled out;</li> <li>• where software has been used to rate policies, advisers should spell out why a particular product has a higher rating, and what features will be lost in a switch; and</li> <li>• where new policies have waiting periods, such as trauma policies, advisers should exercise due care and diligence to ensure that extant policies are not cancelled while waiting periods are in force (e.g. where a client is managing a current illness or awaiting a diagnosis).</li> </ul>
Making a recommendation to pay for insurance from superannuation	<p>Good advice that recommends a client pay insurance premiums from their superannuation contributions cannot ignore the advantages and disadvantages of this strategy. Specifically, advisers should ensure their client understands that:</p> <ul style="list-style-type: none"> <li>• the insurance policy is owned by the trustee of the superannuation fund on behalf of the member;</li> <li>• the <i>Income Tax Assessment Act 1997</i> dictates how the proceeds are taxed, which differs from personally held insurance policies. If the client meets the SIS Act permanent incapacity definition and the trustee pays their superannuation (including total and permanent disability insurance) balance out, the tax payable depends on a range of factors, including age and the existing tax-free component of their superannuation; and</li> <li>• superannuation is not a personally held asset and generally is not dealt with by a person's will or estate planning. Clients must ensure their nomination of beneficiaries reflects their wishes and they must decide whether they need a binding or non-binding nomination of beneficiaries. If there is no nomination of beneficiary, the superannuation fund trustee will use their discretion on how to pay death benefits.</li> </ul> <p>Generic warnings to clients that paying for insurance from superannuation has cash flow benefits but will erode retirement savings are not adequate.</p> <p>Advisers should address the key risk of funding insurance premiums from superannuation funds, that is, that it may prevent the client from meeting their retirement objectives. Advisers should give adequate consideration to this risk when recommending this strategy. This should include consideration about making concessional or non-concessional contributions that at least negate the effect of insurance premiums on retirement benefits. If this option is not appropriate for the client's circumstances, the risks of the strategy need to be clearly explained to the client, including communicating the cost impact.</p> <p>Advice recommending a contribution strategy should also consider the impact on the client's cash flow. This may include comparing the value of making concessional and non-concessional contributions equivalent to the insurance premiums. We expect advisers to:</p> <ul style="list-style-type: none"> <li>• communicate that the cost impact of insurance is simply being deferred from today's cash</li> </ul>

Issue	Considerations
	<p>flow to future cash flow and that the client needs to actively consider the long-term impact of this and strategies to manage it;</p> <ul style="list-style-type: none"> <li>• inform and model for their client the impact on their retirement savings balance with and without insurance premiums over their retirement horizon (e.g. if the client is 20 years from retirement);</li> <li>• communicate that every dollar spent on the insurance premium is a dollar less invested for retirement, and this impact compounds over time where the client may otherwise have a long investment horizon; and</li> <li>• cover the fact that the client may need to work longer to save for retirement.</li> </ul>
Statement of Advice	<p>The SOA must clearly set out the basis on which the advice was given: see RG 175.159–RG 175.196. Good advice should clearly document in the SOA the strategy for achieving the client's objectives, including the product features and client circumstances relevant to the subject matter. Regardless of whether advice is comprehensive or scaled narrowly, an adviser who is acting in the client's best interests should actively engage with their client to gather sufficient information, and apply their knowledge and experience, to provide personal insurance recommendations.</p> <p>Where the client instructions may be '<i>I want to keep the same insurance cover, but I want a cheaper premium</i>', the adviser should discuss why the client is seeking personal advice and explore the cash flow issues that inform that client instruction, as well as whether personal advice is appropriate in this situation. If the client wants personal advice, the SOA should document how the recommended amounts of insurance were arrived at, by reference to the client's circumstances.</p> <p>When a replacement product is recommended (in full or in part), the SOA must include information about:</p> <ul style="list-style-type: none"> <li>• the cost of the recommended action (i.e. the disposal of the existing product and acquisition of the replacement product);</li> <li>• the potential benefits (pecuniary or otherwise) that may be lost; and</li> <li>• any other significant consequences of the switch for the client.</li> </ul>
Personal or general advice	Good advice should clearly communicate to the client whether the adviser has considered their relevant personal circumstances in formulating the advice.

# Key terms

Term	Meaning in this document
advice	Financial product advice
advice provider	A person to whom the obligations in Div 2 of Pt 7.7A of the Corporations Act apply when providing personal advice to a client. This is generally the individual who provides the personal advice. However, if there is no individual that provides the advice, which may be the case if advice is provided through a computer program, the obligations in Div 2 of Pt 7.7A apply to the legal person that provides the advice (e.g. a corporate licensee or authorised representative)
adviser	An advice provider
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services
	Note: This is a definition contained in s761A.
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act
	Note: This is a definition contained in s761A.
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASIC Act	<i>Australian Securities and Investments Commission Act 2001</i>
authorised representative	A person authorised by an AFS licensee, in accordance with s916A or 916B of the Corporations Act, to provide a financial service or services on behalf of the licensee
	Note: This is a definition contained in s761A.
best interests duty	The duty to act in the best interests of the client when giving personal advice to a client as set out in s961B(1) of the Corporations Act
best interests duty and related obligations	The obligations in Div 2 of Pt 7.7A of the Corporations Act
clawback	A commission or benefit that is paid to an adviser that is recovered, or 'clawed back', by the insurer if the policy lapses within a certain period, usually within the first 12 months the policy is on foot
client	A retail client as defined in s761G of the Corporations Act and Div 2 of Pt 7.1 of Ch 7 of the Corporations Regulations

Term	Meaning in this document
conflicted remuneration	<p>A benefit given to an AFS licensee, or a representative of an AFS licensee, who provides financial product advice to clients that, because of the nature of the benefit or the circumstances in which it is given:</p> <ul style="list-style-type: none"> <li>• could reasonably be expected to influence the choice of financial product recommended by the licensee or representative to clients; or</li> <li>• could reasonably be expected to influence the financial product advice given to clients by the licensee or representative.</li> </ul>
Corporations Act	<p>In addition, the benefit must not be excluded from being conflicted remuneration by the Corporations Act or Corporations Regulations</p>
Corporations Regulations	<p><i>Corporations Act 2001</i>, including regulations made for the purposes of that Act</p>
financial product advice	<p>Corporations Regulations 2001</p> <p>A recommendation or a statement of opinion, or a report of either of these things, that:</p> <ul style="list-style-type: none"> <li>• is intended to influence a person or persons in making a decision about a particular financial product or class of financial product, or an interest in a particular financial product or class of financial product; or</li> <li>• could reasonably be regarded as being intended to have such an influence.</li> </ul> <p>This does not include anything in an exempt document</p>
FOFA	<p>Note: This is a definition contained in s766B of the Corporations Act.</p>
Insurance Contracts Act	<p>Future of Financial Advice</p>
level premium policy	<p><i>Insurance Contracts Act 1984</i></p>
life insurance	<p>A policy where the premium is calculated at the start of the policy and remains fixed at the same level for the duration of the policy</p> <p>The lump sum and income stream products, such as life and TPD insurance policies and trauma and income protection, sold to retail clients under personal advice. These policies may be held or purchased inside or outside the superannuation environment (excluding group life policies)</p>

Term	Meaning in this document
personal advice	<p>Financial product advice given or directed to a person (including by electronic means) in circumstances where:</p> <ul style="list-style-type: none"> <li>• the person giving the advice has considered one or more of the client's objectives, financial situation and needs; or</li> <li>• a reasonable person might expect the person giving the advice to have considered one or more of these matters</li> </ul> <p>Note: This is a definition contained in s766B(3) of the Corporations Act.</p>
phase 1	<p>The first phase of the retail life insurance project that included two industry roundtables and a survey of 12 insurers that manufacture and distribute life insurance products under personal advice models</p>
phase 2	<p>The second phase of the retail life insurance project that included a targeted surveillance of advisers who give personal advice to consumers on life insurance products</p>
PJC Inquiry	<p>Parliamentary Joint Committee on Corporations and Financial Services Inquiry into the Corporations Amendment (Future of Financial Advice) Bill 2011 and the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2001</p>
policy lapse	<p>When a policy ceases due to non-payment or cancellation by the client</p>
representative of an AFS licensee	<p>Means:</p> <ul style="list-style-type: none"> <li>• an authorised representative of the licensee;</li> <li>• an employee or director of the licensee;</li> <li>• an employee or director of a related body corporate of the licensee; or</li> <li>• any other person acting on behalf of the licensee</li> </ul> <p>Note: This is a definition contained in s910A of the Corporations Act.</p>
retail life insurance	<p>Life insurance</p>
RG 175 (for example)	<p>An ASIC regulatory guide (in this example numbered 175)</p>
s961 (for example)	<p>A section of the Corporations Act (in this example numbered 961), unless otherwise specified</p>
safe harbour for the best interests duty	<p>The steps set out in s961B(2) of the Corporations Act. If an adviser proves they have taken these steps, they are considered to have met their obligation to act in the best interests of their client</p>
scaled advice	<p>Personal advice that is limited in scope</p>
SIS Act	<p><i>Superannuation Industry (Supervision) Act 1993</i></p>

Term	Meaning in this document
SMSF	Self-managed superannuation fund
Statement of Advice (SOA)	A document that must be given to a client for the provision of personal advice under Subdivs C and D of Div 3 of Pt 7.7 of the Corporations Act
	Note: See s761A for the exact definition.
stepped premium policy	A policy where the premium is recalculated upon each renewal. The premium usually increases according to risk factors such as the client's age
strategic life insurance advice	Includes advice on the type, level, structure and affordability of life insurance cover based on the client's cash flow position and which prioritises the client's insurance needs. Strategic advice can be stand alone or, where appropriate, provide the framework for product advice
switching advice	Personal advice that is, or includes, a recommendation that the client dispose of, or reduce their interest in, all or part of a financial product (or investment option) and instead acquire, or increase their interest in, all or part of another financial product (or investment option). This includes where the client's original holding is money in a bank account
TPD	Total and permanent disability

# Related information

## Headnotes

adviser, AFS licensees, Australian financial services licensees, authorised representatives, best interests duty, conflicted remuneration, financial product advice, Future of Financial Advice reforms, personal advice, representatives, retail clients, Statement of Advice

## Regulatory guide

*RG 175 Licensing: Financial product advisers—Conduct and disclosure*

## Legislation

ASIC Act, s12CA, 12CB, 12DA, 12DB

Corporations Act, Pts 7.7, 7.7A (Divs 4 and 5) and 7.9; s763A, 764A, 766A, 912A, 913B, 915C, 920A, 945A, 947D, 961B, 961G, 961H, 961J, 962H, 963A, 963B

Corporations Regulations, reg 7.7A.12A

*Income Tax Assessment Act 1997*

Insurance Contracts Act, s13, 21 and 29

*Insurance Contracts Amendment Act 2013*

SIS Act, s29SAC

Superannuation Guarantee (Administration) Regulations 1993

## Report

*REP 18 Survey on the quality of financial planning advice*

*REP 69 Shadow shopping survey on superannuation advice*

*REP 224 Access to financial advice in Australia*

*REP 279 Shadow shopping study of retirement advice*

*REP 337 SMSFs: Improving the quality of advice given to investors*

*REP 362 Review of financial advice industry practice: Phase 2*

## **Media releases and advisories**

*13-019MR ASIC cancels licences of national financial planning business*  
(6 February 2013)

*12-60AD ASIC accepts permanent undertaking from Adelaide adviser*  
(2 April 2012)