FSC FINANCIAL SERVICES COUNCIL

FINANCIAL SYSTEM INQUIRY – PHASE TWO

CHAPTER TWO

CONSUMER OUTCOMES

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OUTLINE

This chapter outlines our recommendations on how the life insurance and financial advice sectors could be reformed to improve consumer outcomes and also meet public sector fiscal challenges.

We believe that the existing insurance regulatory architecture will not be fit to address the risks the Australian community will face by 2030.

We share the interim report's view that further reform of the financial advice industry is required to improve consumer clarity and confidence.

This chapter also considers disclosure. We believe that disclosure has not yet been mastered. It has been repeatedly demonstrated that the length and language used in disclosure documents is inappropriate for most Australians. We therefore make recommendations to improve the disclosure framework.

1. LIFE INSURANCE

Australians are heavily underinsured. Rigidities in Australia's insurance regulatory architecture have contributed to underinsurance as providers have not been permitted to develop a wide array of innovative products. Underinsurance was one of the key drivers of the Government's establishment of the National Disability Insurance Scheme (NDIS) as a significant insurance market intervention.

Despite this background, the interim report has not yet assessed why underinsurance has occurred, and whether current policy settings are the most cost-effective and outcomes focused way of providing insurance to Australians.

Existing regulation has not promoted product innovation in the insurance sector.

Despite the best of intentions, current public policy settings governing welfare and disability payments contribute to underinsurance. Public policy settings may lead people to incorrectly assume that they can rely on welfare and government disability payments as sufficient to meet their needs.

A more effective regulatory framework would allow better priced and more consumer focused product offering. This would improve the efficiency and effectiveness of insurance markets in Australia by minimising regulatory compliance costs. Improving these market rigidities would assist in reducing the level of underinsurance in Australia and alleviate the need for such a substantial cost and risk to the Government's balance sheet through existing public policy settings.

Underinsurance of disability risks

To determine the level of underinsurance, a definition of the adequate level of insurance is necessary. We believe that an adequate level of disability insurance would ensure that a family is not forced to sell its home or belongings due to the inability to make mortgage repayments, and would cover the family's needs until any children become adults and if relevant, provide ongoing rental support until the partner retires.[1]

We believe that the figures quoted on the level of underinsurance in the interim Report are understated. A number of studies have demonstrated that underinsurance is a major issue in Australia. Perhaps the most complete and conservative estimates of the level of underinsurance for income protection is a recent analysis by KPMG that provides 'bookend' estimates of underinsurance (see Table 2.1).

According to this research, 35% of employed people in Australia have no private disability insurance at all and 19% of families do not have any life insurance. In total, the level of disability underinsurance is estimated to be $304 billion per annum while the level of underinsurance of the lives of employed people against premature death in Australian families is estimated to be $800 billion.[1]

Table 1.13 in our first submission shows the proportion of adequate insurance levels held by individuals for disability and Table 1.14 shows the same for premature death.

Alarmingly, employed Australians aged 45-64 are the most underinsured with an average of just 23% of their "adequate" insurance needs met by private disability insurance cover.

[1] The definition implies that a healthy partner would be expected to return to work. We acknowledge that other definitions of underinsurance may also be reasonable depending on community expectations. This means that the level of underinsurance determined based on this definition may not be the maximum level of underinsurance.
[1] KPMG, Death and Disability Protection Gap in Australia, 2014

Table 2.1 KPMG's methodology and data sources for determining the level of underinsurance against long-term future income loss in the event of disability

KPMG's study Disability Protection Gap in Australia seeks to determine if there is any underinsurance in protecting family or individual income in the event of a disability or death.

To achive this they adopt a top down approach where:

Underinsurance= Adequate level of protection-Actual level of insurance

And:

Adequate level of protection = Income x Percentage of income protected

The quantitative assumption for the adequate level of disability income insurance consistent with the qualitative definition previously mentioned is 84 per cent of the individual's income (which consist of 75 per cent of salary and 9 per cent superannuation).

A person's retirement age is assumed to be 65. Using the working age population limits the estimated insurance needed to persons employed between the ages of 18 to 64 – roughly 9.5 million Australians or 44 per cent of the population.

In deriving the level of actual disability insurance, the KPMG study included only long term comprehensive disability income insurance, but converted TPD cover into an equivalent income stream. At an aggregate level, the actual level of insurance is tied back to APRA statistics, adjusted where necessary for this purpose. Detailed data (by age, benefit period and gender) come from three separate studies:

a. For insurance provided in industry funds, a bespoke data collection of 6 large group risk insurers;
b. For insurance provided by the retail channel: the FSC-KPMG retail disability income study; and
c. For insurance provided in corporate funds and master trusts: the KPMG Group life study.

Why underinsurance is occurring – regulatory constraints on product development

Innovation in insurance product offerings is driven by the demand of consumers. However the ability of the insurers to create the products demanded is driven by the combination of regulation, legislation and risk profile of the companies themselves. The regulatory architecture therefore determines the level of product innovation which can occur. Innovation of life insurance products will help keep insurance relevant in the ever changing financial services market and assist with reducing the need for costly government interventions such as the NDIS.

A Deloitte study, commissioned by the FSC, compared cross border regulatory arrangements and found Australia operates under a highly segmented insurance framework. This framework is stifling innovation in insurance products and the ability of insurers to meet consumers needs. Further details on the study are provided below (see Table 2.2).

Figure 2.1: Prudential framework

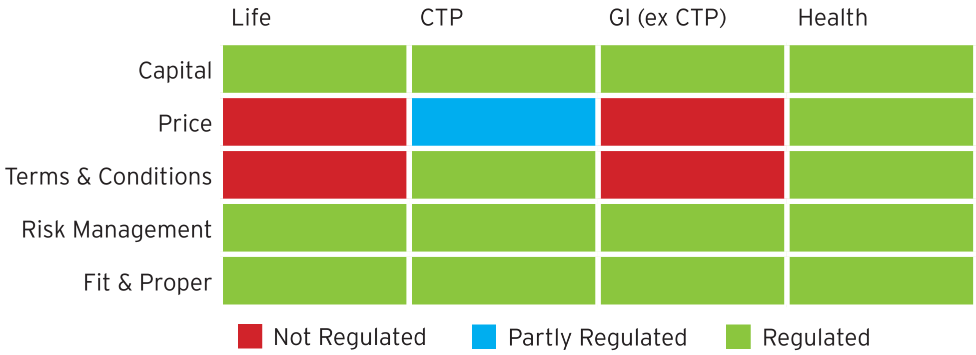

Figure 1 illustrates that the current prudential framework is divided across product types, meaning that individual product types (Life, CTP, GI (ex CPT) and Health) each require a separate license. This limits the ability of providers to provide multi-purpose products.

Table 2.2 Background of Deloitte global comparative review of international insurance markets

For the second phase of this inquiry, FSC engaged Deloitte Access Economics to undertake a global comparative review comparing the Australian legislative and regulatory landscape with that of four major international markets.

The countries reviewed covered a range of regulatory markets and markets undergoing differing levels of change following the GFC. The countries covered were Canada, Germany, South Africa and the United Kingdom.

The Deloitte review of the international markets was conducted through a two stage process with interviews of insurance regulation experts, working with and for insurers in each of the countries. Deloitte also utilised its international offices to gain an understanding of the depth of regulation and its effects on the business.

The review covered a range of areas of regulation as well as a full spectrum of insurance products. The areas of focus included the following:

- The level of capital requirements;
- The hindrance to innovation from regulatory oversight;
- The depth of the regulatory and legislative oversight; and
- The variation in regulation and legislation across insurance product types.

To minimise regulatory compliance costs and help insurers create innovative products which better service the population's need, streamlining regulations across insurance products is important.

RECOMMENDATION

The Australian insurance framework is currently siloed. This impedes innovation and may not meet the needs of future policyholders.

Development of innovative insurance products could be fostered under a streamlined, consolidated prudential framework.

Why underinsurance is occurring – a failure to consider private sector solutions

As noted in the interim report, life insurance products play an important role in the community as they protect the insured and their dependents against the financial risks associated with premature death, permanent and temporary disability, as well as various specified critical medical conditions.

The interim report states: "In addition to the negative effect of non-insurance or underinsurance on the consumer where they suffer loss, costs can be passed on to Government and the non-government organisation sector…"

In order to assist with the sustainability of the federal budget, a viable private disability insurance product is imperative. Internationally the market for long term care insurance, at both an aged care level and a whole of life market are successful when the products are mandated or incentivised by the government.

Private disability life insurance which protects against the economic risks of disability is an under-utilised policy device in Australia. This policy device could reduce Commonwealth budget pressure arising from increasing disability-related welfare costs.

Just as superannuation is the private sector solution to the costs of an ageing population and private health insurance is a private sector solution to managing health care costs, so too life insurance can be the private sector solution to the increasing budget costs of welfare.

Government policy has failed to consider relaxing impediments to private sector solutions, instead opting for large and unfunded social insurance programs.

The NDIS will cost the Australian Government $19.3 billion over seven years from 2012. It is timely to consider whether the costs of the

NDIS could be partially defrayed through private disability insurance provided by the private sector.

We also believe that the costs associated with welfare expenses including the Disability Support Pension (DSP) could be reduced. Higher take up of private disability insurance would reduce pressure on public finances and should deliver a higher standard of living for disabled Australians.

According to research conducted for the FSC by KPMG, roughly 9.5 million Australians, or 44% of the population, could mitigate the economic risks of disability through private disability insurance.

Disability insurance can provide a regular income replacement benefit if an individual suffers an illness or injury and is incapable of working either temporarily or permanently.[2]

Research noted above has consistently shown that Australians are significantly underinsured against the social and economic impacts of disability. Underinsurance means that the government picks up the tab when someone acquires a disability. Further, the impact of public policy settings governing welfare and disability payments are important factors and their impact on underinsurance is more nuanced than the interim report suggests.

A private sector solution to underinsurance

Disability care is a growing area of concern around the world. The costs of long term disability, not just age related disability, are a large strain on the government budget. In Australia this market is fragmented and the insurance cover is currently provided by a combination of life insurers, with income protection and TPD policies, health insurers with rehabilitation and sometimes general insurers with accident policies.

Germany and South Africa have an active market for private disability care benefits. The German model is based around the mandatory nature of long term care insurance, for which disability care is a subset of this. South Africa on the other hand, has means tested the government benefits as well as not hindering innovation of insurance products covering the disability care benefits. By having an active private disability insurance market, both South Africa and Germany are reducing the fiscal burden on their respective governments to care for disabled. In order to demonstrate the potential for the life insurance industry to privatise the costs of some disability-related welfare in Australia and to reduce the long-term burden on the Budget, the FSC commissioned

[2] KPMG, Underinsurance – Disability Insurance Protection Gap in Australia, 2014

Deloitte Access Economics to undertake further, extended research[3].

This research involved a modelling study that considered the potential for cost savings to be achieved through the introduction of appropriate financial incentives and disincentives aimed at improving the level of coverage of private disability insurance.

The following provides an overview of the level of Commonwealth expenditure in these areas and key findings from both the KPMG and the Deloitte Access Economics studies.

Disability Support Pension

There is a direct link between the Commonwealth outlays associated with disability payments and underinsurance.

Social security and welfare spending is the most significant federal budget expense accounting for 35%, or around $138 billion of government expenses in 2013-14.[4] DSP accounts for around 11% of this expenditure or $15.5 billion.

DSP expenditure is projected to increase by 15% to almost $18 billion by 2016-17.[5] In excess of 800,000 people receive DSP benefits and over the past 20 years, DSP recipient numbers have grown more than recipient numbers in any other government income support program.[6] In 2012-13 there were 51,418 new DSP claims granted.[7]

The FSC is concerned about the sustainability of growing DSP expenditure at a time of increased budget pressure. We believe there are options available to the government, which may not have been previously considered, to transfer risk and the associated budget expense to the private insurance sector.

With more employed Australians adequately insured against the economic risks of disability, fewer would need to rely on the DSP as a safety net should they suffer an illness or injury and be unable to work. Social outcomes could be expected to improve as income replacement from insurance would enable the standard of living (in economic terms) to be broadly maintained.

In addition to the social outcomes, further analysis showed that, based on current DSP means-testing, every dollar of income received from

3 Research commissioned by the FSC undertaken by Deloitte Access Economics, Expanding the coverage of private disability insurance to reduce the economic burden of social disability insurance, March 2014
4 Australian Government, 2013-2014 Budget Paper No. 1, Statement 6: Expenses and Net Capital Investment
5 Australian Government, 2013-2014 Budget Paper No. 1, Statement 6: Expenses and Net Capital Investment, Table 3.1
6 2011-12 Budget Review, Disability support pension reforms
7 2012-13 Annual Report, Department of Human Services

private insurance can be expected to reduce the DSP by 50 cents through reduced eligibility if all employed Australians were adequately insured.

This translates to a government cost saving in the first year, if Australians are adequately insured, of at least $340 million for each cohort of new disability pensioners even before the tax revenue foregone is taken into account.

According to the FSC's research, the cumulative annual savings effect of adequate disability insurance is estimated to be $2.5 billion per annum in the 10th year, as measured by lower DSP payments.

National Disability Insurance Scheme

The National Disability Insurance Scheme (NDIS) and the National Injury Insurance Scheme (NIIS) will provide funding for long term, individualised care and support services for those with a significant disability such as attendant nursing care, rehabilitation and home and vehicle modifications.

However, the NDIS and NIIS will not provide an ongoing income replacement benefit where a disability is acquired as provided under adequate disability insurance. Such benefits enable an individual to maintain his or her standard of living and continue to meet financial obligations such as mortgage payments, rent, daily living expenses and education costs for the children in the family.

The Australian Government has committed $19.3 billion over seven years from 2012-13 to fund 53 per cent of the cost of the NDIS with the states and territories to fund the remaining cost. Eligibility for the NDIS will not be means tested and financial support will be available to those who are born with or acquire a permanent disability.

The FSC supports the establishment of the NDIS and the NIIS. However, we submit that the existing funding model is likely to be unsustainable and may ultimately place pressure on the Scheme's long-term viability. We note that the development of the NDIS and NIIS has not placed any emphasis on the role of life insurance or addressing underinsurance generally.

Deloitte Access Economics modelling study

To consider ways in which to address underinsurance and reduce the public sector costs of disability, the FSC engaged Deloitte Access Economics to undertake modelling by assessing private disability insurance alongside the NDIS and DSP.

The Deloitte study considered the potential for budgetary cost savings in the NDIS and DSP through an enhanced role for private disability insurance. Central to the study is a consideration of the net financial impact of the introduction of appropriate financial incentives and disincentives to achieve improved levels of cover.

The study is based on policy settings on private health insurance which could be expected to encourage Australian taxpayers to hold private disability insurance in an analogous manner.

The policy settings around private health insurance are a well understood and easily transferable policy solution to encourage Australian taxpayers to hold private disability insurance. By encouraging higher rates of Private Health Insurance (PHI) coverage, the government has shifted the burden of delivering hospital services to the private system, as well as shifted some of the costs of delivering these services from public budgets to health funds and their members. The PHI rebate, the Medicare Levy surcharge and Lifetime Health Cover Loading all promote the take-up of PHI and improve the risk profile of the insured pool.

Policy settings analogous to private health insurance for disability insurance would meet or exceed the benefits offered through the NDIS while providing sufficient income replacement in the event of illness or injury rendering them ineligible for DSP benefits.

The study demonstrates the potential savings that could be achieved by government if NDIS eligibility for those who acquire a disability was means tested and, by extension, reduced eligibility for DSP benefits, while ensuring social policy objectives of the Scheme and other disability-related welfare programs would continue to be achieved through privatisation of the risk.

The research was undertaken based on the principle of the historical role of private health insurance in Australia in reducing public healthcare expenditure.

The Australian Government has a policy principle of universal entitlement for health services – through funding public hospital services and national programs and providing subsidies to medical and pharmaceutical services.

This mainly occurs through the Medical Benefits Scheme (MBS) and Pharmaceutical Benefits Scheme (PBS) – funded in part through a Medicare Levy on all taxpayers, and a Medicare Levy Surcharge (MLS) that incentivises higher income individuals and families to take out private health insurance hospital cover.

In addition, the Australian Government offers a rebate for private health insurance premiums which is also means-tested. The rebate levels applicable for 1 July 2013 to 30 June 2014 are outlined in Figure 2[1].

Table 2.3: Private health insurance rebate levels

Singles Families	< \$88,000 < \$176,000	\$88,001-102,000 \$176,001-204,000	\$102,001-136,000 \$204,001-272,000	> \$136,001 > \$272,001
Rebate				
< age 65	30%	20%	10%	0%
Age 65-69	35%	25%	15%	0%
Age 70+	40%	30%	20%	0%
Medicare Levy Surcharge				
All ages	0.0%	1.0%	1.25%	1.5%

The private health insurance rebate (originally at a standard 30% rate) and MLS were introduced in the late 1990s, along with the introduction of differential private health insurance premiums for those taking out and maintaining private health insurance cover before the age of 30 years (Lifetime Health Cover).

The effect on private health insurance coverage in Australia was to increase rates of cover from around 30% in 1997 to around 45% by 2001.

In December 2013, 47 per cent of Australians held private hospital cover and almost 55 per cent held general treatment cover.[2]

The study uses the principles of existing policy mechanisms that operate for Australian taxpayers for private health insurance as the basis for considering private disability take up through a range tax incentives (i.e. rebates) and disincentives (i.e. additional surcharges).

Disincentives

Deloitte research suggested that the introduction of a "Disability Levy

[1] Australian Government, Private Health Insurance Ombudsman website, http://www.privatehealth.gov.au/healthinsurance/incentivessurcharges/insurancerebate.htm, accessed March 2014
[2] Private Health Insurance Administration Council, Membership Statistics, 2014

Surcharge" (DLS) would perhaps be the strongest underinsurance policy lever that would 'push' individuals to take up private disability cover.

A DLS would be a disincentive or a 'stick' for those earning over a specified income, in the base case over $88,000, to take out private disability insurance cover.

In the new modelling, the DLS was based on current policy for the MLS which includes a surcharge of up to 1.5% on taxable income (in addition to the 2.0% Medicare Levy) for those without the appropriate level of cover.

Deloitte's base case models the potential savings for government with an assumption that 10 per cent of the total population were covered by adequate insurance.

That represents an assumption that all taxpayers earning above the income threshold and therefore subject to the DLS would take out cover to avoid the "stick".

Incentives

The introduction of rebates is assumed to be necessary to avoid underinsurance, as in a private health insurance setting, as a lever to assist with the affordability of cover.

In this modelling, the rebate level is assumed to be the same as the private health insurance policy. That is, between a ten per cent and 30 per cent rebate for those aged less than 65 with annual taxable income less than $136,000 for individuals and $272,000 for households.

The modelling shows that through these incentives and disincentives improving the level of private disability coverage could generate net savings over five years to 2019, the NDIS of $10.3 billion and to the DSP $3.4 billion.

This includes combined savings from both programs of $3.7 billion for the Commonwealth Government (after accounting for the incentive expenditure of $5.2 billion) and $4.8 billion for state and territory governments.

Table 4 demonstrates the potential savings that could be achieved through improved levels of private disability insurance coverage alongside the NDIS.

Table 2.4: Savings to government programs

Parameters	Savings / (Expenditure) (billion)
Savings to the governments programs	**$**
National Disability Insurance Scheme	$10.3
Disability Support Pensions	$3.4
Gross Savings	$13.7
Commonwealth Rebates	**($5.2)**
Net savings to governments	
Commonwealth	$3.7
States and Territories	$4.8
Total net savings	$8.5

The research also concluded that:

> From a policy perspective, private disability insurance, supported by a broader base of consumers, would potentially provide a more equitable distribution of the financial burden of disability insurance across people who can afford to pay and need not fall back on the safety net provided by the NDIS. It would also avoid the crowding out of private expenditure among those who can afford to pay, and reduce financial risk to the Australian Government (and by extension, taxpayers).]

The modelling of the financial benefits of improved levels of private insurance coverage is supported by the findings of consumer polling recently completed for the FSC by GfK.

When those surveyed without disability insurance were asked to indicate the most persuasive messages to act in relation to taking out income protection cover, the most motivating message to act was the government providing a tax incentive to have insurance (the carrot approach), while the second most motivating message was a minimum level of insurance required to avoid extra taxation (the stick approach adopted for private health insurance).]

Pulling it all together

With the increase in costs around the NDIS and the ongoing strain on the government budget of the DSP, the ability of a private market Permanent Disability Insurance (PDI) product to contribute in this sector is becoming more important.

[3] Research commissioned by the FSC completed by Deloitte Access Economics, Expanding the coverage of private disability insurance to reduce the economic burden of social disability insurance, March 2014, p. ii
[4] GfK, A review of consumer attitudes and behaviour in relation to financial protection: Instilling behavioural change to counter under-insurance in the Australian life insurance category, February 2014

Through updating the existing insurance acts and creating further detail around the NDIS, the private sector may be able to assist the government and the consumer.

To create innovative products such as a private market PDI product, the streamlining of Australian prudential legislation and regulatory oversight is needed. New legislation to enable insurers to offer products across current business lines, without having to have multiple licences and statutory reserves for an individual product, would minimise compliance, duplication of work and therefore costs.

The FSC believes that an expanded, complementary role for the private insurance sector in managing some of the risk that would otherwise remain a public liability would encourage innovation. Particularly in relation to product and services that could be developed to meet the evolving needs of consumers.

It is likely that new long term disability products would need to be developed to provide the same or superior benefits to those available through the NDIS.

Products designed to address underinsurance as discussed above are not possible under the current segmented life, general and health insurance licensing framework in Australia.

RECOMMENDATION

Public policy settings governing welfare and disability payments contribute to underinsurance.

There is significant scope for the life insurance industry to reduce the costs associated with underinsurance.

The insurance prudential and licensing framework should be streamlined to promote innovation.

Sustainability

In recent times, however, there has been significant upward pressure on premiums and increased policy lapse rates that are symptomatic of a number of life insurance sustainability challenges.

Issues such as greater acceptance of mental health as a legitimate health issue, widening of grounds on which a person may be declared totally and permanently disabled under a policy and extensive legal involvement in claims relating to older occurrences has led to higher than expected claims payouts.

The default superannuation market has also placed significant emphasis on lower premiums in the short term to meet expectations under tendering processes at the expense of medium to longer term premium stability. These practices all contribute to upward pressure on premiums leading to lower insurance affordability and to an adverse cycle of rising lapse rates. High lapse rates shrinks the pool of insured persons placing greater pressure on premiums.

In addition to rising premiums, the reasons for falling take-up are likely to include limited consumer engagement with life insurance, lack of suitable simple products, limited access to advice, premiums that increase with age that make the product unaffordable in later years, and lack of product innovation.

Introduction of a reasonable time period for lodging claims from an incident should assist the management of extensive legal involvement. This would not be unlike statutory limitations for actions commonly applying to areas such as motor accidents, work injuries and victim's compensation.

To promote premium stability in the default superannuation market, broader engagement between regulators, superannuation trustees and life companies on insurance sustainability could assist in expanding the focus to include a better risk framework.

The industry could also collaborate on better training and education of underwriters and claims assessors and to provide a clearer definition of disability related terms of conditions to assist consumers and providers. Developments in medicine should also be incorporated into policy terms and conditions.

Changes could be considered to the *Private Health Insurance Act 2007* to allow life insurers to compensate for medical expenses for rehabilitation after accident or illness. This is currently prohibited making early intervention in the case of disability difficult.

RECOMMENDATION

Improving the sustainability and efficiency of the market will likely require a combination of innovation by suppliers, some regulatory intervention, together with collaborative industry efforts and support from regulators and legislators.

Underwriting

The interim report refers to underwriting numerous times. Evidence-based underwriting takes into account an individual's risk profile to ensure an equitable treatment of all lives insured. To achieve this, the premiums paid by a specific policyholder reflect the relative risk the insured person brings to the insured population compared to the other existing insured lives.

As a fundamental principle of voluntary insurance and the insurer's duty to all policyholders, insurers assess an individual's application for life insurance based on a range of relative-risk criteria. These criteria would include, among other things, the applicant's age, present state of health, past health history, relevant familial medical traits, recreational activities and various socioeconomic factors. Prudent, evidence-based underwriting and risk assessment of applicants by life insurers is essential to ensure life insurance products remain affordable and accessible for consumers and that the industry remains sustainable.

In addition to individual risk-rated insurance described above, consumers in Australia are also able to access life and disability insurance through their superannuation.

Group insurance offered through superannuation generally does not require an individual to complete comprehensive underwriting in relation to their individual circumstances as it uses a risk rating pooling criteria based on the employees within the group scheme, unless additional voluntary top-up cover is obtained. As a result, the majority of employed Australians have access to life and disability insurance regardless of their personal circumstances.

The process of risk-stratification is fundamental in ensuring that all policyholders are treated equitably. By the very nature of risk-stratification, an exemption provided in the Disability Discrimination Act (DDA) in relation to the provision of voluntary insurance and superannuation is therefore essential. As such, it is important to ensure that there is regulatory certainty and clarity on the matter.

The current exemptions under the DDA permit insurers to assess risk and make distinctions on the basis of disability. Such exemptions are governed by conditions that strike an appropriate balance between competing interests of those already insured and those seeking insurance. Ultimately it achieves the fundamental purpose of protecting the rights of all Australians. Under the exemptions, there is a requirement that where an insurer makes a distinction on the basis of disability, such decisions are founded on the grounds of reasonable actuarial or statistical data or other relevant factors.

Statistics from the Australian Human Rights Commission highlight the effectiveness of the current exemptions in protecting consumers and supporting the insurance industry. In 2012-13, of the 1,084 complaints received by the Commission in relation to the DDA just 15, or one percent, related to insurance or superannuation.[8]

It is also prudent to highlight the issue of 'adverse-selection'. Adverse-selection in insurance is an issue whereby there is a tendency for those with higher risks to obtain life insurance than those that do not have those risks. Adverse-selection has an adverse impact on both the insurer and also on all policyholders (through rising premiums).

This is because of a disproportionately higher chance of loss than originally priced for when the insurer sets its insurance rates. Due to the situation where applicants may often have personal information that insurers lack (information asymmetry), the ability through legislation to develop insurance products and to risk profile applicants during the underwriting process is crucial in addressing the inherent imbalance and mitigating the risk for all.

RECOMMENDATION

The Inquiry find the existing insurance exemption under the Disability Discrimination Act is achieving its desired purpose and should be retained in order to avoid undesired social and economic consequences for all Australians.

2. FINANCIAL ADVICE

The FSC has long supported a financial advice regime where consumers can access high quality, affordable, conflict-free financial advice from skilled professionals.

We strongly agree with the following observation from the interim report:

> Affordable, quality financial advice can bring significant benefits for consumers. Improving standards of adviser competence and removing the impact of conflicted remuneration can improve the quality of advice. Comprehensive financial advice can be costly, and there is consumer demand for lower-cost scaled advice.

The recent reforms have delivered a mechanism to achieve many of

[8] Australian Human Rights Commission Annual Report 2012-13

these objectives – however there is more work to be done on:

- Clarifying the different segments of financial advice;
- Adviser competence and professionalism;
- Governance and disclosure; and
- Increased powers for ASIC.

We are supportive of new clearly defined advice segments (between personal advice, general information, factual information and intrafund advice), to better explain the different ways in which advice is provided.

This will provide consumers with a better understanding of whether the information they are receiving is factual information or general information (which does not take into account a client's personal circumstances) or personal advice (which does).

To help support and distinguish the advice segments, we believe that a national competency framework should be associated with each segment. Establishing a national comprehensive competency framework will uniformly enhance the professional standards of financial advisers and may ultimately culminate in defining the term "financial adviser / planner" in law.

We also believe that it is important that clients are able to access information on the governance ownership and structure of the licensee. The enhanced public register of advisers which is currently being developed will assist with this and should contain disclosure of the owner of the licensee and the ultimate parent.

Future of financial advice

The Future of Financial Advice (FOFA) reforms provide the framework for meeting the many objectives contained with the interim report's observation.

FOFA establishes a:

- Best interest duty;
- Requirement to always place the client's interest first;
- Prohibition on commissions for personal or general advice (ex risk insurance);
- Prohibition on conflicted remuneration payments for personal advice;
- Permitting scaled advice with legal certainty;
- New disclosure obligation for advisers; and
- Suite of new powers for ASIC.

These are transformational reforms that have substantially changed the structure and operation of the financial advice industry.

The cost of the transition to FOFA alone has cost the financial services industry an estimated $700 million. This cost has now been reduced as a result of refinements made to the FOFA laws in July 2014. There is a flow on cost of advice to consumers of raising standards – which is justifiable.

However the pace and cost of regulatory change in recent years has led to the near collapse of the independent financial advice sector.

There has been significant consolidation in the financial advice industry over the last three years. This has seen the consolidation of over ten takeovers by major players which has included;

- AMP acquiring AXA Asia Pacific;
- CBA acquiring Count;
- Shadforth Financial Group merged with Snowball;
- IOOF acquiring DKN Financial Group;
- Financial Index Wealth Accountants (Findex) acquiring Centric Wealth; and
- Infocus Wealth Management merged with Patron Financial Advice.

This is likely to continue with further takeovers expected this year:

- IOOF looks set to acquire Shadforth Financial Group (if approved); and
- Australian Unity looks set to acquire Premium Wealth Management (if approved).

The rapid consolidation has reduced the number of independent financial advice participants.

A revised advice model

FOFA reforms have placed consumer interest at the forefront of advice and have served to strengthen the financial industry. As many of the reforms however have only recently been implemented it will take time to see the benefits of these reforms. There is more work which needs to be done to raise professional standards in the financial advice sector.

The interim report has raised questions on independence and whether consumers are confused about the nature of advice they are receiving. We believe that FOFA needs to be complemented with clearer advice segment labelling, clearly distinguishing between what is advice and what is information as well as enhanced adviser professional competency for each respective advice segment.

To ensure that consumers receive appropriate advice from advice providers with appropriate competency and skills, it is essential that any 'new model for financial advice' also takes into account intra-fund advice. This is of particular importance from a consumer perspective as intra-fund advice can be provided for both personal and general purposes. Consumers should be able to expect the same degree of professional competency and have trust that the advice provider is acting in their best interests regardless of whether the personal advice is provided in the context of intra-fund advice or not.

RECOMMENDATION

Adopt a new financial advice model which establishes

a. Clear segments of;
   (i) personal advice;
   (ii) general information;
   (iii) factual information; and
   (iv) intrafund advice.

A link between advice / information and professionalism and competency.

Table 2.5: A revised model

ADVICE MODEL				
SEGMENTS	PERSONAL ADVICE	GENERAL INFORMATION (INCLUDING PRODUCT)	FACTUAL INFORMATION	INTRAFUND ADVICE (INCLUDES PERSONAL)
PROVIDED BY	LICENSEE OR ADVISER[12]	- LICENSEE - ADVISER - EMPLOYEE	- LICENSEE - ADVISER - EMPLOYEE	SUPER TRUSTEE or THIRD PARTY (RELATED OR OTHERWISE) THE TRUSTEE ENGAGES
DUTIES	- BEST INTERST - APPROPRIATE ADVICE - PRIORITY RULE - PROFESSIONAL FRAMEWORK - CONDUCT & DISCLOSURE - CONFLICTED REMUNERATION	CONDUCT & DISCLOSURE CONFLICTED REMUNERATION	CONDUCT & DISCLOSURE	- BEST INTEREST - APPROPRIATE ADVICE - PRIORITY RULE - PROFESSIONAL FRAMEWORK - CONDUCT & DISCLOSURE
COMPETENCY	NEW FRAMEWORK APPLIES	NEW FRAMEWORK APPLIES		NEW FRAMEWORK APPLIES

The benefit of the revised model is that it clearly distinguishes between what is personal financial advice and what is information. The new model seeks to limit the use of the term 'advice' to the category of personal

[12] Adviser would defined in law as "adviser" – this would come with restrictions for usage

advice so that it is easier for consumers to understand that they are receiving advice which is tailored to their personal circumstances.

It also proposes clearly defined segments of general information and factual information. Under this model general advice is redefined to general information as it does not and has never take into account the client's personal circumstances. We believe this model will be easier and clearer for consumers to understand.

Competency framework

The FSC supports the creation of a comprehensive adviser competency framework including:

- education requirements (including ethics training;
- and/ or a National exam; and
- enhanced comprehensive register of advisers.

The model

- A new Advice Competency Standards Board (ACSB) be established.
- The Board should include the following representatives:
  - ASIC;
  - Tax Practitioners Board;
  - A representative nominee from each of the applicable advice associations (eg: FSC, FPA, AFA, SPAA, CPA, ICAA) – the suggestion is that this person need not be the CEO but a duly qualified person;
  - Academics;
- The Board establish an Advice Competency model applicable for three of the advice segments (personal advice, general information and intrafund advice) within the new advice model (see principles);
- The Board should set minimum competency requirements and any "advanced competency" to enable specialisations. Ongoing education requirements should also be set by the Board;
- The Board can establish competency setting sub-committees – these sub-committees can be made up of advice training professionals, licensee representatives, academics and other training experts to help establish the competency standards for each advice type; and
- This process could culminate in defining "financial adviser / planner" in law.

Principles

- The profession develops and administers the competency standards required for financial planners/advisers;
- There should be three levels of minimum competency standard set for three of the four different "advice segments" within the new advice model (note: a new competency framework is not proposed for factual information);
- Personal Advice - Financial planners/advisers who provide personal financial advice;
- General information (including product information providers);
- Factual information providers;
- Intrafund advice providers;
- The regulators should supervise, monitor that registration/ licensing requirements are met (i.e. competency met), and undertake enforcement;
- Competency levels need to be raised for personal advice providers;
- Competency standards need to ensure that existing practitioners have sufficient transitional pathways and that new entrants also have a means to enter the evolving profession;
- Ethics training needs to be included in future competency;
- Both advice regulators (ASIC and TPB) are satisfied with the standards;
- Advice competency should be readily accessible for consumers to understand (eg pass an exam, hold a degree or certificate etc);
- A national enhanced public register of personal advice providers could be leveraged to record competency achieved (this does not need to be detailed, it could say "Competency - met" or "exam – passed"; and
- Timeframe – critical the framework should be finalised imminently so that course developments and transitions can commence.

National exam

A national exam is one way of allowing minimum competency to be demonstrated to consumers.

The ACSB should determine the means of achieving enhanced competency including if a single national exam or minimum education/ experience is to be set for the future advice competency frameworks. This may also include consideration of a flexible mechanism for meeting competency, which could, for example include completion of either a national exam or minimum education/experience. The legal profession similarly also offers a flexible approach for admission as a solicitor which commonly includes completion of either an article of clerkship or Practical Legal Training[10] following the completion of legal education.

Enhanced public register for financial advisers

We support the proposal the Commonwealth is currently pursuing in developing an enhanced public register for financial advisers. We also support the inclusion of employee representatives, providing personal advice on Tier 1 products, on the register. The FSC is a participant in the consultation.

RECOMMENDATION

Establish a comprehensive adviser competency framework linked to the revised model segments which is to be developed by a new Advice Competency Standards Board (ACSB).

Increased ASIC powers

ASIC has a range of powers which includes banning someone from providing financial services. It does not however have the power to remove or prevent an individual from managing a financial services business.[14] There may be circumstances where there are strong reasons for ASIC to have such powers.

We support the ability for ASIC to have the power to prevent a person from managing a financial services business provided judicial review is available for such a decision.

3. DISCLOSURE

As canvassed in the interim report, disclosure does not appear to be working as the Wallis inquiry had predicted. We agree with the observation in the interim report that "the current disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs on industry participants."

FSC's members manufacture and/or distribute financial products and services across the wealth management industry. Widely used products include managed investments, superannuation and life insurance.

Following both Wallis and the Financial Services Reform Acts (FSRA) which led to lengthy disclosure documents, the FSC has been

[13] Admission requirements vary on a state by state basis, for example following completion of a legal degree, a Practical Legal Training (PLT) course is completed or a 1 year traineeship for admission in Qld and a PLT course or 12 months article clerkship in Western Australia.

[14] Page 24; Financial System Inquiry: Submission by the Australian Securities and Investment Commission Page 24 ASIC submission to Financial Services Inquiry.

supportive of initiatives to enhance both the relevance and readability of disclosure information designed for consumers.

Industry and the government have undertaken initiatives such as:

- The Standard Risk Measure (SRM) for superannuation products – a backward looking investment risk descriptor created by the FSC and ASFA and endorsed by ASIC and APRA;
- Shorter PDS regime – an eight page document for simple managed investments, superannuation and standard margin lending facilities; and
- The MySuper dashboard – a snapshot of key product features such as investment return target, past performance, fees and costs and the SRM rating;

Each of these measures endeavoured to limit or standardise the disclosure regime. Two of the three of these measures above were specifically targeted at superannuation products. We would agree that there is a strong case to consider disclosure in superannuation differently to discretionary products such as managed investments. The compulsory nature of superannuation has led to initiatives such as the dashboard which are designed to lower disengagement in superannuation.

Product intervention powers

Product issuers are required to provide complete and accurate disclosure which is clear, concise and effective. If product intervention powers are made available to ASIC, there is a risk of some level of moral hazard in the sense that it may appear that if ASIC has not intervened, the product is not inappropriate.

If such powers are required, they should only be provided by the court on application from ASIC.. We consider the intervention on the issue of a product (absence compliance with disclosure and licensee laws) should be a power only vested in the courts (on application by ASIC).

If a licensee (including a licenced product issuer) breaches any licence or other regulatory requirements, ASIC has power to intervene (such as take action against the provider) even without product intervention powers.

Product suitability obligations

There have been calls for some type of additional obligation on product issuers in the form of a product suitability obligation. Currently licenced product issuers are subject to obligations under section 912A of the Corporations Act including to act efficiently, honestly and fairly. Issuers should also comply with disclosure obligations.

It is not practical for a product issuer to understand the personal circumstances of a prospective investor and therefore it is not appropriate that a product issuer be required to assess whether a product is suitable for a prospective investor or a particular class of investor type.

Product issuers are not financial advisers and only the prospective investor (or their advisor) is in a position to assess if the product is suitable given the personal circumstances of the investor.

We consider there may be some risks in requiring product issuers to suggest which type of investor a product may be suited to (or not suited to) – because it may not always be the case that a product is suited to that investor type given the personal circumstances of the investor.

Expanded use of electronic media for disclosure

We strongly encourage increased and better use of internet and other media for the purposes of providing relevant disclosure that both informs and educates. Whilst there is a place for traditional disclosures such as PDS, these should be complimented and supported by meaningful related electronic disclosures at the outset and on an ongoing basis.

Recent additional disclosures relating to superannuation under the Stronger Super reforms (primarily those required by s.29QB of the SIS Act) have significantly increased the volume of disclosure to members.

The policy intent of this extended disclosure has been generalised as "system transparency". Whilst many of these disclosures may be of value to support the integrity of the superannuation system, their usefulness as disclosures to members is questionable particularly where that disclosure is irrelevant to some or many.

Enhanced disclosure should not leave a member asking the question "what do I do with this information?".

Further, the expanded disclosure obligations impose an additional compliance burden and cost which must be appropriately balanced with the benefit derived.

These recent additional disclosures have been promoted as enhancing competition and providing better outcomes for members to drive costs down. We support the view that greater disclosure can enhance competition, however we caution that driving down fees and costs can also produce detrimental outcomes for members, through forced abandonment of valued services that can no longer be sustained under the product cost structures - a "race to the bottom" with no winner.

GfK research

To better understand how effective consumers find the current disclosure regime, the FSC engaged GfK to undertake consumer testing on the matters raised in the interim report.

- The key aim of the research is to understand what consumers need in terms of financial product information in order to make purchase decisions:
  - Current financial product disclosure experience;
  - Relative importance of different aspects of 'disclosure' from consumer perspective; and
  - Appeal of enhancement mechanisms as outlined in the Interim FSI report.

Current experience of financial product information appears to be challenging for consumers:

- Most (94%) adult Australians have experience with financial product information, and three in four (74%) have interacted with financial product information in the last 12 months;
  - One in two (51%) have read a product disclosure statement (PDS) in the last 12 months, increasing to two thirds of those who have a managed investment, self-managed investment or online share trading account (62%, 69% and 67% read a PDS in the last 12 months, respectively);
  - No real demographic differences in product information exposure apart from a slight younger age related skew (fewer people over 65 are reading financial product information compared to other age groups);
- Evaluation of the current way in which financial product information is provided is not favourable;
  - A third of consumers who have read financial product information in the last 12 months believe there is too much information to read (72%) and that legal or technical information makes it difficult to understand (64%);
  - Whilst a third of consumers agree that the information is

easy to understand and informs all aspects of products, making comparisons easy, more consumers disagree with these statements;

- Therefore, current financial product disclosure does not necessarily make product choice easy;
  - At least three in four who have read a PDS in the last 12 months say that it contained product features and benefits, charges, inclusions and exclusions and how the product works;
  - However, a third state that the PDS did not include information to help choose the right product (including risks, past performance and different product options available);
- Information sought to inform product choice focuses on product costs versus benefits;
- Fees/charges are by far the most sought after product information when choosing a new product, with over a quarter of consumers (28%) choosing this as the most important information and over two thirds (71%) choosing it in their top three;
- Product details (features, benefits, inclusions and exclusions and risks) are the next most sought after information, selected by around a third of consumers;
- How a product works and how to choose the best product to meet needs are the other product choice information sought by at least one in five consumers;
- All other product information, such as company information, commissions, complaint avenues, cooling off periods, application information and technical definitions are sought after by few; and
- There are no real demographic differences in information sought, nor does it differ by financial product ownership or involvement with a financial adviser.

Current product disclosure is not optimal – consumers want standardised information so they can make informed product choices

- When presented with the range of possible mechanisms for financial product disclosure current practice was ranked last in preference:
  - Most preferred: A standardised format used across all product disclosure documents to allow easy comparison of key information such as risk (risk profile disclosure);
  - Second: Product disclosure documents to be reformatted into short, clear documents with plain English and graphics (better information presentation);

  - Third: Financial product information is disclosed in a series of steps (layered disclosure);
  - Fourth: All information provided in product disclosure statements be available in online product comparison sites (online comparators and choice engines);
  - Last: current product disclosure format (current PDSs);
- Standardised risk profile disclosure and better information presentation are clear favourites in terms of product disclosure, accounting for two thirds of first preference (38% and 30% respectively);

- Only half of consumers are open to assistance in financial product literacy – one in two (43%) do not want product suitability decided or advised for them:
  - One in three (32%) are comfortable with someone else determining the best product for their needs, with an even split across the government regulator, product issuer or a financial adviser; and
  - One in two (45%) are open to financial advise though one in three (30%) want product recommendations only rather than for an adviser to decide what is best.

This information shows us that:

1. The existing disclosure regime is not meeting consumer needs or expectations;
2. Consumers value:
   a. comparable, standardised information;
   b. plain English;
   c. less voluminous materials; and
3. Consumers are not open to products being chosen or suggested by a government regulator.

This research does not necessarily present information which comes as a revelation to industry or regulators, which is why the range of initiatives listed above have been previously supported.

However, the research does highlight that there is more work to do on improving disclosure of which are are supportive. Further it shows that more work needs to be done on making disclosure work rather than discarding disclosure as a regulatory tool.

RECOMMENDATION

The Inquiry finds:

1. Consumer testing should be a mandatory element of Regulatory Impact Statements where new disclosure reforms are being considered;
2. Existing disclosure documents should be reviewed against these key consumer factors of plain English, comparable templates and less volume;
3. All disclosure documents should be deliverable by digital means;
4. Imposing product suitability obligations on product issuers risks a consumer inappropriately using or relying on statements as to suitability.; and
5. The disclosure should be relevant, targeted and facilitate member action. Disclosure of too much information does not equate to usefulness.

4. COMPENSATION SCHEMES

Multiple reviews, including the Wallis Inquiry and Richard St John Report, have confirmed there is no compelling reason for introducing a statutory consumer compensation scheme.

The most comprehensive examination of compensation arrangements, by Richard St John in 2012, concluded that such a scheme would be “inappropriate and possibly counter-productive”. In particular, St John highlighted the risk of regulatory moral hazard, and the inappropriateness of having more responsible, financially secure licensees, underwriting others.

It should not be forgotten that consumers already have legislatively mandated, free access to external dispute resolution systems, such as the Financial Ombudsman Service (FOS), which are binding on financial service providers (FSPs).

Ongoing reform of the Financial Ombudsman Service - currently on foot - will only improve the dispute resolution system, producing a more timely, more efficient and less costly service.

Notwithstanding such mechanisms, the courts provide an additional, time-honoured avenue for consumer redress. As highlighted most recently in the FSI interim report, statutory compensation schemes merely lead to better participants in the industry subsidising less scrupulous entities.

RECOMMENDATION

That the introduction of a statutory compensation scheme for consumers would be counter productive, involve regulatory moral hazard and lead to the most responsible providers underwriting others.